REINSURANCE GROUP OF AMERICA INC
Form 10-Q
August 05, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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, 2013

OR

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

Commission File Number 1-11848

REINSURANCE GROUP OF AMERICA, INCORPORATED

(Exact name of Registrant as specified in its charter)

MISSOURI	**43-1627032**
(State or other jurisdiction of incorporation or organization)	**(IRS employer identification number)**

1370 Timberlake Manor Parkway

Chesterfield, Missouri 63017

(Address of principal executive offices)

(636) 736-7000

(Registrant s telephone number, including area code)

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 (§232.405 of this chapter) 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 ___ 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_

As of July 31, 2013, 70,984,449 shares of the registrant s common stock were outstanding.

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REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2013	December 31, 2012
	(Dollars in thousands, except share data)	
Assets		
Fixed maturity securities:		
Available-for-sale at fair value (amortized cost of $19,757,321 and $19,559,432)	$ 21,284,216	$ 22,291,614
Mortgage loans on real estate (net of allowances of $7,903 and $11,580)	2,377,246	2,300,587
Policy loans	1,245,252	1,278,175
Funds withheld at interest	5,777,395	5,594,182
Short-term investments	38,601	288,082
Other invested assets	1,035,809	1,159,543
Total investments	31,758,519	32,912,183
Cash and cash equivalents	973,619	1,259,892
Accrued investment income	233,153	201,344
Premiums receivable and other reinsurance balances	1,314,004	1,356,087
Reinsurance ceded receivables	585,555	620,901
Deferred policy acquisition costs	3,453,513	3,619,274
Other assets	472,258	390,757
Total assets	$ 38,790,621	$ 40,360,438
Liabilities and Stockholders Equity		
Future policy benefits	$ 11,491,692	$ 11,372,856
Interest-sensitive contract liabilities	12,991,981	13,353,502
Other policy claims and benefits	3,316,727	3,160,250
Other reinsurance balances	254,815	233,630
Deferred income taxes	1,839,909	2,120,501
Other liabilities	584,488	742,249
Short-term debt	120,000	
Long-term debt	1,815,533	1,815,253
Collateral finance facility	487,556	652,010
Total liabilities	32,902,701	33,450,251
Commitments and contingent liabilities (See Note 8)		
Stockholders Equity:		
Preferred stock - par value $.01 per share, 10,000,000 shares authorized, no shares issued or outstanding		
Common stock - par value $.01 per share, 140,000,000 shares authorized, 79,137,758 shares issued at June 30, 2013 and December 31, 2012	791	791
Additional paid-in-capital	1,772,811	1,755,421
Retained earnings	3,428,646	3,357,255
Treasury stock, at cost - 8,170,066 and 5,210,427 shares	(496,462)	(312,182)
Accumulated other comprehensive income	1,182,134	2,108,902
Total stockholders equity	5,887,920	6,910,187
Total liabilities and stockholders equity	$ 38,790,621	$ 40,360,438

See accompanying notes to condensed consolidated financial statements (unaudited).

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REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(Dollars in thousands, except per share data)			
Revenues:				
Net premiums	$ 2,035,156	$ 1,950,661	$ 4,014,849	$ 3,814,143
Investment income, net of related expenses	444,234	328,334	869,365	669,274
Investment related gains (losses), net:				
Other-than-temporary impairments on fixed maturity securities	(9,803)	(1,959)	(10,005)	(9,566)
Other-than-temporary impairments on fixed maturity securities transferred to (from) accumulated other comprehensive income	(306)	162	(306)	(7,059)
Other investment related gains (losses), net	58,352	25,598	152,925	83,946
Total investment related gains (losses), net	48,243	23,801	142,614	67,321
Other revenues	63,009	72,957	164,916	117,990
Total revenues	2,590,642	2,375,753	5,191,744	4,668,728
Benefits and Expenses:				
Claims and other policy benefits	2,030,574	1,625,446	3,719,484	3,205,595
Interest credited	118,345	66,697	243,828	154,739
Policy acquisition costs and other insurance expenses	370,505	335,939	727,862	643,573
Other operating expenses	113,408	105,541	232,909	215,639
Interest expense	29,918	23,360	58,404	46,682
Collateral finance facility expense	2,650	2,878	5,188	5,845
Total benefits and expenses	2,665,400	2,159,861	4,987,675	4,272,073
Income (loss) before income taxes	(74,758)	215,892	204,069	396,655
Provision for income taxes	(25,146)	74,781	68,146	132,226
Net income (loss)	$ (49,612)	$ 141,111	$ 135,923	$ 264,429
Earnings per share:				
Basic earnings per share	$ (0.69)	$ 1.91	$ 1.86	$ 3.59
Diluted earnings per share	$ (0.69)	$ 1.91	$ 1.85	$ 3.57
Dividends declared per share	$ 0.24	$ 0.18	$ 0.48	$ 0.36

See accompanying notes to condensed consolidated financial statements (unaudited).

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REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Comprehensive income (loss)				
Net income (loss)	$ (49,612)	$ 141,111	$ 135,923	$ 264,429
Other comprehensive income (loss), net of tax:				
Change in foreign currency translation adjustments	(88,832)	(16,865)	(102,937)	7,215
Change in net unrealized gains and losses on investments	(706,848)	203,156	(826,181)	167,741
Change in other-than-temporary impairment losses on fixed maturity securities	199	(106)	650	4,588
Changes in pension and other postretirement plan adjustments	875	1,211	1,700	1,501
Total other comprehensive income (loss), net of tax	(794,606)	187,396	(926,768)	181,045
Total comprehensive income (loss)	$ (844,218)	$ 328,507	$ (790,845)	$ 445,474

See accompanying notes to condensed consolidated financial statements.

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REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six months ended June 30, 2013	2012
	(Dollars in thousands)	
Cash Flows from Operating Activities:		
Net income	$ 135,923	$ 264,429
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in operating assets and liabilities:		
Accrued investment income	(35,457)	(38,182)
Premiums receivable and other reinsurance balances	(5,100)	(47,370)
Deferred policy acquisition costs	104,002	(63,690)
Reinsurance ceded receivable balances	64,814	(540)
Future policy benefits, other policy claims and benefits, and other reinsurance balances	806,172	755,790
Deferred income taxes	69,071	(5,469)
Other assets and other liabilities, net	(165,129)	62,682
Amortization of net investment premiums, discounts and other	(43,662)	(69,347)
Investment related gains, net	(142,614)	(67,321)
Gain on repurchase of collateral finance facility securities	(46,506)	
Excess tax benefits from share-based payment arrangement	(2,420)	24
Other, net	66,027	27,251
Net cash provided by operating activities	805,121	818,257
Cash Flows from Investing Activities:		
Sales of fixed maturity securities available-for-sale	1,898,833	1,759,932
Maturities of fixed maturity securities available-for-sale	62,734	104,008
Purchases of fixed maturity securities available-for-sale	(2,487,016)	(2,518,580)
Cash invested in mortgage loans	(244,939)	(225,005)
Cash invested in policy loans	(17)	(1,589)
Cash invested in funds withheld at interest	(60,156)	(60,145)
Principal payments on mortgage loans on real estate	150,098	46,313
Principal payments on policy loans	32,940	11,752
Change in short-term investments	241,136	35,989
Change in other invested assets	(1,591)	62,541
Net cash used in investing activities	(407,978)	(784,784)
Cash Flows from Financing Activities:		
Dividends to stockholders	(35,169)	(26,524)
Repurchase of collateral finance facility securities	(112,000)	
Net change in short-term debt	120,000	
Purchases of treasury stock	(234,690)	(6,924)
Excess tax benefits from share-based payment arrangement	2,420	(24)
Exercise of stock options, net	11,439	(651)
Change in cash collateral for derivatives and other arrangements	(31,858)	(15,096)
Deposits on universal life and other investment type policies and contracts	39,706	79,134
Withdrawals on universal life and other investment type policies and contracts	(397,033)	(70,753)
Net cash used in financing activities	(637,185)	(40,838)
Effect of exchange rate changes on cash	(46,231)	1,836
Change in cash and cash equivalents	(286,273)	(5,529)
Cash and cash equivalents, beginning of period	1,259,892	962,870
Cash and cash equivalents, end of period	$ 973,619	$ 957,341

Supplementary information:				
Cash paid for interest	$	58,387	$	49,094
Cash paid for income taxes, net of refunds	$	105,401	$	40,735

See accompanying notes to condensed consolidated financial statements (unaudited).

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REINSURANCE GROUP OF AMERICA, INCORPORATED AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Organization and Basis of Presentation

Reinsurance Group of America, Incorporated (RGA) is an insurance holding company that was formed on December 31, 1992. The accompanying unaudited condensed consolidated financial statements of RGA and its subsidiaries (collectively, the Company) have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, these financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Results for the six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. There were no subsequent events that would require disclosure or adjustments to the accompanying condensed consolidated financial statements through the date the financial statements were issued. These unaudited condensed consolidated financial statements include the accounts of RGA and its subsidiaries, all intercompany accounts and transactions have been eliminated. They should be read in conjunction with the Company s 2012 Annual Report on Form 10-K (2012 Annual Report) filed with the Securities and Exchange Commission (SEC) on March 1, 2013.

2. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share on net income (loss) (in thousands, except per share information):

	Three months ended June 30, 2013	Three months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012
Earnings:				
Net income (loss) (numerator for basic and diluted calculations)	$ (49,612)	$ 141,111	$ 135,923	$ 264,429
Shares:				
Weighted average outstanding shares (denominator for basic calculation)	72,350	73,718	73,089	73,646
Equivalent shares from outstanding stock options		336	484	402
Denominator for diluted calculation	72,350	74,054	73,573	74,048
Earnings per share:				
Basic	$ (0.69)	$ 1.91	$ 1.86	$ 3.59
Diluted	$ (0.69)	$ 1.91	$ 1.85	$ 3.57

As a result of the net loss for the three months ended June 30, 2013, the Company was required to use basic weighted average common shares outstanding in the calculation of diluted loss per share, since the inclusion of shares for outstanding stock options of 0.4 million would have been antidilutive to the earnings (loss) per share calculations. In the absence of the losses, weighted average common shares outstanding and dilutive potential common shares would have totaled 72.8 million.

