NETSCOUT SYSTEMS INC
Form 10-Q
August 09, 2006
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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 June 30, 2006

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 is large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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 August 3, 2006 was 31,714,830.

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NETSCOUT SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2006

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PART I: FINANCIAL INFORMATION

Item 1. Unaudited Financial Statements

NetScout Systems, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except share and per share data)

(Unaudited)

	June 30, 2006	March 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 51,999	$ 61,676
Marketable securities	32,761	19,810
Accounts receivable, net of allowance for doubtful accounts of $23 and $44 at June 30, 2006 and March 31, 2006, respectively	15,021	16,765
Inventories	4,386	2,816
Refundable income taxes	202	985
Deferred income taxes	2,837	2,896
Restricted cash	1,342	1,339
Prepaid expenses and other current assets	2,953	3,119
Total current assets	111,501	109,406
Fixed assets, net	7,757	7,577
Goodwill	36,561	36,561
Other intangible assets, net	872	1,015
Capitalized software development costs, net	293	312
Deferred income taxes	4,803	4,889
Long-term marketable securities	6,030	5,979
Other assets	13	16
Total assets	$ 167,830	$ 165,755
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,469	$ 2,727
Accrued compensation	7,490	8,635
Accrued other	2,139	2,325
Income taxes payable	467	
Deferred acquisition payment	1,342	1,339
Deferred revenue	21,747	21,382
Total current liabilities	35,654	36,408
Accrued other	1,103	1,157
Deferred revenue	1,248	1,599
Total liabilities	38,005	39,164

Commitments and contingencies (Note 8)		
Stockholders equity:		
Preferred stock, $0.001 par value: 5,000,000 shares authorized; no shares issued or outstanding at June 30, 2006 and March 31, 2006		
Common stock, $0.001 par value: 150,000,000 shares authorized; 35,900,002 and 35,488,019 shares issued and 31,696,779 and 31,284,796 shares outstanding at June 30, 2006 and March 31, 2006, respectively	36	35
Additional paid-in capital	117,494	120,057
Accumulated other comprehensive loss	(134)	(122)
Deferred compensation		(4,434)
Treasury stock at cost, 4,203,223 shares at June 30, 2006 and March 31, 2006	(26,490)	(26,490)
Retained earnings	38,919	37,545
Total stockholders equity	129,825	126,591
Total liabilities and stockholders equity	$ 167,830	$ 165,755

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

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NetScout Systems, Inc.

Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Revenue:		
Product	$ 14,227	$ 15,046
Service	9,348	8,271
License and royalty		184
Total revenue	23,575	23,501
Cost of revenue:		
Product (1)	3,856	4,626
Service (1)	1,267	1,257
Total cost of revenue	5,123	5,883
Gross profit	18,452	17,618
Operating expenses:		
Research and development (1)	4,422	4,614
Sales and marketing (1)	10,830	10,022
General and administrative (1)	2,106	2,286
Amortization of other intangible assets	39	32
In-process research and development		143
Total operating expenses	17,397	17,097
Income from operations	1,055	521
Interest income and other expenses, net	1,015	515
Income before income tax expense and cumulative effect of accounting change	2,070	1,036
Income tax expense	766	384
Income before cumulative effect of accounting change	1,304	652
Cumulative effect of accounting change, net of taxes of $41	70	
Net income	$ 1,374	$ 652
Basic net income per share	$ 0.04	$ 0.02
Diluted net income per share	$ 0.04	$ 0.02
Shares used in computing:		
Basic net income per share	31,480	30,840
Diluted net income per share	33,049	31,413

(1) Share-based compensation expense included in these amounts is as follows:

Cost of product revenue	$ 9	$
Cost of service revenue	13	
Research and development	133	59
Sales and marketing	157	20
General and administrative	75	
Total share-based compensation expense, before income tax effect	$ 387	$ 79

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

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NetScout Systems, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Three Months Ended June 30, 2006	2005
Cash flows from operating activities:		
Net income	$ 1,374	$ 652
Adjustments to reconcile net income to cash provided by operating activities, net of the effects of the acquisition of Quantiva s business:		
Depreciation	679	613
Amortization of other intangible assets	143	119
Amortization of capitalized software	34	166
In-process research and development		143
Loss on disposal of fixed assets	17	30
Share-based compensation expense associated with equity awards	387	79
Cumulative effect of accounting change	(111)	
Deferred income taxes	145	303
Changes in assets and liabilities:		
Accounts receivable, net	1,744	779
Inventories	(1,570)	(9)
Refundable income taxes	783	(78)
Prepaid expenses and other current assets	161	71
Other assets	3	(3)
Accounts payable	(258)	4
Accrued compensation and other expenses	(1,385)	177
Income taxes payable	467	
Deferred revenue	14	(272)
Net cash provided by operating activities	2,627	2,774
Cash flows from investing activities:		
Purchase of marketable securities	(17,622)	(25,757)
Proceeds from maturity of marketable securities	4,613	8,794
Purchase of fixed assets	(474)	(843)
Capitalized expenditures for internal use software	(402)	(170)
Acquisition of Quantiva s business		(9,442)
Capitalized software development costs	(15)	
Net cash used in investing activities	(13,900)	(27,418)
Cash flows from financing activities:		
Proceeds from issuance of common stock	1,485	1,072
Tax benefit from stock options exercised	111	
Net cash provided by financing activities	1,596	1,072
Net decrease in cash and cash equivalents	(9,677)	(23,572)
Cash and cash equivalents, beginning of period	61,676	57,070

Cash and cash equivalents, end of period	$ 51,999	$ 33,498
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 5	$ 2
Cash paid for income taxes	$ 496	$ 177

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

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements

(In thousands, except share and per share data)

(Unaudited)

1. Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements as of June 30, 2006 and for the three months ended June 30, 2006 and 2005, respectively, have been prepared by NetScout Systems, Inc. (NetScout or the Company) in accordance with generally accepted accounting principles for interim financial reports and the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared under generally accepted accounting principles have been condensed or omitted pursuant to such regulations. In the opinion of the Company s management, the unaudited interim condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the Company s financial position, results of operations and cash flows. The results of operations for the three months ended June 30, 2006 are not necessarily indicative of the results of operations for the year ending March 31, 2007. The balance sheet at March 31, 2006 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Certain prior period amounts have been reclassified to conform with the current period presentation.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended March 31, 2006, as filed with the Securities and Exchange Commission on June 2, 2006.

2. Share-Based Compensation

Effective April 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (SFAS 123R) which require the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to our employees and directors including employee stock option awards, employee stock purchases made under our Employee Stock Purchase Plan (ESPP) and restricted stock units. The Company previously applied the provisions of Accounting Principle Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and related Interpretations and provided the required pro forma disclosures under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123).