The calculation of common equivalent shares does not include the impact of options having a strike or conversion price that exceeds the average stock price for the earnings period, as the result would be antidilutive. The calculation of common equivalent shares also excludes the impact of outstanding performance contingent shares, as the conditions necessary for their issuance have not been satisfied as of the end of the reporting period. For the three months ended June 30, 2013, no stock options and approximately 0.7 million performance contingent shares were excluded from the calculation. For the three months ended June 30, 2012, approximately 1.8 million stock options and approximately 0.7 million performance contingent shares were excluded from the calculation. Year-to-date amounts for equivalent shares from outstanding stock options and performance contingent shares are the weighted average of the individual quarterly amounts.

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3. Accumulated Other Comprehensive Income

The balance of and changes in each component of accumulated other comprehensive income (loss) (AOCI) for the six months ended June 30, 2013 and 2012 are as follows (dollars in thousands):

	Accumulated Other Comprehensive Income (Loss), Net of Income Tax			
	Accumulated Currency Translation Adjustments	Unrealized Appreciation (Depreciation) of Investments[1]	Pension and Postretirement Benefits	Total
Balance, December 31, 2012	$ 267,475	$ 1,877,657	$ (36,230)	$ 2,108,902
Other comprehensive income (loss) before reclassifications	(102,937)	(819,019)	206	(921,750)
Amounts reclassified from AOCI		(6,512)	1,494	(5,018)
Net current-period other comprehensive income (loss)	(102,937)	(825,531)	1,700	(926,768)
Balance, June 30, 2013	$ 164,538	$ 1,052,126	$ (34,530)	$ 1,182,134

	Accumulated Other Comprehensive Income (Loss), Net of Income Tax			
	Accumulated Currency Translation Adjustments	Unrealized Appreciation (Depreciation) of Investments[1]	Pension and Postretirement Benefits	Total
Balance, December 31, 2011	$ 229,795	$ 1,419,318	$ (30,960)	$ 1,618,153
Change in component during the period	7,215	172,329	1,501	181,045
Balance, June 30, 2012	$ 237,010	$ 1,591,647	$ (29,459)	$ 1,799,198

(1) Includes cash flow hedges. See Note 5 - Derivative Instruments for additional information on cash flow hedges.

The following table presents the amounts reclassified out of AOCI for the three and six months ended June 30, 2013 (dollars in thousands):

	Amount Reclassified from AOCI		
Details about AOCI Components	Three months ended June 30, 2013	Six months ended June 30, 2013	Affected Line Item in Statement of Income
Unrealized gains and losses on available-for-sale securities	$ 13,510	$ 23,858	Investment related gains (losses), net
Gains and losses on cash flow hedge - interest rate swap	201	506	Investment income
Deferred policy acquisition costs attributed to unrealized gains and losses[1]	(13,283)	(14,831)	
	428	9,533	Total before tax
	(87)	(3,021)	Tax expense
	$ 341	$ 6,512	Net of tax
Amortization of unrealized pension and postretirement benefits:			
Prior service cost[2]	$ (213)	$ (307)	
Actuarial gains/(losses)[2]	(968)	(1,991)	
	(1,181)	(2,298)	Total before tax

		413		804	Tax benefit
	$	(768)	$	(1,494)	Net of tax
Total reclassifications for the period	$	(427)	$	5,018	Net of tax

(1) This AOCI component is included in the computation of the deferred policy acquisition cost. See Note 8 Deferred Policy Acquisition Costs of the 2012 Annual Report for additional details.
(2) These AOCI components are included in the computation of the net periodic pension cost. See Note 9 Employee Benefit Plans for additional details.

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4. Investments

Fixed Maturity and Equity Securities Available-for-Sale

The following tables provide information relating to investments in fixed maturity and equity securities by sector as of June 30, 2013 and December 31, 2012 (dollars in thousands):

June 30, 2013:	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	% of Total	Other-than-temporary impairments in AOCI
Available-for-sale:						
Corporate securities	$ 11,346,144	$ 648,955	$ 191,618	$ 11,803,481	55.4%	$
Canadian and Canadian provincial governments	2,633,388	901,567	9,162	3,525,793	16.6	
Residential mortgage-backed securities	1,015,155	53,581	13,768	1,054,968	5.0	(241)
Asset-backed securities	789,849	18,998	18,537	790,310	3.7	(2,259)
Commercial mortgage-backed securities	1,564,924	110,294	36,586	1,638,632	7.7	(5,125)
U.S. government and agencies	394,026	21,417	2,453	412,990	1.9	
State and political subdivisions	278,148	25,513	11,850	291,811	1.4	
Other foreign government, supranational and foreign government-sponsored enterprises	1,735,687	51,165	20,621	1,766,231	8.3	
Total fixed maturity securities	$ 19,757,321	$ 1,831,490	$ 304,595	$ 21,284,216	100.0%	$ (7,625)
Non-redeemable preferred stock	$ 85,483	$ 6,722	$ 1,747	$ 90,458	56.4%	
Other equity securities	74,273		4,392	69,881	43.6	
Total equity securities	$ 159,756	$ 6,722	$ 6,139	$ 160,339	100.0%	

December 31, 2012:	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value	% of Total	Other-than-temporary impairments in AOCI
Available-for-sale:						
Corporate securities	$ 11,333,431	$ 1,085,973	$ 39,333	$ 12,380,071	55.5%	$
Canadian and Canadian provincial governments	2,676,777	1,372,731	174	4,049,334	18.2	
Residential mortgage-backed securities	969,267	76,520	3,723	1,042,064	4.7	(241)
Asset-backed securities	700,455	19,898	28,798	691,555	3.1	(2,259)
Commercial mortgage-backed securities	1,608,376	142,369	51,842	1,698,903	7.6	(6,125)
U.S. government and agencies	231,256	33,958	24	265,190	1.2	
State and political subdivisions	270,086	38,058	5,646	302,498	1.4	
Other foreign government, supranational and foreign government-sponsored enterprises	1,769,784	94,929	2,714	1,861,999	8.3	
Total fixed maturity securities	$ 19,559,432	$ 2,864,436	$ 132,254	$ 22,291,614	100.0%	$ (8,625)
Non-redeemable preferred stock	$ 68,469	$ 6,542	$ 170	$ 74,841	33.6%	
Other equity securities	148,577	416	1,134	147,859	66.4	
Total equity securities	$ 217,046	$ 6,958	$ 1,304	$ 222,700	100.0%	

The Company enters into various collateral arrangements that require both the pledging and acceptance of fixed maturity securities as collateral. The Company pledged fixed maturity securities as collateral to derivative and reinsurance counterparties with an amortized cost of $32.9 million and $16.9 million, and an estimated fair value of $33.9 million and $17.0 million, as of June 30, 2013 and December 31, 2012 respectively. The pledged fixed maturity securities are included in fixed maturity securities, available-for-sale in the condensed consolidated balance sheets as of June 30, 2013, and are included in other invested assets in the condensed consolidated balance sheets as of December 31, 2012. Securities with an amortized cost of $8,046.9 million and $7,549.0 million, and an estimated fair value of $8,377.6 million and $7,913.8 million, as of June 30, 2013 and December 31, 2012, respectively, were held in trust to satisfy collateral requirements under certain third-party reinsurance treaties.

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The Company received fixed maturity securities as collateral from derivative and reinsurance counterparties with an estimated fair value of $91.5 million and $95.6 million, as of June 30, 2013 and December 31, 2012, respectively. The collateral is held in separate custodial accounts and is not recorded on the Company s condensed consolidated balance sheets. Subject to certain constraints, the Company is permitted by contract to sell or re-pledge this collateral; however, as of June 30, 2013 and December 31, 2012, none of the collateral had been sold or re-pledged.

As of June 30, 2013, the Company held securities with a fair value of $1,231.6 million that were guaranteed or issued by the Canadian province of Ontario and $1,516.3 million that were guaranteed or issued by the Canadian province of Quebec, both of which exceeded 10% of total stockholders equity. As of December 31, 2012, the Company held securities with a fair value of $1,400.0 million that were guaranteed or issued by the Canadian province of Ontario and $1,785.0 million that were guaranteed or issued by the Canadian province of Quebec, both of which exceeded 10% of total stockholders equity.

The amortized cost and estimated fair value of fixed maturity securities available-for-sale at June 30, 2013 are shown by contractual maturity in the table below. Actual maturities can differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Asset and mortgage-backed securities are shown separately in the table below, as they are not due at a single maturity date. At June 30, 2013, the contractual maturities of investments in fixed maturity securities were as follows (dollars in thousands):

	Amortized Cost	Fair Value
Available-for-sale:		
Due in one year or less	$ 426,022	$ 432,495
Due after one year through five years	3,613,328	3,773,306
Due after five years through ten years	6,893,971	7,127,743
Due after ten years	5,454,072	6,466,762
Asset and mortgage-backed securities	3,369,928	3,483,910
Total	$ 19,757,321	$ 21,284,216

The tables below show the major industry types of the Company s corporate fixed maturity holdings as of June 30, 2013 and December 31, 2012 (dollars in thousands):

June 30, 2013:	Amortized Cost	Estimated Fair Value	% of Total
Finance	$ 3,636,121	$ 3,770,773	32.0%
Industrial	5,914,051	6,138,234	52.0
Utility	1,768,696	1,867,151	15.8
Other	27,276	27,323	0.2
Total	$ 11,346,144	$ 11,803,481	100.0%

December 31, 2012:	Amortized Cost	Estimated Fair Value	% of Total
Finance	$ 3,619,455	$ 3,900,152	31.5%
Industrial	5,881,967	6,443,846	52.0
Utility	1,799,658	2,002,611	16.2
Other	32,351	33,462	0.3
Total	$ 11,333,431	$ 12,380,071	100.0%

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Other-Than-Temporary Impairments

As discussed in Note 2 Summary of Significant Accounting Policies of the 2012 Annual Report, a portion of certain other-than-temporary impairment (OTTI) losses on fixed maturity securities are recognized in AOCI. For these securities the net amount recognized in earnings (credit loss impairments) represents the difference between the amortized cost of the security and the net present value of its projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. Any remaining difference between the fair value and amortized cost is recognized in AOCI. The following table sets forth the amount of pre-tax credit loss impairments on fixed maturity securities held by the Company as of the dates indicated, for which a portion of the OTTI loss was recognized in AOCI, and the corresponding changes in such amounts (dollars in thousands):

	Three months ended June 30, 2013	Three months ended June 30, 2012
Balance, beginning of period	$ 14,773	$ 62,236
Initial impairments - credit loss OTTI recognized on securities not previously impaired		60
Additional impairments - credit loss OTTI recognized on securities previously impaired		161
Credit loss OTTI previously recognized on securities impaired to fair value during the period	(1,449)	(8,288)
Credit loss OTTI previously recognized on securities which matured, paid down, prepaid or were sold during the period		(8,266)
Balance, end of period	$ 13,324	$ 45,903

	Six months ended June 30, 2013	Six months ended June 30, 2012
Balance, beginning of period	$ 16,675	$ 63,947
Initial impairments -credit loss OTTI recognized on securities not previously impaired		1,962
Additional impairments - credit loss OTTI recognized on securities previously impaired		8,881
Credit loss OTTI previously recognized on securities impaired to fair value during the period	(1,449)	(19,669)
Credit loss OTTI previously recognized on securities which matured, paid down, prepaid or were sold during the period	(1,902)	(9,218)
Balance, end of period	$ 13,324	$ 45,903

Purchased Credit Impaired Fixed Maturity Securities Available-for-Sale

In the third quarter of 2012, the Company began purchasing certain structured securities that had experienced deterioration in credit quality since their issuance. Securities acquired with evidence of credit quality deterioration since origination and for which it is probable at the acquisition date that the Company will be unable to collect all contractually required payments are classified as purchased credit impaired securities. For each security, the excess of the cash flows expected to be collected as of the acquisition date over its acquisition date fair value is referred to as the accretable yield and is recognized as net investment income on an effective yield basis. At the date of acquisition, the timing and amount of the cash flows expected to be collected was determined based on a best estimate using key assumptions, such as interest rates, default rates and prepayment speeds. If subsequently, based on current information and events, it is probable that there is a significant increase in cash flows previously expected to be collected or if actual cash flows are significantly greater than cash flows previously expected to be collected, the accretable yield is adjusted prospectively. The excess of the contractually required payments (including interest) as of the acquisition date over the cash flows expected to be collected as of the acquisition date is referred to as the nonaccretable difference, and this amount is not expected to be realized as net investment income. Decreases in cash flows expected to be collected can result in OTTI.

The following tables present information on the Company s purchased credit impaired securities, which are included in fixed maturity securities available-for-sale (dollars in thousands):

	June 30, 2013	December 31, 2012
Outstanding principal and interest balance[1]	$ 178,911	$ 108,831
Carrying value, including accrued interest[2]	$ 132,985	$ 84,765

(1) Represents the contractually required payments which is the sum of contractual principal, whether or not currently due, and accrued interest.
(2) Estimated fair value plus accrued interest.

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The following table presents information about purchased credit impaired investments acquired during the six months ended June 30, 2013 (dollars in thousands).

	At Date of Acquisition
Contractually required payments (including interest)	$ 109,931
Cash flows expected to be collected(1)	88,422
Fair value of investments acquired	58,471

(1) Represents undiscounted principal and interest cash flow expectations at the date of acquisition.

The following table presents activity for the accretable yield on purchased credit impaired securities for the three and six months ended June 30, 2013 (dollars in thousands):

	Three months ended June 30, 2013	Six months ended June 30, 2013
Balance, beginning of period	$ 59,915	$ 39,239
Investments purchased	7,885	29,951
Accretion	(1,879)	(3,822)
Disposals	(832)	(832)
Reclassification from nonaccretable difference	1,180	1,733
Balance, end of period	$ 66,269	$ 66,269

Unrealized Losses for Fixed Maturity and Equity Securities Available-for-Sale

The following table presents the total gross unrealized losses for the 1,394 and 567 fixed maturity and equity securities as of June 30, 2013 and December 31, 2012, respectively, where the estimated fair value had declined and remained below amortized cost by the indicated amount (dollars in thousands):

	June 30, 2013		December 31, 2012	
	Gross Unrealized Losses	% of Total	Gross Unrealized Losses	% of Total
Less than 20%	$ 267,765	86.2%	$ 54,951	41.2%
20% or more for less than six months	5,629	1.8	734	0.5
20% or more for six months or greater	37,340	12.0	77,873	58.3
Total	$ 310,734	100.0%	$ 133,558	100.0%

The Company s determination of whether a decline in value is other-than-temporary includes analysis of the underlying credit and the extent and duration of a decline in value. The Company s credit analysis of an investment includes determining whether the issuer is current on its contractual payments, evaluating whether it is probable that the Company will be able to collect all amounts due according to the contractual terms of the security and analyzing the overall ability of the Company to recover the amortized cost of the investment. The Company continues to consider declines in value as a potential indicator of credit deterioration. However, the Company believes that due to fluctuating market conditions and an extended period of economic uncertainty, the extent and duration of a decline in value have become less indicative of when there has been credit deterioration with respect to a fixed maturity security since it may not have an impact on the ability of the issuer to service all scheduled payments and the Company s evaluation of the recoverability of all contractual cash flows or the ability to recover an amount at least equal to amortized cost. In the Company s impairment review process, the duration and severity of an unrealized loss position for equity securities are given greater weight and consideration given the lack of contractual cash flows or deferability features.

The following tables present the estimated fair values and gross unrealized losses, including other-than-temporary impairment losses reported in AOCI, for 1,394 and 567 fixed maturity and equity securities that have estimated fair values below amortized cost as of June 30, 2013 and December 31, 2012, respectively (dollars in thousands). These investments are presented by class and grade of security, as well as the length of time the related fair value has remained below amortized cost.

June 30, 2013:	Less than 12 months Estimated Fair Value	Less than 12 months Gross Unrealized Losses	12 months or greater Estimated Fair Value	12 months or greater Gross Unrealized Losses	Total Estimated Fair Value	Total Gross Unrealized Losses
Investment grade securities:						
Corporate securities	$ 3,229,715	$ 161,032	$ 89,098	$ 12,531	$ 3,318,813	$ 173,563
Canadian and Canadian provincial governments	138,843	9,162			138,843	9,162
Residential mortgage-backed securities	210,336	9,553	14,822	2,643	225,158	12,196
Asset-backed securities	220,912	4,719	51,673	5,567	272,585	10,286
Commercial mortgage-backed securities	227,712	9,172	18,893	6,455	246,605	15,627
U.S. government and agencies	191,973	2,344	4,037	109	196,010	2,453
State and political subdivisions	97,877	6,351	11,402	5,499	109,279	11,850
Other foreign government, supranational and foreign government-sponsored enterprises	657,957	19,787	5,698	721	663,655	20,508
Total investment grade securities	4,975,325	222,120	195,623	33,525	5,170,948	255,645
Non-investment grade securities:						
Corporate securities	366,159	11,452	40,425	6,603	406,584	18,055
Residential mortgage-backed securities	53,715	1,007	2,359	565	56,074	1,572
Asset-backed securities	25,233	376	30,434	7,875	55,667	8,251
Commercial mortgage-backed securities	19,324	198	43,879	20,761	63,203	20,959
Other foreign government, supranational and foreign government-sponsored enterprises	952	113			952	113
Total non-investment grade securities	465,383	13,146	117,097	35,804	582,480	48,950
Total fixed maturity securities	$ 5,440,708	$ 235,266	$ 312,720	$ 69,329	$ 5,753,428	$ 304,595
Non-redeemable preferred stock	$ 30,787	$ 1,745	$ 1	$ 2	$ 30,788	$ 1,747
Other equity securities	69,881	4,392			69,881	4,392
Total equity securities	$ 100,668	$ 6,137	$ 1	$ 2	$ 100,669	$ 6,139

December 31, 2012:	Less than 12 months Estimated Fair Value	Less than 12 months Gross Unrealized Losses	12 months or greater Estimated Fair Value	12 months or greater Gross Unrealized Losses	Total Estimated Fair Value	Total Gross Unrealized Losses
Investment grade securities:						
Corporate securities	$ 786,203	$ 13,276	$ 108,187	$ 17,386	$ 894,390	$ 30,662
Canadian and Canadian provincial governments	12,349	174			12,349	174
Residential mortgage-backed securities	22,288	97	19,394	3,199	41,682	3,296
Asset-backed securities	59,119	449	96,179	9,508	155,298	9,957
Commercial mortgage-backed securities	89,507	797	29,181	7,974	118,688	8,771
U.S. government and agencies	7,272	24			7,272	24
State and political subdivisions	20,602	1,514	11,736	4,132	32,338	5,646
Other foreign government, supranational and foreign government-sponsored enterprises	244,817	1,953	7,435	761	252,252	2,714
Total investment grade securities	1,242,157	18,284	272,112	42,960	1,514,269	61,244
Non-investment grade securities:						
Corporate securities	181,168	3,170	39,123	5,501	220,291	8,671
Residential mortgage-backed securities	15,199	80	2,633	347	17,832	427
Asset-backed securities	3,421	26	31,938	18,815	35,359	18,841
Commercial mortgage-backed securities	3,317	764	68,405	42,307	71,722	43,071
Total non-investment grade securities	203,105	4,040	142,099	66,970	345,204	71,010

Total fixed maturity securities	$ 1,445,262	$ 22,324	$ 414,211	$ 109,930	$ 1,859,473	$ 132,254
Non-redeemable preferred stock	$ 5,577	$ 52	$ 5,679	$ 118	$ 11,256	$ 170
Other equity securities	85,374	1,134			85,374	1,134
Total equity securities	$ 90,951	$ 1,186	$ 5,679	$ 118	$ 96,630	$ 1,304

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As of June 30, 2013, the Company does not intend to sell these fixed maturity securities and does not believe it is more likely than not that it will be required to sell these fixed maturity securities before the recovery of the fair value up to the current amortized cost of the investment, which may be maturity. As of June 30, 2013, the Company has the ability and intent to hold the equity securities until the recovery of the fair value up to the current cost of the investment. However, unforeseen facts and circumstances may cause the Company to sell fixed maturity and equity securities in the ordinary course of managing its portfolio to meet certain diversification, credit quality, asset-liability management and liquidity guidelines.