The Company s unearned stock-based compensation balance of $4.4 million as of April 1, 2006, which was accounted for under APB 25, was reclassified against additional paid-in-capital upon the adoption of SFAS 123R. The unearned stock-based compensation balance was from the issuance of restricted stock units accounted for based on the intrinsic value on the date of grant. Under SFAS 123R the unrecognized expense of restricted stock units and employee stock option awards not yet vested at March 31, 2006 will be recognized as expense in operations in the periods after that date, based on their fair value, which was determined under the original provisions of SFAS 123, as disclosed in the Company s previous filings. The impact of adopting SFAS 123R on the post-adoption results of operations was decreased as a result of the Company s action in fiscal 2006 to accelerate the vesting on a significant portion of its outstanding stock options (see Note 9).

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

Pro forma Information for Periods Prior to the Adoption of SFAS 123R

Prior to the adoption of SFAS 123R, the Company provided the disclosures required under SFAS 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosures. Forfeitures of awards were recognized as they occurred. Previously reported amounts have not been restated. The pro forma information for the three months ended June 30, 2005 was as follows:

	Three Months Ended June 30, 2005	
Net income as reported	$	652
Add: stock-based compensation under APB No. 25		79
Deduct: stock-based employee compensation expense determined under fair value-based methods for all awards, net of tax		(849)
Pro forma net income (loss)	$	(118)
Basic net income (loss) per share:		
As reported	$	0.02
Pro forma	$	(0.00)
Diluted net income (loss) per share:		
As reported	$	0.02
Pro forma	$	(0.00)

Impact of the Adoption of SFAS 123R

The Company adopted SFAS 123R using the modified prospective transition method beginning April 1, 2006. Accordingly, during the three months ended June 30, 2006, the Company recorded share-based compensation expense for awards granted prior to but not yet vested as of April 1, 2006 as if the fair value method required for pro forma disclosure under SFAS 123 were in effect for expense recognition purposes, but adjusted for estimated forfeitures. The Company recorded a pre-tax cumulative benefit of accounting change of $111 related to estimating forfeitures for restricted stock units that were unvested as of April 1, 2006. For share-based awards granted after April 1, 2006, the Company recognized compensation expense based on the estimated grant date fair value method required under SFAS 123R. For all awards the Company has recognized compensation expense using a straight-line amortization method. As SFAS 123R requires that share-based compensation expense be based on awards that are ultimately expected to vest, estimated share-based compensation for the three months ended June 30, 2006 has been reduced for estimated forfeitures.

Under the provisions of SFAS 123R, the Company recorded $369 of stock-based compensation in operations in the accompanying Consolidated Condensed Statement of Operations for the three months ended June 30, 2006. Stock-based compensation capitalized in conjunction with our costs related to internally developed software and software for internal use was immaterial.

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The impact on the Company s results of operating income, net income and earnings per share from the adoption of SFAS 123R for the three months ended June 30, 2006 was as follows:

	Three Months Ended June 30, 2006	
Stock options	$	(40)
Impact on operating income		(40)
Cumulative effect of accounting change		111
Impact after cumulative effect of accounting change	$	71
Impact on net income	$	45
Impact on earnings per share:		
Basic	$	0.01
Diluted	$	0.01

Total share-based compensation recorded in the Condensed Consolidated Statements of Operation for the three months ended June 30, 2006 and 2005 was as follows:

	Three Months Ended June 30,	
	2006	2005
Cost of revenue Product	$ 9	$
Cost of revenue Service	13	
Research and development	133	59
Sales and marketing	157	20
General and administrative	75	
Less non-employee compensation	(18)	
Total employee share based compensation expense	$ 369	$ 79

Valuation Assumptions

As of June 30, 2006 and 2005, respectively, the fair value of share-based awards for employee stock option awards and employee stock purchases made under our ESPP were estimated on the date of grant using the Black-Scholes option pricing model with the assumptions below. No grants were given during the three months ended June 30, 2006. There was no activity for the ESPP in the three months ended June 30, 2006 due to the suspension of the Employee Stock Purchase plan (see Note 9.)

	Three Months Ended June 30, 2006	2005
Option Plans		
Expected option term		5years
Weighted average risk-free interest rate		4.0%
Expected volatility		95%
Dividend yield		
Weighted average fair value	$	$ 3.31
Employee Stock Purchase Plan		
Expected option term		0.5 years
Weighted average risk-free interest rate		3.2%
Expected volatility		59%
Dividend yield		
Weighted average fair value	$	$ 1.23

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options. The risk-free interest rate is derived from the average U.S. Treasury rate during the period, which approximates the rate in effect at the time of grant, commensurate with the expected life of the instrument. The expected option term is based on the exercise behavior that different employee groups exhibited historically.

The fair value per share of the restricted stock unit is equal to the quoted market price of the Company s common stock on the date of grant.

Restricted Stock Units

The 1999 Stock Option Plan permits the granting of restricted stock and restricted stock units, collectively referred to as equity-based awards. Equity-based award grants are generally measured at fair value on the date of grant based on the number of shares granted and the quoted price of the Company s common stock. Such value is recognized as a cost of revenue or an operating expense over the corresponding vesting period.

On April 14, 2005, the Company granted stock-based awards to employees who were former employees of Quantiva and to a consultant who was a former consultant of Quantiva, a company that sold substantially all of its assets to the Company (Note 6). These awards consisted of grants of 154,345 restricted stock units, which vest over two years and do not have an exercise price. The Company records expense for the restricted stock units granted to the employees over the vesting period, and records expense for the restricted stock granted to the consultant to stockholders equity in accordance with EITF 96-18. The Company estimated the fair value of these restricted stock units using a per share value of $4.14, which represented the closing price of the Company s common stock on the date of grant. The restricted stock units issued to the consultant of Quantiva will be marked-to-market at each reporting date until exercised with changes being charged to compensation expense on a pro-rata basis over the vesting period.

On September 14, 2005, the Company granted equity-based awards to members of the Company s Board of Directors. These awards consisted of 33,210 restricted stock units, which vest over one year after grant, provided that during such year, such directors attend at least 75% of the meetings of the Board and at least 75% of the meetings of any committee of the Board of which such directors are a member. In the event that the foregoing attendance requirements are not met, the restricted stock units will not vest until the third anniversary of the date of grant. The restricted stock units do not have an exercise price. The gross value of these awards at June 30, 2006 was approximately $180. In addition, the Company will pay each member of the Board of Directors $20 upon issuance of underlying shares in conjunction with the vesting and payout of the restricted stock units to defray personal taxes related to the issuance. The Company is recognizing the expense related to these payments over a period equal to the vesting period of the restricted stock units, which is one year. Operating expenses related to these tax defrayment payments for the three months ended June 30, 2006, was $30.

Periodically, the Company grants equity-based awards to employees and officers of the Company. These awards represent restricted stock units, which vest over four years and do not have an exercise price.

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

Share-Based Payment Award Activity

The following table summarizes equity share-based payment award activity for the three months ended June 30, 2006 and 2005, respectively:

	Stock Options		Restricted Stock Units	
	Number of Shares	Weighted Average Exercise Price	Number of Awards	Weighted Average Fair Value
Outstanding-March 31, 2005	4,700,743	$ 6.01		$
Granted	167,600	$ 4.48	154,345	$ 4.14
Exercised	(180,601)	$ 4.28		$
Canceled	(86,147)	$ 5.97		$
Outstanding-June 30, 2005	4,601,595	$ 6.02	154,345	$ 4.14
Outstanding-March 31, 2006	4,189,844	$ 6.08	842,528	$ 6.14
Granted		$	27,054	$ 8.83
Exercised	(332,825)	$ 4.46	(79,158)	$ 8.52
Canceled	(4,813)	$ 6.23	(5,329)	$ 6.55
Outstanding-June 30, 2006	3,852,206	$ 6.22	785,095	$ 5.99

The following tables summarizes information about options outstanding and exercisable at June 30, 2006:

	Outstanding			Exercisable	
Range of Exercise Prices	Number of Shares	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
$1.27 to 2.50	104,191	1.4	$ 2.42	104,191	$ 2.42
$3.01 to 5.00	1,820,853	4.5	$ 4.19	1,715,095	$ 4.19
$5.04 to 7.40	904,189	6.1	$ 5.75	851,158	$ 5.73
$7.60 to 11.25	769,754	6.7	$ 8.23	769,754	$ 8.23
$13.44 to 14.94	93,031	3.8	$ 13.72	93,031	$ 13.72
$15.13 to 18.50	66,000	4.5	$ 15.32	66,000	$ 15.32
$21.25 to 28.94	94,188	4.0	$ 24.04	94,188	$ 24.04
	3,852,206	5.2	$ 6.22	3,693,417	$ 6.28

The aggregate intrinsic value of stock options and restricted stock units as of June 30, 2006 and 2005 was as follows:

	June 30, 2006	June 30, 2005
Options:		
Outstanding (1)	$ 12,687	$ 6,782
Exercisable (1)	$ 12,036	$ 5,264
Restricted Stock Units (2)	$ 7,003	$ 1,017

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

(1) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on June 30, 2006 ($8.92) and 2005 ($6.59) and the exercise price of the underlying options.

(2) The aggregate intrinsic value on this table was calculated based on the positive difference between the closing market value of the Company s common stock on June 30, 2006 ($8.92) and 2005 ($6.59) and the exercise price of the underlying Restricted Stock Units.

Information regarding cash proceeds received, the intrinsic value and the total tax benefit realized resulting from stock based awards and stock option exercises was as follows:

	June 30, 2006
Cash proceeds received	$ 1,484
Intrinsic value realized	$ 2,046
Income tax benefit realized	$ 111

As of June 30, 2006, the total unrecognized compensation cost related to stock options was $394 which is expected to be recognized over a weighted-average period of 2.7 years.

The total fair value of restricted stock units vested during the three months ended June 30, 2006 was $712. As of June 30, 2006, the total unrecognized compensation cost related to restricted stock awards was $3,159 which is expected to be amortized over a weighted-average period of 3.5 years.

3. 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 are considered to be marketable securities. Cash equivalents and short-term marketable securities are stated at cost plus accrued interest, which approximates fair value. Long-term marketable securities are stated at fair value based on quoted market prices. Cash equivalents and marketable securities consist primarily of money market instruments and U.S. Treasury bills.

Marketable Securities

The following is a summary of marketable securities held by NetScout at June 30, 2006, with maturity dates of July 2006 through February 2008:

	Amortized Costs	Unrealized Losses	Fair Value
U.S. government and municipal obligations	$ 21,101	$ (143)	$ 20,958
Commercial paper	18,912		18,912
Less restricted investment	1,108	(29)	1,079
Marketable securities	$ 38,905	$ (114)	$ 38,791

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The following is a summary of marketable securities as classified between short and long-term for June 30, 2006:

Short-term marketable securities	$ 32,761
Long-term marketable securities	6,030
Total marketable securities	$ 38,791

The following is a summary of marketable securities held by NetScout at March 31, 2006, with maturity dates of April 2006 through February 2008:

	Amortized Costs	Unrealized Losses	Fair Value
U.S. government and municipal obligations	$ 16,213	$ (122)	$ 16,091
Commercial paper	10,819		10,819
Less restricted investment	1,145	(24)	1,121
Marketable securities	$ 25,887	$ (98)	$ 25,789

The following is a summary of marketable securities as classified between short and long-term for June 30, 2005:

Short-term marketable securities	$ 19,810
Long-term marketable securities	5,979
Total marketable securities	$ 25,789

Restricted Investment

The Company has a restricted investment account related to a deferred compensation plan of $1.1 million, which is currently included in prepaid expenses and other current assets. As of June 30, 2006 and March 31, 2006, there were unrealized losses of $29 and $24, respectively, recorded as other comprehensive income (loss), net of $0 tax.

4. Inventories

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

	June 30, 2006	March 31, 2006
Raw materials	$ 2,703	$ 2,213
Work in process	223	102
Finished goods	1,460	501
	$ 4,386	$ 2,816

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

5. Acquisition

On April 14, 2005, the Company completed the acquisition of substantially all of the assets of Quantiva, Inc. (Quantiva), a provider of automated analytics solutions for application performance management. The acquisition of Quantiva s business is intended to extend the Company s product offering with unique technology that automates detection and diagnosis of application performance problems before they impact business critical services. Quantiva s patent pending technology analyzes real-time performance metrics using advanced statistical modeling and analytic techniques to establish dynamic thresholds and detect behavioral anomalies quickly. The Company s financial statements include the results of operations of Quantiva subsequent to the acquisition date.

The total purchase price was approximately $9.5 million and was paid in cash. Cash paid includes $1.3 million in escrow to be paid sixteen months from the date of the acquisition. The Company has recorded the cash in escrow as Restricted cash on the balance sheet, with a corresponding liability reported as Deferred acquisition payment. In August 2006, the sixteenth month anniversary of the acquisition, the $1.3 million escrow and any interest earned on the balance, will be paid to Quantiva or its successors, which will reduce the restricted cash and corresponding liability balances to $0. The escrow account was established to satisfy potential claims and obligations that could arise subsequent to the acquisition. No claims have arisen as of June 30, 2006. The purchase price includes capitalized acquisition costs of approximately $166 consisting of legal, consulting and accounting services. The acquisition was accounted for using the purchase method of accounting in accordance with SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. The total purchase price of $9.5 million has been allocated to the tangible and intangible assets acquired based on the Company s estimates of fair values at the time of acquisition as follows:

Current assets	$ 7
Fixed assets	26
Intangible assets	1,708
Goodwill	7,722
Total purchase price including acquisition costs	$ 9,463

Goodwill was recognized for the excess purchase price over the fair value of the assets acquired. Goodwill is primarily attributable to the expected growth from new technology and synergies related to the integration of Quantiva with the Company s High Definition Performance Monitoring and *nGenius* Flow Recorder. Goodwill from the Quantiva acquisition will be included within the Company s one reporting unit and will be included in the Company s enterprise-level annual review for impairment. Goodwill for tax purposes is deductible over a 15-year period.