Unrealized losses on non-investment grade securities are principally related to asset and mortgage-backed securities and were the result of wider credit spreads resulting from higher risk premiums since the time of initial purchase, largely due to macroeconomic conditions and credit market deterioration, including the impact of lower real estate valuations. As of June 30, 2013 and December 31, 2012, approximately $29.2 million and $61.5 million, respectively, of gross unrealized losses greater than 12 months was associated with non-investment grade asset and mortgage-backed securities. This class of securities was evaluated based on actual and projected collateral losses relative to the securities positions in the respective securitization trusts and security specific expectations of cash flows. This evaluation also takes into consideration credit enhancement, measured in terms of (i) subordination from other classes of securities in the trust that are contractually obligated to absorb losses before the class of security the Company owns, and (ii) the expected impact of other structural features embedded in the securitization trust beneficial to the class of securities the Company owns, such as overcollateralization and excess spread.

Investment Income, Net of Related Expenses

Major categories of investment income, net of related expenses, consist of the following (dollars in thousands):

	Three months ended June 30, 2013	Three months ended June 30, 2012	Six months ended June 30, 2013	Six months ended June 30, 2012
Fixed maturity securities available-for-sale	$ 240,590	$ 193,388	$ 479,834	$ 384,806
Mortgage loans on real estate	28,362	16,000	56,605	30,966
Policy loans	15,450	16,334	33,360	33,117
Funds withheld at interest	159,212	62,992	296,471	178,006
Short-term investments	422	781	1,235	1,769
Investment receivable		36,752		36,752
Other invested assets	13,379	11,356	27,301	22,679
Investment revenue	457,415	337,603	894,806	688,095
Investment expense	(13,181)	(9,269)	(25,441)	(18,821)
Investment income, net of related expenses	$ 444,234	$ 328,334	$ 869,365	$ 669,274

Investment Related Gains (Losses), Net

Investment related gains (losses), net consist of the following (dollars in thous (1,146) (0.8) 1,146

Other income

720 0.4 115 0.1 605

Total other income (expense)	1,028	0.5	(854)	(0.6)	1,882

Income before income taxes	84,803	42.8	61,150	40.1	23,653
Income tax expense	22,360	11.3	16,404	10.8	5,956
Net income	$62,443	31.5%	$44,746	29.4%	$17,697

Revenue

Revenue increased $46.0 million, or 30.2%, in the year ended December 31, 2011 compared to the year ended December 31, 2010. Maintenance and other revenue increased $29.3 million due to a growing maintenance renewal customer base and an increase in new license sales which drives new maintenance revenue. We have maintained high customer retention and our renewal base has continued to grow with acquisitions. License revenue increased $16.7 million due to continued growth in new license sales of our network management products and sales of our newly developed and newly acquired products such as those in the virtualization and log and security information management markets.

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Our core product transaction growth increased 30.9% in 2011 compared to 2010 as a result of our growth in new license sales of our network management products and the release of new stand-alone products and acquired products. As the number of core product transactions fluctuates with changes in the business or product mixes, this also affects our trailing 12-month average transaction size for new license sales. As of December 31, 2011, the trailing 12-month average transaction size for new license sales was approximately $8,600 as compared to approximately $8,300 for the trailing 12-month period as of December 31, 2010, an increase of 3.6%.

New license sales in our global commercial business increased 23.4% and new license sales in our U.S. federal government business increased 21.2% in 2011 as compared to 2010. This growth in both businesses was driven by year-over-year growth in core product transaction volume. We had three transactions in 2011 and two transactions in 2010 with the U.S. federal government that each resulted in license revenue greater than $0.5 million. Our revenue from our foreign subsidiaries was 23.7% and 22.1% of total revenue in 2011 and 2010, respectively.

Cost of Revenue

Cost of revenue increased $4.1 million, or 51.2%, in 2011 compared to 2010. Cost of license revenue increased by $2.2 million in 2011 compared to 2010, primarily due to the amortization of acquired product technologies associated with the Hyper9 and TriGeo acquisitions. The increase in cost of revenue was also due to a $1.9 million increase in cost of maintenance revenue related to increased headcount from the acquisition of TriGeo combined with an increase in the headcount in our international organization to support new customers added in 2011, additional product offerings from acquisitions and internal product development.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased $10.6 million, or 24.5%, in 2011 compared to 2010. We increased the size of our sales management team and marketing personnel to give us the ability to scale our sales effort as we continue to grow and enter new markets. As a result of these expansions efforts, our sales and marketing personnel costs, which include stock-based compensation expense, increased by $9.9 million and consulting and contractor fees increased $0.7 million offset by a decrease of $0.3 million in marketing program costs.

Research and Development. Research and development expenses increased $5.6 million, or 35.6%, in 2011 compared to 2010. In order to support our product development strategy and the development of new stand-alone, acquired and other products, we continued to increase the size of our Czech Republic research center during 2010 and 2011. We also added research and development personnel in the United States with the acquisition of Hyper9 in January 2011 and TriGeo in July 2011. Due to this growth, our personnel costs, which include stock-based compensation expense, increased by $4.8 million in 2011 compared to 2010. Other costs such as contract services and travel expenses increased by $0.6 million.

General and Administrative. General and administrative expenses increased $4.6 million, or 19.6%, in 2011 compared to 2010. This increase was primarily due to an increase of $2.1 million in amortization expense related to certain acquired intangible assets, $1.5 million in acquisition related costs and a $0.7 million in professional fees.

Accrued Earnout Gain. We recorded a $0.7 million accrued earnout gain in 2011 due to the change in probability of achieving sales milestones during 2011 related to the Hyper9 accrued earnout. In February 2012, we paid approximately $3.5 million of cash upon the achievement of these sales milestones.

Other Income (Expense)

Other income increased by $0.6 million in 2011 as compared to 2010 primarily due to the receipt of payment for the government grant related to job creation and related training costs in our Czech entity. Interest

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expense in 2011 was $0, decreasing by $1.1 million from 2010, because we paid all of the outstanding principal balance of our credit facilities in 2010.

Income Tax Expense

Our income tax expense increased by $6.0 million for the year ended December 31, 2011 as compared to 2010. This increase resulted from an increase in our income before income taxes of $23.7 million when comparing the same periods. Our effective tax rate decreased from 26.8% for the year ended December 31, 2010 compared to 26.4% for the year ended December 31, 2011, which was primarily attributable to an increase in permanent U.S. income tax benefit related to the U.S. domestic production activities deduction and an increase in international earnings, which are generally taxed at lower tax rates.

Non-GAAP Financial Measures

In addition to disclosing financial measures prepared in accordance with GAAP, this Form 10-K includes the following financial measures which are non-GAAP financial measures under SEC rules: (i) non-GAAP operating income; (ii) non-GAAP net income; (iii) non-GAAP diluted earnings per share; and (iv) free cash flow. Each of these financial measures excludes the impact of certain items and therefore has not been calculated in accordance with GAAP. In this report, these non-GAAP financial measures exclude stock-based compensation expense and related employer-paid payroll taxes; amortization of intangible assets; and acquisition related adjustments, including contingent consideration fair value adjustments due to the changes in probability assumptions of achieving the earnout criteria and due to the passage of time. Each of these non-GAAP adjustments is described in more detail below. In addition to these adjustments, management may include or exclude additional items from these or similar non-GAAP financial measures in future periods to the extent that management believes such items may not be indicative of our core business. A reconciliation of each of these non-GAAP financial measures to its most comparable GAAP financial measure is also included below.

We believe that these non-GAAP financial measures provide meaningful supplemental information regarding our operating results because they exclude certain amounts that our management and Board of Directors do not consider part of core operating results when assessing our operational performance, allocating resources, preparing annual budgets and determining employee incentive compensation. Accordingly, these non-GAAP financial measures may provide insight to investors into the motivation and decision-making of management in operating the business. In addition, by comparing our non-GAAP financial measures in different historical periods, our investors can evaluate our operating results without the additional variations of certain items that may not be indicative of our core operations, including stock-based compensation expense, which is a non-cash expense that is not a key measure of our operations.

While we believe that these non-GAAP financial measures provide useful supplemental information, there are limitations associated with the use of these non-GAAP financial measures. These non-GAAP financial measures are not prepared in accordance with GAAP, do not reflect a comprehensive system of accounting and may not be comparable to similarly titled measures of other companies due to potential differences in their financing and accounting methods, the book value of their assets, their capital structures, the method by which their assets were acquired and the manner in which they define non-GAAP measures. Items such as the amortization of intangible assets, stock-based compensation expense and related employer-paid payroll taxes and acquisition related adjustments, as well as the related tax impacts of these items can have a material impact on operating and net income. In addition, free cash flow does not represent the total increase or decrease in the cash balances for the period. As a result, these non-GAAP financial measures have limitations and should not be considered in isolation from, or as a substitute for, their most comparable GAAP measures. We compensate for these limitations by using these non-GAAP financial measures as supplements to GAAP financial measures and by reconciling the non-GAAP financial measures to their most comparable GAAP financial measure. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to their most comparable GAAP financial measures below.

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For a detailed explanation of the adjustments made to comparable GAAP financial measures, the reasons why management uses these measures and the usefulness of these measures, see footnotes (1) (7) below.

Non-GAAP Operating Income

(in thousands)	Year Ended December 31, 2012	2011	2010
GAAP operating income	$ 113,670	$ 83,775	$ 62,004
Amortization of intangible assets (1)	14,894	7,170	3,170
Stock-based compensation expense and related employer-paid payroll taxes (2)	15,819	10,974	12,047
Public offering costs (3)			170
Lawsuit settlement costs and related legal fees (reimbursements) (3)			(217)
Severance costs related to retirement of former Executive Chairman (3)			208
Acquisition related adjustments (4)	445	1,339	501
Non-GAAP operating income	$ 144,828	$ 103,258	$ 77,883

The increase in non-GAAP operating income for the year ended December 31, 2012 as compared to the same periods in 2011 and 2010 was primarily due to increases in the corresponding GAAP operating income, which were driven by higher revenue volumes in the corresponding periods. Amortization of intangible assets, which is excluded from our non-GAAP operating income, also increased in 2012 as compared to 2011 and 2010 primarily due to increases in intangible assets resulting from the various acquisitions that were completed during 2011 and 2012. See Note 2, *Acquisitions* of our Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K for additional acquisition details including the intangibles acquired. Stock-based compensation expense and related employer-paid payroll taxes increased in 2012 as compared to 2011 and 2010 primarily due to share-based incentive awards issued to employees for retention and, to a lesser extent, the addition of employees through acquisitions and organic growth. The 2010 stock-based compensation expense and related employer-paid payroll taxes amount includes a one-time stock-based compensation expense of $1.4 million from the acceleration of the vesting of certain options related to the retirement of our former Executive Chairman on June 30, 2010. Our acquisition related adjustments fluctuate due to variations in the legal, accounting and advisory fees and restructuring costs associated with each of our acquisitions.