The following table reflects the estimated fair value of the acquired intangible assets and related estimates of useful lives:

Software	$ 1,255	3-year useful life
Non-compete agreements	310	2-year useful life
In-process research and development	143	
	$ 1,708	

The acquired research and development of $143 was charged to expense as a separate line item within operating expenses on the consolidated statement of operations during the fiscal quarter ended June 30, 2005.

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

6. Goodwill & Other Intangible Assets

Goodwill

The carrying amount of goodwill was $36.6 million and $36.5 million as of June 30, 2006 and 2005, respectively. The Company s goodwill resulted from the acquisition of NextPoint Networks, Inc. in July 2000 and substantially all of the assets of Quantiva on April 14, 2005 (Note 5). The Company recorded $7.7 million of goodwill at the acquisition date related to Quantiva. In accordance with SFAS No. 142, goodwill is not amortized, but instead is reviewed for impairment at the enterprise-level at least annually or more frequently when events and circumstances occur indicating that the recorded goodwill may be impaired. If the book value of the Company s enterprise exceeds its fair value for a sustained period, the implied fair value of goodwill will be compared with the carrying amount of goodwill. If the carrying amount of goodwill exceeds the implied fair value, an impairment loss will be recorded in an amount equal to that excess.

The change in the carrying amount of goodwill for the three months ended June 30, 2006 and 2005, respectively, are as follows:

	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005
Balance as of beginning of period	$ 36,561	$ 28,839
Goodwill related to the acquisition of Quantiva s business		7,694
Balance as of the ending of period	$ 36,561	$ 36,533

Other Intangible Assets

The carrying amount of other intangible assets was $872 and $1.4 million as of June 30, 2006 and 2005, respectively. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. The Company amortizes other intangible assets over their estimated useful lives on a straight-line basis. Other Intangible Assets consist of the following as of June 30, 2006 and 2005, respectively:

	June 30, 2006			June 30, 2005		
	Cost	Accumulated Amortization	Net	Cost	Accumulated Amortization	Net
Software	$ 1,255	$ 505	$ 750	$ 1,255	$ 87	$ 1,168
Non-Compete Agreements	310	188	122	310	32	278
	$ 1,565	$ 693	$ 872	$ 1,565	$ 119	$ 1,446

Amortization of acquired software, that is included as cost of product revenue, was approximately $104 and $87 for the three months ended June 30, 2006 and 2005, respectively. Amortization of other acquired intangible assets, that is included as operating expense, was approximately $39 and $32 for the three months ended June 30, 2006 and 2005, respectively.

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NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The following is the expected future amortization expense as of June 30, 2006 for the years ended March 31:

2007	$ 430
2008	425
2009	17
Total	$ 872

The weighted average useful life of other intangible assets is 2.8 years.

7. Capitalized Software Development Costs and Purchased Software

Costs incurred in the research and development of the Company s products are expensed as incurred, except for certain software development costs. Costs associated with the development of computer software are expensed prior to the establishment of technological feasibility (as defined by SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed) and capitalized thereafter until the related software products are available for first customer shipment. During fiscal year ended March 31, 2004, the Company capitalized $1.3 million of software development costs. Amortization of this capitalized software development costs was $0 and $166 for the three months ending June 30, 2006 and 2005, respectively. During the fiscal year ended March 31, 2006, the Company met technological feasibility for its *nGenius* Performance Analytics product. As of June 30, 2006, capitalized software development costs for the Analytics product totaled $327. Beginning in April 2006, the Company commenced amortization of capitalized software development costs for the Analytics product over its estimated economic life which approximates two years . Amortization of capitalized software development costs for the Analytics product was $34 for the three months ending June 30, 2006.

The Company also capitalizes purchased software in accordance with SFAS No. 86. During the fiscal year ended March 31, 2006, the Company capitalized $1.3 million of purchased software obtained in connection with the acquisition of Quantiva s business (Note 5). Purchased capitalized software is included on the balance sheet within other intangible assets, net. Amortization of purchased software is recorded on a straight-line basis over three years. Amortization of capitalized purchased software was $104 and $87 for the three months ended June 30, 2006 and 2005, respectively.

Capitalized software development costs are periodically assessed for recoverability in the event of changes to the anticipated future revenue for the software products or changes in product technologies. Unamortized capitalized software development costs that are determined to be in excess of the net realizable value of the software products would be expensed in the period in which such a determination is made.

8. Commitments and Contingencies

From time to time the Company 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 will not have a significant adverse effect on the Company s financial position or results of operations.

Guarantor s Agreements

The Company warrants that its software and hardware products will substantially conform to the documentation accompanying such products on their original date of shipment. For software, which also includes

NetScout Systems, Inc.

Notes to Condensed Consolidated Financial Statements (Continued)

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software embedded in the probes sold to customers, the standard warranty commences upon shipment and expires ninety (90) days thereafter. With regard to hardware, the standard warranty commences upon shipment and expires twelve (12) months thereafter. Additionally, this warranty is subject to various exclusions which include but are not limited to non-conformance resulting from modifications made to the software or hardware by a party other than the Company or damage to hardware caused by a power surge or a force majeure event. The Company also warrants that all support services shall be performed in a good and workmanlike manner. The Company believes that its product and support services warranties are consistent with commonly accepted industry standards. No warranty cost information is presented since service revenue associated with warranty is deferred at the time of a sale and recognized over the warranty period. Therefore, no warranty costs are accrued.

Contracts that the Company enters into in the ordinary course of business may contain standard indemnification provisions. Pursuant to these agreements, the Company may agree to defend any third party claims brought against a partner or direct customer claiming infringement of such third party s (i) U.S. patent and/or EU or other selected countries patents, (ii) Berne convention member country copyright, and/or (iii) U.S., EU and/or OHIM trademark or intellectual property rights. Moreover, this indemnity may require the Company to pay any damages awarded against the partner or direct customer in such type of lawsuit as well as reimburse the partner or direct customer for any reasonable attorney s fees incurred by them from the lawsuit.

On very limited occasions, the Company may agree to provide other forms of indemnification to partners or direct customers, such as indemnification that would obligate the Company to defend and pay any damages awarded to a third party against a partner or direct customer based on a lawsuit alleging that such third party has suffered personal injury and/or tangible property damage legally determined to have been caused by negligently designed or manufactured products.

The term associated with these indemnification agreements is generally perpetual. The maximum potential amount of future payments that the Company could be required to pay arising from indemnification agreements may be limited to a certain monetary value. However, the monetary exposure associated with the majority of these indemnification agreements is unlimited. Historically, the Company has incurred no costs to defend lawsuits or settle claims relating to such indemnity agreements and believes the estimated fair value of these agreements is immaterial. If the Company were to have to defend a lawsuit and settle claims, the costs could potentially have a material impact on the Company s financial results.

9. Material Transactions Affecting Stockholders Equity
Restricted Stock

On April 14, 2005, the Company granted stock-based awards to employees who were former employees of Quantiva and to a consultant who was a former consultant of Quantiva, a company that sold substantially all of its assets to the Company (Note 6). These awards consisted of grants of 154,345 restricted stock units, which vest over two years. The Company recorded the intrinsic value and the fair value of the restricted stock units granted to former employees as deferred compensation and recognized the current period expense in accordance with EITF 96-18. The Company recorded the current period expense for the restricted stock units granted to the consultant to stockholders equity in accordance with EITF 96-18. The Company estimated the fair value of these restricted stock units using a per share value of $4.14, which represented the closing price of the Company s common stock on the date of grant. Upon the grant of the restricted stock units to employees, deferred compensation for the fair market value of the restricted stock units were recorded within stockholders equity and will be subsequently amortized as compensation expense over the vesting period. The restricted stock units issued to the consultant of Quantiva will be marked-to-market at each reporting date until exercised with changes

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being charged to compensation expense on a pro-rata basis over the vesting period. The aggregate intrinsic value of these awards at June 30, 2005 was approximately $674. Amortization expense related to these grants for the three months ended June 30, 2006 and 2005 was $90 and $71, respectively.

Stock Options

On April 14, 2005, the Company granted equity-based awards to certain former consultants of Quantiva, a company that sold substantially all of its assets to the Company (Note 5). These awards consisted of options to purchase 20,000 shares of the Company s common stock, which vest over a four-year period, and have an exercise price of $4.14 per share. The Company recorded the current period expense for the stock options granted to the consultants to stockholders equity. Compensation expense related to these options for the three months ended June 30, 2006 and 2005 was $10 and $6, respectively. The Company calculated the fair value and related compensation expense in accordance with EITF 96-18. These options will be marked-to-market at each reporting date until exercised with changes being charged to compensation expense on a pro-rata basis over the expected vesting period with any unexpensed amounts included in deferred compensation. Fair value of the stock options was calculated using the Black-Scholes option-pricing model with the following weighted average assumptions:

Dividend yield	None
Expected volatility	95%
Risk-free interest rate	3.72%
Expected life (years)	4.75

Acceleration of Stock Option Vesting Period

On May 4, 2005, the Board of Directors of the Company approved the acceleration of vesting of all stock options issued on or before December 31, 2004 that became exercisable on or after April 1, 2006, so that all such options became fully exercisable on March 31, 2006. Such options had been granted under the Company s equity compensation plans and are held by the Company s officers and employees, including its executive officers. The exercise prices of substantially all of these options were in excess of the then current market price of the Company s common stock and thus were considered out-of-the-money as of the modification date. Options to purchase 621,234 shares of common stock or 39% of the Company s outstanding unvested options (of which 7% of the Company s outstanding unvested options are held by the Company s executive officers) were subject to the acceleration. The weighted average exercise price of the options subject to the acceleration is $5.62. As a result of the acceleration, the Company recorded $14 of deferred compensation within stockholder s equity, which was fully amortized over the remaining vesting periods during the fiscal year ended March 31, 2006 as compensation expense.

Employee Stock Purchase Plan

In April 1999, NetScout adopted the 1999 Employee Stock Purchase Plan (the 1999 Purchase Plan). The 1999 Purchase Plan is administered by the Compensation Committee. All employees of NetScout whose customary employment is for more than 20 hours per week and for more than three months in any calendar year are eligible to participate in the 1999 Purchase Plan. Employees who would own 5% or more of the total combined voting power or value of NetScout s stock immediately after the grant of the option may not participate in the 1999 Purchase Plan. The Board of Directors suspended the 1999 Purchase Plan as of October 31, 2005.

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10. Treasury Stock

On September 17, 2001, the Company announced an open market stock repurchase program to purchase up to one million shares of outstanding Company common stock, subject to market conditions and other factors. Any purchases under the Company s stock repurchase program may be made from time to time without prior notice. Through June 30, 2006, the Company has repurchased 158,000 shares of common stock under this original program. During the three months ended June 30, 2006 and 2005, the Company did not repurchase any shares of common stock. On July 26, 2006, the Company announced that it has expanded the existing open market stock repurchase program to enable the Company to purchase up to an additional three million shares of the Company s outstanding common stock, bringing the total number of shares authorized for repurchase to 3,842,000 shares.

11. Net Income Per Share

Calculations of the basic and diluted net income per share and potential common shares are as follows:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Basic:		
Net income applicable to common stockholders	$ 1,374	$ 652
Weighted average common shares outstanding	31,480,493	30,839,747
Basic net income per share	$ 0.04	$ 0.02
Diluted:		
Net income applicable to common stockholders	$ 1,374	$ 652
Weighted average common shares outstanding	31,480,493	30,839,747
Weighted average stock options	1,363,481	492,767
Weighted average restricted stock units	205,508	80,490
Diluted weighted average shares	33,049,482	31,413,004
Diluted net income per share	$ 0.04	$ 0.02

The following table sets forth common stock and restricted stock units excluded from the calculation of diluted net income per share, since their inclusion would be antidilutive:

	Three Months Ended June 30,	
	2006	2005
Stock options	528,839	1,657,769
Restricted stock units	15,753	
Total	544,592	1,657,769

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12. Other Comprehensive Income (Loss)

Other comprehensive income (loss) adjustments consist of unrealized gains and losses on marketable securities and restricted investment. Other comprehensive income (loss) for the three months ended June 30, 2006 and 2005 is as follows:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Net income	$ 1,374	$ 652
Unrealized gains (loss) on cash equivalent, marketable securities and restricted investment, net of $0 tax	(12)	38
Other comprehensive income (loss)	$ 1,362	$ 690

13. Geographic Information

Total revenue was distributed geographically as follows:

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
North America	$ 19,806	$ 18,456
Europe Middle East Africa	2,319	3,768
Asia Pacific	1,450	1,277
	$ 23,575	$ 23,501

The North America revenue includes sales to North American resellers. These North American resellers fulfill customer orders based upon joint selling efforts in conjunction with the Company s direct sales force and may subsequently ship the Company products to international locations. The Company reports these shipments as North America revenue since the Company ships the products to a North American location. Revenue attributable to locations outside of North America is a result of export sales. Substantially all of the Company s identifiable assets are located in the United States.

14. Recently Issued Accounting Pronouncements

In March 2006, the EITF reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation) that the entities may adopt a policy of presenting taxes in the income statement on either a gross or net basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. Taxes within the scope of this EITF would include taxes that are imposed on a revenue transaction between a seller and a customer, for example, sales taxes, use taxes, value-added taxes, and some types of excise taxes. EITF 06-3 will not impact the method for recording these sales taxes in the Company s consolidated financial statements as the Company presents sales net of any and all taxes.

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48) which prescribes a recognition threshold and measurement attribute, as well as criteria for subsequently recognizing, derecognizing and measuring uncertain

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NetScout Systems, Inc.

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tax positions for financial statement purposes. FIN 48 also requires expanded disclosure with respect to the uncertainty in income tax assets and liabilities. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be recognized as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is currently evaluating the impact of adopting the provisions of FIN 48 in fiscal 2008.