Non-GAAP Net Income and Non-GAAP Diluted Earnings Per Share

(in thousands)	Year Ended December 31, 2012	2011	2010
GAAP net income	$ 81,343	$ 62,443	$ 44,746
Amortization of intangible assets (1)	14,894	7,170	3,170
Stock-based compensation expense and related employer-paid payroll taxes (2)	15,819	10,974	12,047
Debt issuance costs write-off (3)			334
Public offering costs (3)			170
Lawsuit settlement costs and related legal fees (reimbursements) (3)			(217)
Severance costs related to retirement of former Executive Chairman (3)			208
Acquisition related adjustments (4)	519	1,578	758
Tax benefits associated with above adjustments (5)	(8,886)	(4,970)	(4,494)
Non-GAAP net income	$ 103,689	$ 77,195	$ 56,722
Weighted-average number of shares used in computing diluted earnings per share	76,035	74,413	72,862
Non-GAAP diluted earnings per share (6)	$ 1.36	$ 1.04	$ 0.78

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The increase in non-GAAP net income for year ended December 31, 2012 as compared to the same periods in 2011 and 2010 was primarily due to increases in the corresponding GAAP net income and the adjustments discussed above in the calculation of non-GAAP operating income. Other adjustments to non-GAAP net income include fair value adjustments due to the passage of time related to contingent consideration included in acquisition related costs and the tax benefits associated with the excluded items. Non-GAAP diluted earnings per share increased for the year ended December 31, 2012 as compared to the same periods in 2011 and 2010 primarily due to the increase in non-GAAP net income as discussed above as the number of shares used in the computation did not change significantly.

Free Cash Flow

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
GAAP cash flows from operating activities	$ 143,447	$ 110,530	$ 66,043
Excess tax benefit from stock-based compensation	10,486	6,359	26,748
Purchases of property and equipment	(3,885)	(2,945)	(2,740)
Free cash flow (7)	$ 150,048	$ 113,944	$ 90,051

The increase in free cash flow for the year ended December 31, 2012 as compared to the same periods in 2011 and 2010 was primarily due to the increase in operating income that converted to cash flow. The excess tax benefit from stock-based compensation fluctuates with the exercise of stock option awards.

Non-GAAP Footnotes:

(1) *Amortization of Intangible Assets*. We provide non-GAAP information that excludes expenses for the amortization of intangible assets that primarily relate to purchased intangible assets associated with our acquisitions. We believe that eliminating this expense from our non-GAAP measures is useful to investors, because the amortization of intangible assets can be inconsistent in amount and frequency and is significantly impacted by the timing and magnitude of our acquisition transactions, which also vary in frequency from period to period. Accordingly, we analyze the performance of our operations in each period without regard to such expenses.

(2) *Stock-Based Compensation Expense and Related Employer-Paid Payroll Taxes*. We provide non-GAAP information that excludes expenses for stock-based compensation and related employer-paid payroll taxes. We believe the exclusion of these items allows for financial results that are more indicative of our continuing operations. We believe that the exclusion of stock-based compensation expense provides for a better comparison of our operating results to prior periods and to our peer companies as the calculations of stock-based compensation vary from period to period and company to company due to different valuation methodologies, subjective assumptions and the variety of award types. Employer-paid payroll taxes on stock-based compensation is dependent on our stock price and the timing of the taxable events related to the equity awards, over which our management has little control, and does not correlate to the core operation of our business. Because of these unique characteristics of stock-based compensation and the related employer-paid payroll taxes, management excludes these expenses when analyzing the organization s business performance.

(3) *Other Items*. We exclude certain other unplanned items which we believe are not indicative of our continuing operations and which amounts and timing are difficult to estimate in advance, including the following, when applicable: (i) write-off of debt issuance costs; (ii) public offering costs; (iii) lawsuit settlement costs and related legal fees, net of related reimbursements from insurance proceeds; and (iv) severance costs related to retirement of certain executive officers. Although these events are reflected in our GAAP financials, these transactions which are not indicative of our continuing operations may limit the comparability of our ongoing operations with prior and future periods. Because of these factors, we assess

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our operating performance both with these amounts included and excluded, and by providing this information, we believe the users of our financial statements are better able to understand the financial results of what we consider our continuing operations.

(4) *Acquisition Related Adjustments*. We exclude certain expense items resulting from acquisitions including the following, when applicable: (i) amortization of purchased intangible assets associated with our acquisitions (see Note 1 for further discussion); (ii) legal, accounting and advisory fees to the extent associated with acquisitions; (iii) changes in fair value of contingent consideration; (iv) costs related to integrating the acquired businesses; and (v) restructuring costs, including adjustments related to changes in estimates, related to acquisitions. We consider these adjustments, to some extent, to be unpredictable and dependent on a significant number of factors that are outside of our control. Furthermore, acquisitions result in non-continuing operating expenses, which would not otherwise have been incurred by us in the normal course of our organic business operations, with respect to each acquisition. We believe that providing non-GAAP information for acquisition related expense items in addition to the corresponding GAAP information allows the users of our financial statements to better review and understand the historical and current results of our continuing operations, and also facilitates comparisons to our historical results and results of less acquisitive peer companies, both with and without such adjustments.

(5) *Income Tax Effect of Non-GAAP Exclusions.* We believe providing financial information with and without the income tax effect of excluding items related to our non-GAAP financial measures provide our management and users of the financial statements with better clarity regarding the ongoing performance and future liquidity of our business.

(6) *Non-GAAP Diluted Earnings Per Share Item*. We provide non-GAAP diluted earnings per share. The non-GAAP diluted earnings per share amount was calculated based on our non-GAAP net income and the shares used in the computation of GAAP diluted earnings per share.

(7) *Free Cash Flow.* We define free cash flow as cash flows from operating activities plus the excess tax benefit from stock-based compensation and less the purchases of property and equipment. We believe free cash flow is an important liquidity measure that reflects the cash generated by the business after the purchase of property and equipment that can then be used for, among other things, strategic acquisitions and investments in the business, stock repurchases and funding ongoing operations. Free cash flow does not represent the total increase or decrease in the cash balance for the period. The changes in free cash flow result from fluctuations in cash flows from operating activities offset by excess tax benefits associated with the exercises of options. For further discussion regarding cash flows from operating activities, see the discussion under the caption Liquidity and Capital Resources included in this Item 7.

Liquidity and Capital Resources

Cash and cash equivalents and short-term and long-term investments were $241.8 million as of December 31, 2012. Our international subsidiaries held approximately $47.8 million of cash and cash equivalents of which 93.3% was held in Euros as of December 31, 2012. We expect our international cash and cash equivalents to continue to increase as a percentage of our consolidated cash and cash equivalents. We currently intend that the earnings generated by our international operations will be invested indefinitely in those operations and we do not expect to repatriate those earnings to our domestic operations. If we were to try and repatriate these earnings, we would incur a U.S. federal income tax liability that is not currently accrued in our consolidated financial statements.

Our available cash and cash equivalents are held in bank demand deposits and money market funds at December 31, 2012. Our short-term and long-term investments, classified as available-for-sale securities, consist of corporate bonds, municipal bonds and commercial paper held in investment accounts in the United States.

Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances held in our demand deposit accounts in the United States may exceed the Federal Deposit Insurance

Corporation, or FDIC, insurance limits. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted by adverse conditions in the financial markets or by failure of the underlying depository institutions or guarantors. We strive to maintain our cash deposits, money market funds and investments with multiple financial institutions of reputable credit and therefore, bear minimal credit risk. We actively monitor the third party depository institutions that hold our cash, cash equivalents and investments. To date, we have experienced no loss or lack of access to our invested cash, cash equivalents, and investments; however, we can provide no assurances that access to our funds will not be impacted by future adverse conditions.

Summarized annual cash flow information is as follows (in thousands):

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Net cash provided by operating activities	$ 143,447	$ 110,530	$ 66,043
Net cash used in investing activities	(103,118)	(142,414)	(31,574)
Net cash provided by (used in) financing activities	15,482	14,193	(21,313)
Effect of exchange rate changes	1,184	(1,605)	(941)
Net increase (decrease) in cash and cash equivalents	56,995	(19,296)	12,215

Operating Activities

Cash provided by operating activities is comprised of net income, adjustments primarily related to non-cash operating activities and changes in operating assets and liabilities. Adjustments for non-cash (benefits) expenses were $23.3 million, $16.5 million and $(11.9) million for the years ended December 31, 2012, 2011 and 2010, respectively. These adjustments primarily consist of depreciation and amortization, stock-based compensation expense and excess tax benefits related to employee stock-based awards. Stock-based compensation expense reduced income before income taxes by $15.3 million, $10.7 million and $10.9 million in the years ended December 31, 2012, 2011 and 2010, respectively. We also recognized a gain on the change in fair value of our acquisition related earnouts of $0.6 million and $0.7 million for years ended December 31, 2012 and 2011, respectively, due to adjustments in our probability assumption of achieving the specified earnout criteria.

The change in cash flows relating to operating activities resulted from changes in operating assets and liabilities and is primarily driven by the sales of our software and maintenance renewals. The significant changes in operating assets and liabilities include the following:

Deferred revenue increased to $102.8 million at December 31, 2012 as compared to $77.1 million at December 31, 2011, resulting in an increase in operating liabilities and reflecting a cash inflow of $22.5 million for the year ended December 31, 2012. For the years ended December 31, 2011 and 2010, net cash provided by operating activities increased $19.1 million and $15.3 million, respectively, due to an increase in deferred revenue during those years as compared to the respective prior year. The increase in deferred revenue was due primarily to the increase in the sales of our software and maintenance renewals.