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

The following information should be read in conjunction with the unaudited condensed consolidated financial information and the notes thereto included in this Quarterly Report on Form 10-Q. In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements that involve risks and uncertainties. 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 discussed in Item 1A. *Risk Factors* and elsewhere in this Quarterly Report. These factors may cause our actual results to differ materially from any forward-looking statement.

Overview

NetScout Systems, Inc. (NetScout or the Company) designs, develops, manufactures, markets, sells and supports a family of integrated products that enable performance management and optimization of complex, high-speed networks, including the ability to deliver critical business applications and content efficiently to end-users. We manufacture and market these products in an integrated hardware and software solution that has been used by commercial enterprises, large governmental agencies and service providers worldwide. We manage our business as a single operating segment and substantially all of our identifiable assets are located in the United States.

NetScout was incorporated in 1984 as a consulting services company. In 1992, we began to develop, manufacture and market our first infrastructure performance management products. Our operations have been financed principally through cash provided by operations.

Our operating results are influenced by a number of factors, including the mix of products and services sold, pricing, costs of materials used in our products and the expansion of our operations during the fiscal year. Factors that affect our ability to maximize our operating results include: our ability to introduce new and enhance existing products, the marketplace acceptance of those new or enhanced products, continued expansion into international markets and current economic conditions.

For the three months ended June 30, 2006, our total revenue was relatively flat increasing $74,000 to $23.6 million compared to the $23.5 million of total revenue for the three months ended June 30, 2005. In addition, our cost of revenue decreased by $760,000 to $5.1 million for the three months ended June 30, 2006 compared to $5.9 million in the three months ended June 30, 2005. Gross profit at $18.5 million, or 78.2% of revenue, in the three months ended June 30, 2006 increased from $17.6 million, or 74.9% of revenue, in the three months ended June 30, 2005. Our gross margin is primarily impacted by the mix and volume of product and service revenue. We realize significantly higher gross margins on service revenue relative to product revenue.

For the three months ended June 30, 2006, our total operating expenses, which include research and development, sales and marketing, general and administrative expenses, amortization of intangibles and in-process research and development expenses, were $17.4 million, increasing by $300,000 compared to the $17.1 million of total operating expenses in the three months ended June 30, 2005. The primary contributors to this increase in operating expenses was $365,000 in stock-based compensation expenses. Net income for the three months ended June 30, 2006 increased by $722,000 to $1.4 million compared to net income of $652,000 for the three months ended June 30, 2005. This increase is primarily due to the increase in gross profit of $834,000 that resulted from a change in the revenue mix and the increase of $500,000 in interest income and other expense, net due to higher interest rates and increased cash, partially offset by the increase in operating expenses of $300,000 and an increase of $382,000 in income tax expense due to higher income before tax.

The underlying drivers of our revenue and market share growth remain strong, evidenced by strong new product flow and expanding sales force. We are focused on tight expense control and expanding operating margins. During the quarter we began shipping two new products, our nGenius Analytics and our new nGenius Application Fabric Monitor based upon our next generation Application Fabric Performance Management

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architecture. These products are market-leading solutions that proactively identify and resolve performance problems faster and assure business service reliability in increasingly complex, high-speed networks. The nGenius Analytics product adds intelligent early warning capabilities to our solution set, and is based on a sophisticated behavior modeling technology for which we have recently been granted a U.S. patent. The nGenius Application Fabric Monitor represents a new class of instrumentation, combining the capabilities of our nGenius Probe and nGenius Flow Recorder products in a single high capacity, high performance platform that puts us in a superior cost-to-capability position versus our key competitors.

Critical Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates are continuously monitored and analyzed by management for changes in facts and circumstances and material changes in these estimates could occur in the future.

NetScout considers the following accounting policies to be critical in fully understanding and evaluating our financial results:

- revenue recognition;
- allowance for doubtful accounts receivable;
- valuation of inventories;
- valuation of goodwill and other intangible assets;
- capitalization of software development costs, purchased software and internal use software;
- stock-based compensation; and
- income taxes.

Revenue Recognition

Product revenue consists of sales of our hardware products and licensing of our software products. Product revenue is recognized upon shipment, provided that evidence of an arrangement exists, title and risk of loss have passed to the customer, fees are fixed or determinable and collection of the related receivable is probable.

Service revenue consists primarily of fees from customer support agreements, consulting and training. NetScout generally provides three months of software support and 12 months of hardware support as part of product sales. Revenue related to the software support is recognized ratably over the three-month support period. Revenue related to the hardware support is recognized ratably over the 12-month support period. After the expiration of these initial support periods the customer may elect to purchase an extended support agreement that typically runs for an additional 12 months. Revenue from customer support agreements is recognized ratably over the support period. Revenue from consulting and training services is recognized as the work is performed.

License and royalty revenue consists primarily of royalties under license agreements by original equipment manufacturers that incorporate components of our data collection technology into their own products or reproduce and sell our software products. License revenue is recognized when delivery of the original equipment manufacturer s product has occurred and when we become contractually entitled to receive license fees, provided that such fees are fixed or determinable and collection is probable. Royalty revenue is recognized based upon reported product shipments by the license holder.

Multi-element arrangements are customer purchases of a combination of NetScout product and service offerings that may be delivered at various points in time. For multi-element arrangements, each element of the

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purchase is analyzed and a portion of the total purchase price is allocated to the undelivered elements, primarily support agreements and training, using vendor-specific objective evidence of fair value of the undelivered element. Under the residual method, the remaining portion of the purchase price is allocated to the delivered elements, generally hardware and licensed software products, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value of the undelivered elements is based on the price customers pay when the element is sold separately.

Allowance for Doubtful Accounts Receivable

Accounts receivable is reduced by an allowance for doubtful accounts. Our standard payment terms are net 30 days. We monitor all accounts receivable balances of our customers and assess any collection issues as they arise. We believe our credit policies are prudent and reflect normal industry terms and business risk. At June 30, 2006, one customer accounted for more than 12% of our accounts receivable balance. At June 30, 2005, one different customer accounted for more than 11% of our accounts receivable balance. Historically, we have not experienced any significant non-performance by our customers nor do we anticipate non-performance by our customers in the future and, accordingly, typically we do not require collateral from our customers. On rare occasions we will require select international customers to provide a letter of credit. We perform credit checks on all potential new customers prior to acceptance of an order. We maintain allowances for doubtful accounts for possible losses resulting from the failure of our customers to make their required payments and any losses are recorded as general and administrative expenses. As of June 30, 2006, our allowance for doubtful accounts was $23,000. The allowance for doubtful accounts is based upon our judgments and estimates of the uncollectability of specific accounts receivable, historical bad debts, customer credit-worthiness, current economic trends and customer concentrations. Significant judgments and estimates are made when establishing the allowance for doubtful accounts. If these accounting judgments and estimates prove to be materially inaccurate, our financial results could be materially and adversely impacted in future periods.