Changes in our income tax receivable and payable balances are also significant components of our cash flows from operating activities. The increase in our income tax payable was primarily due to the growth in our taxable income. Net cash provided by operating activities was reduced by income tax payments of $15.3 million in 2012, $1.0 million in 2011, was increased by a U.S. federal income tax refund of $3.3 million in 2010.

Accounts receivables increased to $32.5 million at December 31, 2012 as compared to $27.0 million at December 31, 2011 resulting in an increase in operating assets and reflecting a cash outflow of $5.7 million for the year ended December 31, 2012. The increase in accounts receivable for the years ended December 31, 2011 and 2010 as compared to the respective prior year resulted in cash outflows of $7.0 million and $5.1 million, respectively. Our accounts receivable balance fluctuates from period to period depending on the timing of our sales, cash collections and changes to our allowance for doubtful accounts, which affects our cash flow from operating activities. Our accounts receivable balance represents trade receivables from customers, including resellers and distributors, when we have provided software licenses and/or software maintenance agreements and we have not yet received payment. We have historically had insignificant write-offs related to bad debts. The allowance for doubtful accounts was $0.3 million, $0.2 million and $0.2 million at December 31, 2012, 2011 and 2010, respectively. We use days sales outstanding, or DSO, calculated on a quarterly basis, as a measurement of the quality and status of our receivables. We define DSO as (a) accounts receivable divided by (b) total revenue for the most recent quarter, multiplied by (c) the number of days in the quarter. Our DSO was 40.7 days and 44.6 days at December 31, 2012 and 2011, respectively.

Other changes in operating assets and liabilities include cash paid for interest payments of $1.3 million in 2010.

Investing Activities

Net cash used in investing activities for the year ended December 31, 2012 was primarily related to $65.9 million of cash used to purchase available-for-sale securities classified as short-term and long-term investments, $66.0 million of cash used for acquisitions (refer to Note 2, *Acquisitions*, of our Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K for additional details) and $33.9 million of proceeds from maturities of investments.

Net cash used in investing activities for the year ended December 31, 2011 was primarily related to $109.5 million of cash used for acquisitions (refer to Note 2, *Acquisitions,* of our Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K for additional details) and $33.2 million of cash used to purchase available-for-sale securities classified as short-term and long-term investments. Also during 2011, we had $4.0 million of proceeds from maturities of investments.

Net cash used in investing activities for the year ended December 31, 2010 was primarily due to the $28.0 million of cash used in our purchase of certain assets of Tek-Tools.

We expect our capital expenditures in fiscal year 2013 to be approximately $6.0 to $8.0 million. Our estimated capital expenditures for 2013 primarily include equipment, software, leasehold improvements and furniture related to the expected growth of our corporate headquarters in Austin, Texas and our international research and development centers in the Czech Republic and India.

Financing Activities

Net cash provided by financing activities for the year ended December 31, 2012 was primarily due to $10.6 million of proceeds from the exercise of employee stock options and $10.5 million of excess tax benefit related to stock-based awards, which is a reduction in cash payments related to income taxes. In addition, for the year ended December 31, 2012, we withheld and retired shares of common stock to satisfy $1.5 million of minimum statutory withholding tax requirements that we pay in cash to the appropriate taxing authorities on behalf of our employees related to restricted stock units issued during the period. These shares are treated as common stock repurchases in our consolidated financial statements as of December 31, 2012. Also during the year ended December 31, 2012, we paid approximately $4.5 million of cash upon the achievement of certain earnout objectives related to acquisition accrued earnouts. The earnout payments of $4.2 million are reflected in cash flows from financing activities and the changes in fair value due to the passage of time of $0.3 million are reflected in cash flows from operating activities in the consolidated statement of cash flows for the year ended December 31, 2012. We reclassified our earnout payments from cash flows from investing activities to cash flows from financing activities in our consolidated statement of cash flows for the year ended December 31, 2012. See Note 1, *Summary of Significant Accounting Policies*, in the Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K for further information.

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Net cash provided by financing activities for the year ended December 31, 2011 was primarily due to $11.9 million of proceeds from the exercise of employee stock options and the excess tax benefit related to stock-based awards of $6.4 million, which is a reduction in cash payments related to income taxes. Also during 2011, we paid $4.0 million of cash to Tek-Tools upon the achievement of certain performance criteria related to the asset acquisition in January 2010. The earnout payment of $3.7 million is reflected in cash flows from financing activities and the change in fair value due to the passage of time of $0.3 million is reflected in cash flows from operating activities in the consolidated statement of cash flows for the year ended December 31, 2011.

Net cash used in financing activities for the year ended December 31, 2010 was due to a $44.1 million repayment of long-term debt partially offset by $21.0 million of proceeds from the exercise of stock options and a $26.7 million excess tax benefit related to stock-based compensation, which is a reduction in cash payments related to income taxes. The debt payments in 2010 paid off our entire outstanding principal under our First Lien Note and Second Lien Note.

On August 2, 2010, our board of directors approved a share repurchase program, authorizing us to purchase up to $25.0 million of our outstanding common stock. The share repurchase program was completed in August 2010, and we repurchased and retired 1.7 million shares of our common stock for an aggregate purchase price of $25.0 million. The repurchase was authorized to reflect the confidence of management and the board of directors in our business. We believed the share repurchase program would generate a positive return to our shareholders by reducing the number of shares outstanding. Given the low rates of return on cash and short-term investments and as there was no outstanding debt at the time of the share repurchase, we believed the share repurchase program was a proper use of our available cash.

Anticipated Cash Flows

We believe that our existing cash and cash equivalents and our cash flows from operating activities will be sufficient to fund our operations and our capital expenditures for at least the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of any acquisitions to expand our business, the timing of expansions to our office facilities, the timing of introductions of new software products and enhancements to existing software products, and the continuing market acceptance of our software offerings. We expect to continue to pursue acquisitions that will enable us to enter new markets or new segments of our existing markets by bringing new product offerings to market more quickly than we can develop them.

Although we are not currently a party to any material definitive agreement regarding potential investments in, or acquisitions of, complementary businesses, applications or technologies, we may enter into these types of arrangements, which could reduce our cash and cash equivalents, require us to seek additional equity or debt financing or repatriate cash generated by our international operations that would cause us to incur a U.S. federal income tax liability. Additional funds from financing arrangements may not be available on terms favorable to us or at all.

Contractual Obligations and Commitments

We generally do not enter into long-term minimum purchase commitments. Our principal commitments as of December 31, 2012 consisted of operating lease obligations for our office facilities. The following table summarizes our outstanding contractual obligations as of December 31, 2012, that require us to make future cash payments:

		Payments Due by Period			
(in thousands)	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating leases	$ 20,221	$ 4,488	$ 7,672	$ 2,765	$ 5,296
Purchase obligations (1)	8,177	8,014	163		
Accrued earnout (2)	121	121			
Sub-total	$ 28,519	$ 12,623	$ 7,835	$ 2,765	$ 5,296
Uncertain tax positions (3)	8,776				
Total	$ 37,295				

(1) Purchase obligations represent purchases of software license and support fees, marketing activities, accounting, legal and contractor fees, corporate health insurance costs and computer hardware and software.

(2) Acquisition related contingent consideration of $2.5 million to be paid if new license sales during the one-year earnout measurement period equal or exceed the milestone specified in the purchase agreement. The contingent consideration is recorded at fair value in our consolidated balance sheet at December 31, 2012 as an accrued earnout of $0.1 million. See Note 5, *Fair Value Measurements*, in the Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K for additional details.

(3) We have included our long-term tax liabilities related to uncertain tax positions at December 31, 2012, however, we have not included the payments due by period as the timing and amounts that will be settled in cash, if any, are not known.

Off-Balance Sheet Arrangements

During 2012, 2011 and 2010, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

See Note 1, *Summary of Significant Accounting Policies*, in the Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K, for a full description of recent accounting pronouncements which is incorporated herein by reference.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to certain financial market risks, including the following:

Interest Rate Risk

We had cash and cash equivalents of $179.7 million and $122.7 million at December 31, 2012 and 2011, respectively. We also had short-term and long-term investments classified as available-for-sale securities of $62.1 million and $29.7 million at December 31, 2012 and 2011, respectively. Our cash and cash equivalents consist primarily of bank demand deposits and money market funds, and our available-for-sale securities consist primarily of corporate bonds, municipal bonds and commercial paper held in investment accounts in the United

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States. We hold cash, cash equivalents and available-for-sale securities for working capital purposes. Our investments are made for capital preservation purposes, and we do not enter into investments for trading or speculative purposes.

We do not have material exposure to market risk with respect to our cash and cash equivalents, as these consist of highly liquid investments purchased with original maturities of three months or less at December 31, 2012. Our portfolio of available-for-sale securities classified as investments is subject to market risk due to changes in interest rates. Changes in interest rates could impact our future investment income, or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates. However, because we classify our investment securities as available for sale, no gains or losses are recognized due to changes in interest rates unless such securities are sold prior to maturity or declines in fair value are determined to be other-than-temporary.

Foreign Currency Risk

As a global company, we face exposure to adverse movements in foreign currency exchange rates. Our revenue from our foreign subsidiaries was approximately 24.5% of our total revenue for the year ended December 31, 2012. The foreign currencies that we invoice and on which we collect are the Euro, British Pound Sterling, Australian Dollar and Japanese Yen. Expenses incurred by our international subsidiaries are, generally, denominated in the local currency of the subsidiary. Our consolidated statements of income are translated into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currency denominated transactions results in reduced revenues, operating expenses and net income for our international operations. Similarly, our revenues, operating expenses and net income will increase for our international operations if the U.S. dollar weakens against foreign currencies.