Valuation of Inventories

Inventories are stated at the lower of actual cost or their net realizable value. Cost is determined by using the first-in, first-out (FIFO) method. Inventories consist primarily of raw materials and finished goods. Inventory carrying values are reduced to our estimate of net realizable value. As of June 30, 2006, we recorded net realizable value adjustments of $624,000. We regularly monitor our inventories for potential obsolete and excess inventory. Our net realizable value adjustment is based upon our estimates of forecasts of unit sales, expected timing and impact of new product introductions, historical product demand, current economic trends, expected market acceptance of our products and expected customer buying patterns. Significant judgments and estimates are made when establishing the net realizable value adjustment. If these accounting judgments and estimates prove to be materially inaccurate, our financial results could be materially and adversely impacted in future periods.

Valuation of Goodwill and Other Intangible Assets

The carrying value of goodwill was $36.6 million and $36.5 million as of June 30, 2006 and 2005, respectively. Goodwill will be reviewed for impairment at the enterprise-level at least annually or more frequently when events and circumstances occur indicating that the recorded goodwill may be impaired. If the book value of our enterprise exceeds its fair value, the implied fair value of goodwill is compared with the carrying value of goodwill. If the carrying value of goodwill exceeds the implied fair value, an impairment loss is recorded in an amount equal to that excess.

We compute the market capitalization of our outstanding common stock versus our stockholders equity as one potential indicator that goodwill may be impaired. At times, the market capitalization of our common stock may decline temporarily below our stockholders equity; however, we do not believe that any temporary decline below our stockholders equity would necessarily indicate impairment. If adverse economic or industry trends or decrease in customer demand result in a significant decline in our stock price for a sustained period in the future, we would need to assess an impairment loss. Significant judgments and estimates are made when assessing impairment. If these accounting judgments and estimates prove to be materially inaccurate, an asset may be determined to be impaired and our financial results could be materially and adversely impacted in future periods. Likewise, if a future event or circumstance indicates that an impairment assessment is required and an asset is determined to be impaired, our financial results could be materially and adversely impacted in future periods. As of June 30, 2006, based upon our review, we determined that there has been no goodwill impairment.

The carrying value of other intangible assets was $872,000 and $1.4 million as of June 30, 2006 and 2005, respectively. We account for our other intangible assets at historical cost. The carrying value of other intangible assets acquired in a business combination is recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. We amortize other intangible assets over their estimated useful lives on a straight-line basis. The Company s other intangible assets include software and non-compete agreements, resulting from the acquisition of Quantiva s business on April 14, 2005 (see Note 5 and Note 6).

In-process research and development was $143,000 fiscal year ended March 31, 2006 due to the acquisition of Quantiva s business. In-process research and development was identified and valued by management with the assistance of an independent valuation specialist. The amount assigned to in-process research and development was determined by identifying the specific projects that would be continued and for which technological feasibility had not been established as of the acquisition date and which had no alternative future use. The cost approach, as represented by time invested by Quantiva programmers, was used in valuing the in-process research and development. We recognize that the income approach is the preferable valuation methodology. However, due to the lack of a historical market for the technology, a meaningful cash flow projection could not be developed and therefore the cost approach was determined to be most appropriate.

Capitalization of Software Development Costs, Purchased Software and Internal Use Software

Costs incurred in the research and development of NetScout s products, including the various small point releases and small product enhancements that are released throughout each fiscal year, are expensed as incurred. Costs associated with the development of computer software are expensed prior to establishment of technological feasibility (as defined by SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed) and capitalized thereafter, until the related software products are available for first customer shipment. Judgment is required in determining the point at which technological feasibility has been met. Future major product enhancements would be capitalized under the guidance of SFAS No. 86. Amortization, for any reporting period, is determined based on the greater of the amount calculated using the ratio that current revenue for a product bear to the total of current and anticipated future reveneues for that product or the straight-line method over the remaining estimated economic life of the product. NetScout also capitalizes purchased software in accordance with SFAS No. 86.

As of June 30, 2006, capitalized software development costs were $1.7 million and accumulated amortization of such costs was $1.4 million, resulting in net capitalized software costs of $293,000. Capitalized software development costs are subject to an ongoing assessment of recoverability based upon anticipated future revenue for the software products and changes in product technologies. Unamortized capitalized software development costs that are determined to be in excess of the net realizable value of the software product will be expensed in the period in which such a determination is made. Significant judgments and estimates are made when assessing the net realizable value of the unamortized software development costs. If our accounting judgments and estimates prove to be materially inaccurate, we may expense such software development costs immediately and our financial results could be materially and adversely impacted in future periods. During the twelve months ended March 31, 2006, NetScout met technological feasibility for its *nGenius* Analytics product. Capitalized costs to date include payroll and payroll related costs for employees who are directly associated with and devote time to the project and who are working on software development tasks eligible for capitalization, such as design requirements, development, infrastructure, testing and project management. General and administrative costs and overhead costs are not capitalized. As of June 30, 2006, capitalized software development costs for the *nGenius* Analytics product totaled $327,000. Beginning in April 2006, the Company commenced amortization of capitalized software development costs for the Analytics product over it s estimated economic life of two years. Amortization of capitalized software development costs for the Analytics product was $34,000 for the three months ending June 30, 2006.

During the twelve months ended March 31, 2006, NetScout capitalized $1.3 million of purchased software obtained in connection with the acquisition of Quantiva s business (Note 5). Purchased capitalized software is included on the balance sheet within other intangible assets, net. Amortization of capitalized purchased software is recorded on a straight-line basis over three years from the date of the purchase. Accumulated amortization at June 30, 2006 was $505,000, resulting in net capitalized software cost of $750,000. The Company considered the economic consumption method alternative for amortizing these costs and determined that the straight-line method was preferable given the amount of subjectivity involved in projecting the timing of revenues related to the acquired Quantiva software.

NetScout is implementing a new Enterprise Resource Planning, or ERP, system in order to manage better the growth and increasing complexity of our business and to enhance the effectiveness and efficiency of our internal control over financial reporting. Certain costs that are incurred in the procurement and development of this ERP system are capitalized in accordance with SOP 98-1 (Accounting for the Costs of Computer Software Developed or Obtained for Internal Use). Preliminary project planning costs associated with the project were expensed as incurred. Once we executed contracts with third parties and committed to develop the software system, capitalization of eligible costs began. Capitalized costs to date include fees paid for the purchase of software, fees paid to third parties to develop customizations to the software during the application development stage, and payroll and payroll related costs for employees who are directly associated with and devote time to the software project and who are working on software development tasks such as design requirements, development, infrastructure, testing and project management. General and administrative costs and overhead costs are not capitalized. As of June 30, 2006, capitalized software costs relating to the ERP system implementation totaled $2.2 million. Amortization of internal use software will be recorded on a straight-line basis over five years once the project is substantially complete and ready for its intended use, which is currently expected to be in fiscal year 2007.