During the first quarter of 2012, we began utilizing purchased foreign currency forward contracts to minimize our foreign exchange exposure on certain foreign balance sheet positions denominated in currencies other than the Euro. We do not enter into any derivative financial instruments for trading or speculative purposes. Our objective in managing our exposure to foreign currency exchange rate fluctuations is to reduce the impact of adverse fluctuations in such exchange rates on our earnings and cash flow. The notional amounts and currencies underlying our foreign currency forward contracts will fluctuate period to period as they are principally dependent on the balances of the balance sheet positions that are denominated in currencies other than the Euro held by our global entities. There can be no assurance that our foreign currency hedging activities will substantially offset the impact of fluctuation in currency exchange rates on our results of operational and functional positions. As of December 31, 2012, we did not have any forward contracts outstanding and while we do not have a formal policy to settle all derivatives prior to the end of each quarter, our current practice is to do so. See Note 6, *Derivative Instruments,* in the Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K, for a summary of the effect of derivative instruments on our consolidated statements of income.

We are exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments, but we do not expect any counterparties to fail to meet their obligations given their high credit ratings. In addition, we diversify this risk across several counterparties and actively monitor their ratings.

We are also exposed to foreign exchange rate fluctuations as we translate the financial statements of our foreign subsidiaries into U.S. dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries financial statements into U.S dollars will lead to a translation gain or loss that is recorded as a component of accumulated other comprehensive income (loss).

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this item is incorporated by reference to the Consolidated Financial Statements set forth on pages F-1 through F-38 hereof.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There were no changes in or disagreements with our accountants on accounting and financial disclosure matters.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2012. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2012, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management s Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that our degree of compliance with the policies or procedures may deteriorate.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of the end of the period covered by this report based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this evaluation, management concluded that the Company s internal control over financial reporting was effective as of the end of the period covered by this report.

Our independent registered public accounting firm, which has audited our consolidated financial statements, has also audited the effectiveness of the Company s internal control over financial reporting as of December 31, 2012, as stated in their report, which is included in Part II, Item 8 of this report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2012, that have materiality affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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ITEM 9B. OTHER INFORMATION

None.

PART III

Certain information required by Part III is omitted from this report. We intend to file such information within our definitive proxy statement pursuant to Regulation 14A with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year covered by this report relating to our 2013 annual meeting of stockholders (the Proxy Statement).

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item will be included in our Proxy Statement and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item will be included in our Proxy Statement and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item will be included in our Proxy Statement and is incorporated herein by reference.

Equity Compensation Plan Information

The following table provides information as of December 31, 2012, with respect to shares of our common stock that may be issued, subject to certain vesting requirements, under our existing equity compensation plans, including our Amended and Restated Stock Incentive Plan (2005 Plan) and our 2008 Equity Incentive Plan (2008 Plan):

Plan Category	A Number of securities to be issued upon exercise of outstanding options, warrants and rights	B Weighted-average exercise price of outstanding options, warrants and rights	C Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (A))
Equity compensation plans approved by security holders	4,220,868(1)	$ 14.48	10,298,837(2)
Equity compensation plans not approved by security holders			
Total	4,220,868	$ 14.48	10,298,837

(1) Consists of 1,292,171 shares and 2,928,697 shares of common stock underlying outstanding options and restricted stock units granted under our 2005 Plan and 2008 Plan, respectively.

(2) Represents shares of common stock available for issuance under our 2008 Plan as of December 31, 2012 and does not include the automatic increase on January 1, 2013 of 3,545,087 additional shares of our common stock reserved for issuance under our 2008 Plan.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item will be included in our Proxy Statement and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item will be included in our Proxy Statement and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Documents Filed with Report

(1) *Financial Statements.*

Management s Report on Internal Control Over Financial Reporting	F-2
Report of Independent Registered Public Accounting Firm	F-3
Consolidated Balance Sheets	F-4
Consolidated Statements of Income	F-5
Consolidated Statements of Comprehensive Income	F-6
Consolidated Statements of Changes in Stockholders Equity	F-7
Consolidated Statements of Cash Flows	F-8
Notes to Consolidated Financial Statements	F-9

(2) *Financial Statement Schedules.*

The following financial statement schedule should be read in conjunction with the consolidated financial statements of SolarWinds, Inc. filed as part of this Report:

Schedule II Valuation and Qualifying Accounts

Schedules other than that listed above have been omitted since they are either not required or not applicable or because the information required is included in the consolidated financial statements included elsewhere herein or the notes thereto.

(3) *Exhibits.*

The information required by this Item is set forth on the exhibit index that follows the signature page of this Annual Report on Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SOLARWINDS, INC.

Dated: February 19, 2013

By: /s/ Michael J. Berry
Michael J. Berry
Executive Vice President and
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Kevin B. Thompson **Kevin B. Thompson**	President, Chief Executive Officer and Director (principal executive officer)	February 19, 2013
/s/ Michael J. Berry **Michael J. Berry**	Executive Vice President and Chief Financial Officer (principal financial officer)	February 19, 2013
/s/ J. Barton Kalsu **J. Barton Kalsu**	Chief Accountant and Senior Vice President, Finance (principal accounting officer)	February 19, 2013
/s/ Steven M. Cakebread **Steven M. Cakebread**	Lead Independent Director	February 19, 2013
/s/ Mark Bonham **Mark Bonham**	Director	February 19, 2013
/s/ J. Benjamin Nye **J. Benjamin Nye**	Director	February 19, 2013
/s/ Ellen F. Siminoff **Ellen F. Siminoff**	Director	February 19, 2013
/s/ Roger J. Sippl **Roger J. Sippl**	Director	February 19, 2013
/s/ Lloyd G. Waterhouse	Director	February 19, 2013

Lloyd G. Waterhouse

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MANAGEMENT S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company, (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that our degree of compliance with the policies or procedures may deteriorate.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of the end of the period covered by this report based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organization of the Treadway Commission. Based on this evaluation, management concluded that the Company s internal control over financial reporting was effective as of the end of the period covered by this report.

Our independent registered public accounting firm, which has audited our consolidated financial statements in Part II, Item 8 of this report, has also audited the effectiveness of the Company s internal control over financial reporting as of December 31, 2012, as stated in their report, which is included below.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of SolarWinds, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of comprehensive income, of changes in stockholders equity and of cash flows present fairly, in all material respects, the financial position of SolarWinds, Inc. and its subsidiaries at December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Austin, Texas

February 19, 2013

SolarWinds, Inc.

Consolidated Balance Sheets

(In thousands, except share and per share information)

	December 31, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 179,702	$ 122,707
Short-term investments	49,276	29,688
Accounts receivable, net of allowances of $271 and $192 as of December 31, 2012 and 2011, respectively	32,506	26,965
Income tax receivable	142	110
Deferred taxes	1,712	668
Prepaid and other current assets	3,322	2,770
Total current assets	266,660	182,908
Property and equipment, net	8,342	7,341
Long-term investments	12,823	
Deferred taxes	338	3,334
Goodwill	158,601	110,746
Intangible assets and other, net	70,631	58,079
Total assets	$ 517,395	$ 362,408
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 4,050	$ 2,213
Accrued liabilities	14,226	9,442
Accrued earnout	121	3,513
Income taxes payable	4,037	779
Current portion of deferred revenue	97,672	73,774
Total current liabilities	120,106	89,721
Long-term liabilities:		
Deferred revenue, net of current portion	5,084	3,373
Non-current deferred taxes	483	289
Other long-term liabilities	8,908	4,078
Total liabilities	134,581	97,461
Commitments and contingencies (Note 14)		
Stockholders equity:		
Common stock, $0.001 par value: 123,000,000 shares authorized and 74,633,412 and 73,367,367 shares issued and outstanding as of December 31, 2012 and 2011, respectively	75	73
Additional paid-in capital	229,277	194,379
Accumulated other comprehensive loss	(1,145)	(2,769)
Accumulated earnings	154,607	73,264
Total stockholders equity	382,814	264,947
Total liabilities and stockholders equity	$ 517,395	$ 362,408

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

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SolarWinds, Inc.

Consolidated Statements of Income

(In thousands, except for per share information)

	Year Ended December 31,		
	2012	**2011**	**2010**
Revenue:			
License	$ 123,984	$ 92,254	$ 75,603
Maintenance and other	144,980	106,104	76,790
Total revenue	268,964	198,358	152,393
Cost of license revenue	8,203	4,097	1,943
Cost of maintenance and other revenue	10,197	7,892	5,987
Gross profit	250,564	186,369	144,463
Operating expenses:			
Sales and marketing	73,046	53,850	43,252
Research and development	28,769	21,332	15,731
General and administrative	35,649	28,076	23,476
Accrued earnout gain	(570)	(664)	
Total operating expenses	136,894	102,594	82,459
Operating income	113,670	83,775	62,004
Other income (expense):			
Interest income	430	308	177
Interest expense			(1,146)
Other income, net	419	720	115
Total other income (expense)	849	1,028	(854)
Income before income taxes	114,519	84,803	61,150
Income tax expense	33,176	22,360	16,404
Net income	$ 81,343	$ 62,443	$ 44,746
Net income per share:			
Basic earnings per share	$ 1.10	$ 0.86	$ 0.65
Diluted earnings per share	$ 1.07	$ 0.84	$ 0.61
Weighted-average shares used to compute net income per share:			
Shares used in computation of basic earnings per share	74,166	72,812	68,664
Shares used in computation of diluted earnings per share	76,035	74,413	72,862

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

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SolarWinds, Inc.

Consolidated Statements of Comprehensive Income

(In thousands)

	Year Ended December 31,		
	2012	**2011**	**2010**
Net income	$ 81,343	$ 62,443	$ 44,746
Other comprehensive income (loss):			
Foreign currency translation adjustment	1,597	(1,502)	(1,097)
Unrealized gains (losses) on investments, net of income tax expense (benefit) of $14, $(6) and $0 for the years ended December 31, 2012, 2011 and 2010 respectively	27	(11)	
Other comprehensive income (loss)	1,624	(1,513)	(1,097)
Comprehensive income	$ 82,967	$ 60,930	$ 43,649

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

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SolarWinds, Inc.