Stock-based Compensation

Effective April 1, 2006, NetScout adopted the fair value recognition provisions of SFAS 123R, using the modified prospective application transition method, and therefore have not restated prior periods results. Under this method we recognize compensation expense for all share-based payments granted after April 1, 2006 and those shares granted in prior periods but not yet vested as of April 1, 2006, in accordance with SFAS 123R. Under the fair value recognition provisions of SFAS 123R, we recognize stock-based compensation net of an estimated forfeiture rate and only recognize compensation cost for those shares expected to vest on a straight-line basis over the requisite service period of the award. Prior to SFAS 123R s adoption, we accounted for share-based payments under APB Opinion No. 25, Accounting for Stock Issued to Employees and accordingly, generally recognized compensation expense only when we granted options with a discounted exercise price or granted restricted stock unit.

Based on historical experience the Company has assumed an annualized forfeiture rate of 0% for awards granted to its two most senior executives and directors, and a 12% forfeiture rate for its remaining employees. The Company will record additional expense if the actual forfeitures are lower than estimated and will record a recovery of prior expense if the actual forfeitures are higher than estimated. The cumulative effect of the accounting change resulted in pre-tax income of $111,000 and was recognized in the statement of operations for the three-month period ending June 30, 2006.

Determining the appropriate fair value model and calculating the fair value of share-based payment awards requires the input of highly subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. Management estimated the volatility based on historical volatility of its own stock. The assumptions used in calculating the fair value of share-based payment awards represent management s best estimates, but these estimates involve inherent uncertainties and the application of management s judgment. As a result, if circumstances change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 2 to the Consolidated Condensed Financial Statements for a further discussion on stock-based compensation.

Income Taxes

NetScout estimates the quarterly income tax expense based on our projected annual effective tax rate. Significant judgments and estimates are made when assessing NetScout s projected annual effective tax rate. In addition, we may record certain tax reserves to address potential exposures involving our tax positions. Our estimate of the value of our tax reserves contains assumptions based on past experiences and judgments about the interpretation of statutes, rules and regulations by taxing jurisdictions. If these judgments and estimates prove to be materially inaccurate, our tax rate could fluctuate significantly and our financial results could be materially and adversely impacted in the future.

NetScout recognizes deferred income tax assets and liabilities based on the differences between the financial statement carrying amounts and the tax basis of assets and liabilities as well as an acquired or incurred net operating loss carryforward amounts. We make an assessment of the likelihood that our deferred income tax assets will be recovered from future taxable income, and, to the extent that recovery is not believed to be more likely than not, a valuation allowance is established. All available evidence, both positive and negative, is considered in the determination of recording a valuation allowance. We consider future taxable income and ongoing tax planning strategies when assessing the need for a valuation allowance. We believe future taxable income will be sufficient to realize the deferred tax benefit of the net deferred tax assets.

As of June 30, 2006, deferred income tax assets were $7.6 million, consisting primarily of $328,000 of federal net operating loss carryforwards and $319,000 of federal research and development tax credits, which begin to expire in fiscal year 2012, and $6.4 million of other temporary book and tax accounting differences. Significant accounting judgments and estimates are made when determining whether it is more likely than not that our deferred income tax assets will not be realized and, accordingly, require a valuation allowance. If these judgments and estimates prove to be materially inaccurate, a valuation allowance may be required and our financial results could be materially and adversely impacted in the future. If we determine that we will not be able to realize some or all of the deferred income taxes in the future, an adjustment to the deferred income tax assets will be charged to income tax expense in the period such determination is made.

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Results of Operations

The following table sets forth for the periods indicated the percentage of total revenue of certain line items included in our Statements of Operations:

NetScout Systems, Inc.

Statements of Operations

Percentages of Total Revenue

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005
Revenue:		
Product	60.3%	64.0%
Service	39.7	35.2
License and royalty		0.8
Total revenue	100.0	100.0
Cost of revenue:		
Product	16.4	19.7
Service	5.4	5.4
Total cost of revenue	21.8	25.1
Gross margin	78.2	74.9
Operating expenses:		
Research and development	18.8	19.6
Sales and marketing	45.9	42.7
General and administrative	8.9	9.7
Amortization of other intangible assets	0.2	0.1
In-process research and development		0.6
Total operating expenses	73.8	72.7
Income from operations	4.4	2.2
Interest income and other expenses, net	4.3	2.2
Income before income tax expense and cumulative effect of accounting change	8.7	4.4
Income tax expense	3.2	1.6
Income before cumulative effect of accounting change	5.5	2.8
Cumulative effect of accounting change, net of taxes	0.3	0.0
Net income	5.8%	2.8%

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Three Months Ended June 30, 2006 and 2005

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. License and royalty revenue consists of royalties under license agreements by original equipment manufacturers that incorporate components of our data collection technology into their own products or reproduce and sell our software products. No one customer or indirect channel partner accounted for more than 10% of our total revenue during the three months ended June 30, 2006 and 2005.

	Three Months Ended June 30, (Dollars in Thousands)					
	2006		2005		Change	
		% of Revenue		% of Revenue	$	%
Revenue:						
Product	$ 14,227	60%	$ 15,046	64%	($ 819)	(5%)
Service	9,348	40	8,271	35	1,077	13%
License and royalty			184	1	(184)	(100%)
Total Revenue	$ 23,575	100%	$ 23,501	100%	$ 74	%

Product. The 5%, or $819,000, decrease in product revenue, which includes hardware and software products, was primarily due to a decrease of approximately 21% in unit sales offset by an increase of approximately 15% in average selling price per unit due to product mix during for the three month period. The decrease in unit sales was primarily due to decreased sales in our Europe-Middle East-Africa (EMEA) operations. The increase in average selling price was partially due to sales of our new Application Fabric Performance Management, or AFPM, product.

Service. The 13%, or $1.1 million, increase in service revenue was primarily due to an increase in the number of customer support agreements attributable to new product sales generated during the last 12, combined with continued renewals of customer support agreements from our expanding installed base. Certain older probe products were removed from service eligibility during fiscal year 2006 and others will be removed in fiscal year 2007.

License and royalty. The 100%, or $184,000, decrease in license and royalty revenue was due to Cisco s discontinuation of reselling Real Time Monitor as of February 8, 2005. There will be no future royalty revenue from Cisco related to this reseller agreement.

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

	Three Months Ended June 30, (Dollars in Thousands)					
	2006		2005		Change	
		% of Revenue		% of Revenue	$	%
Indirect	$ 14,047	60%	$ 14,336	61%	($ 289)	(2%)
Direct	9,528	40	9,165	39	363	4%

Total Revenue	$ 23,575	100%	$ 23,501	100%	$ 74	%

Sales to customers outside North America are primarily export sales through indirect channel partners, who are generally responsible for selling products and providing technical support and service to customers within

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their territory. All sales arrangements are transacted in United States dollars. Our reported international revenue does not include any revenue from sales to customers outside North America that are shipped through our North American-based indirect channel partners. These domestic resellers fulfill customer orders based upon joint selling efforts in conjunction with our direct sales force and may subsequently ship our products to international locations; however, we report these shipments as North America revenue since we ship the products to a domestic location.

Total revenue was distributed geographically as follows:

	Three Months Ended June 30, (Dollars in Thousands)		
	2006	2005	Change
	% of Revenue		