Consolidated Statements of Changes in Stockholders Equity

(In thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings (Deficit)	Total Stockholders Equity
	Shares	Amount				
Balances at December 31, 2009	66,502	$ 67	$ 123,083	$ (159)	$ (33,925)	$ 89,066
Comprehensive income:						
Foreign currency translation adjustment				(1,097)		(1,097)
Net income					44,746	44,746
Comprehensive income						43,649
Shares issued in connection with business acquisition	453		9,221			9,221
Exercise of stock options	6,406	7	21,025			21,032
Repurchase of common stock	(1,702)	(2)	(24,985)			(24,987)
Stock-based compensation			10,880			10,880
Excess tax benefit from stock-based compensation			26,748			26,748
Balances at December 31, 2010	71,659	72	165,972	(1,256)	10,821	175,609
Comprehensive income:						
Foreign currency translation adjustment				(1,502)		(1,502)
Unrealized gains (losses) on investments, net of taxes				(11)		(11)
Net income					62,443	62,443
Comprehensive income						60,930
Exercise of stock options	1,664	1	11,918			11,919
Restricted stock units issued, net of shares withheld for taxes	44		(342)			(342)
Stock-based compensation			10,690			10,690
Excess tax benefit from stock-based compensation			6,141			6,141
Balances at December 31, 2011	73,367	73	194,379	(2,769)	73,264	264,947
Comprehensive income:						
Foreign currency translation adjustment				1,597		1,597
Unrealized gains (losses) on investments, net of taxes				27		27
Net income					81,343	81,343
Comprehensive income						82,967
Exercise of stock options	1,142	2	10,620			10,622
Restricted stock units issued, net of shares withheld for taxes	124		(1,472)			(1,472)
Stock-based compensation			15,264			15,264
Excess tax benefit from stock-based compensation			10,486			10,486

Balances at December 31, 2012	74,633	$ 75	$ 229,277	$ (1,145)	$ 154,607	$ 382,814

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

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SolarWinds, Inc.

Consolidated Statements of Cash Flows

(In thousands)

	Year Ended December 31,		
	2012	**2011**	**2010**
Cash flows from operating activities			
Net income	$ 81,343	$ 62,443	$ 44,746
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	18,359	9,957	5,498
Provision for doubtful accounts	258	97	194
Stock-based compensation expense	15,264	10,690	10,880
Accrued earnout gain	(570)	(664)	
Deferred taxes	(989)	2,123	(2,220)
Excess tax benefit from stock-based compensation	(10,486)	(6,359)	(26,748)
Premium on investments	(1,605)	(888)	
Other non-cash expenses	1,432	622	470
Changes in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:			
Accounts receivable	(5,695)	(7,038)	(5,078)
Income taxes receivable	(28)	(33)	31
Prepaid income taxes			4,675
Prepaid and other current assets	(1,220)	(189)	(1,199)
Accounts payable	1,807	56	(1,127)
Accrued liabilities	4,473	747	3,958
Accrued interest payable			(539)
Income taxes payable	18,565	19,886	17,160
Deferred revenue	22,539	19,080	15,342
Net cash provided by operating activities	143,447	110,530	66,043
Cash flows from investing activities			
Purchases of investments	(65,929)	(33,241)	
Maturities of investments	33,930	4,000	
Purchases of property and equipment	(3,885)	(2,945)	(2,740)
Purchases of intangible assets and other	(1,203)	(745)	(795)
Acquisition of businesses, net of cash acquired	(66,031)	(109,483)	(28,039)
Net cash used in investing activities	(103,118)	(142,414)	(31,574)
Cash flows from financing activities			
Repurchase of common stock	(1,472)	(342)	(24,987)
Exercise of stock options	10,622	11,919	21,032
Excess tax benefit from stock-based compensation	10,486	6,359	26,748
Earnout payments for acquisitions	(4,154)	(3,743)	
Repayment of long-term debt			(44,097)
Repayment of capital lease obligations			(9)
Net cash provided by (used in) financing activities	15,482	14,193	(21,313)
Effect of exchange rate changes on cash and cash equivalents	1,184	(1,605)	(941)
Net increase (decrease) in cash and cash equivalents	56,995	(19,296)	12,215
Cash and cash equivalents			
Beginning of period	122,707	142,003	129,788
End of period	$ 179,702	$ 122,707	$ 142,003
Supplemental disclosure of cash flow information			

Cash paid for interest	$	$	$ 1,280
Cash paid (received) for income taxes	$ 15,285	$ 1,013	$ (3,282)
Noncash investing and financing transactions			
Accrued earnout (Note 5)	$ 1,547	$ 3,938	$ 3,743
Stock issued for acquisition (Note 2)	$	$	$ 9,221

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

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SolarWinds, Inc.

Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Organization and Nature of Operations

SolarWinds, Inc., a Delaware corporation, and its subsidiaries (we or us) design, develop, market, sell and support enterprise-class information technology, or IT, infrastructure management software to IT professionals in organizations of all sizes. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT professionals. Our products are designed to help enable efficient and effective management of their networks, systems and application infrastructure.

Basis of Consolidation

The accompanying consolidated financial statements include our accounts and the accounts of our wholly owned subsidiaries. We have eliminated all intercompany balances and transactions.

Reclassifications

Certain reclassifications have been made to prior periods consolidated financial statements to conform to the current period presentation. These reclassifications did not result in any change in previously reported net income, total assets or shareholders equity.

Use of Estimates

The preparation of financial statements in conformity with United States of America generally accepted accounting principles, or GAAP, requires our management to make estimates and assumptions that affect the reported amounts and the disclosure of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. The actual results that we experience may differ materially from our estimates. The accounting estimates that require our most significant, difficult and subjective judgments include:

- the valuation of goodwill, intangibles, long-lived assets and contingent consideration, including accrued earnouts;
- revenue recognition;
- stock-based compensation;
- income taxes; and
- loss contingencies.

Foreign Currency Translation

The functional currency of our foreign subsidiaries is determined in accordance with authoritative guidance issued by the Financial Accounting Standards Board, or FASB. We translate assets and liabilities for these subsidiaries at exchange rates in effect at the balance sheet date. We translate income and expense accounts for these subsidiaries at the average monthly exchange rates for the periods. We record resulting translation adjustments as a component of accumulated other comprehensive income (loss) within stockholders equity (deficit). We record gains and losses from currency transactions denominated in currencies other than the functional currency as other income (expense) in our consolidated statements of income. There were no equity transactions denominated in foreign currencies for the years ended December 31, 2012 and 2011.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Local currency transactions of international subsidiaries that have the U.S. dollar as the functional currency are remeasured into U.S. dollars using current rates of exchange for monetary assets and liabilities and historical rates of exchange for non-monetary assets and liabilities. Gains and losses from remeasurement of monetary assets and liabilities, as reflected within our consolidated statements of income, were not material for the years ended December 31, 2012, 2011 and 2010.

Recent Accounting Pronouncements

In July 2012, FASB issued a standard to provide updated guidance on the periodic testing of indefinite-lived intangible assets for impairment. This guidance will allow companies to assess qualitative factors to determine if it is more likely than not that the indefinite-lived intangible asset might be impaired and whether it is necessary to perform the quantitative impairment test required under current accounting standards. The updated accounting guidance is effective for annual periods beginning after September 15, 2012. Early application is permitted. We adopted the updated guidance in the fourth quarter of fiscal year 2012. Adoption of this standard did not have an impact on our consolidated financial statements.

Acquisitions

We account for acquired businesses using the acquisition method of accounting, which requires that the assets acquired, liabilities assumed, contractual contingencies and contingent consideration be recorded at the date of acquisition at their respective fair values. Goodwill represents the excess of the purchase price, including any contingent consideration, over the fair value of the net assets acquired. It further requires acquisition related costs to be recognized separately from the acquisition and expensed as incurred, most restructuring costs to be expensed in periods subsequent to the acquisition date and changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period to impact the provision for income taxes. The acquired developed product technologies recorded for each acquisition were feasible at the date of acquisition as they were being actively marketed and sold by the acquired company at the acquisition date. In addition to the acquired developed product technologies, we also recorded intangible assets for the acquired companies customer relationships, trademarks, in process research and development and certain non-competition covenants. We include the operating results of acquisitions in our consolidated financial statements from the effective date of the acquisitions. Acquisition related costs are included in general and administrative expenses in our consolidated statements of income.

The fair value of identifiable intangible assets is based on significant judgments made by management. We typically engage third party valuation appraisal firms to assist us in determining the fair values and useful lives of the assets acquired. Such valuations and useful life determinations require us to make significant estimates and assumptions. These estimates and assumptions are based on historical experience and information obtained from management, and also include, but are not limited to, future expected cash flows earned from the product technology and discount rates applied in determining the present value of those cash flows. Unanticipated events and circumstances may occur that could affect the accuracy or validity of such assumptions, estimates or actual results. Acquired identifiable intangible assets are amortized on the net cash flow method over their estimated economic lives, which are generally three to seven years for trademarks, customer relationships, non-competition covenants and acquired developed product technologies and ten years for intellectual property. We include amortization of acquired developed product technologies in cost of license revenue and amortization of other acquired intangible assets in general and administrative expenses in our consolidated statements of income. We record acquired in process research and development as indefinite-lived intangible assets. On completion of the related development projects, the in process research and development assets are reclassified to developed technology and amortized over their estimated economic lives.

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Goodwill, Intangible Assets and Long-lived Assets

As we operate our business in one operating segment and one reporting unit, our goodwill is assessed at the consolidated level for impairment in the fourth quarter of each year or more frequently if events or changes in circumstances indicate that impairment may exist. If we perform a qualitative assessment, we first determine whether it is more likely than not that the fair value of our reporting unit is less than its carrying amount and whether the two-step quantitative analysis is necessary. If determined necessary, for the first step of our quantitative analysis, we consider our market capitalization compared with the carrying amount of our net assets on the date of the test, since we have only one reporting unit. An impairment of goodwill is recognized when the carrying amount exceeds the fair value.

We also evaluate indefinite-lived intangible assets for impairment annually during our fourth fiscal quarter and whenever events or changes in circumstances indicate impairment may exist. We first perform a qualitative assessment to determine whether it is more likely than not that the fair value of our indefinite-lived intangible assets is less than its carrying amount and whether the quantitative analysis is necessary. The quantitative analysis compares the fair value of our indefinite-lived intangible assets to their carrying amount and an impairment loss is recognized when the carrying amount exceeds the fair value.

The process of evaluating the potential impairment related to our goodwill and indefinite-lived intangible assets is highly subjective and requires the application of significant judgment. If an event occurs that would cause us to revise our estimates and assumptions used in analyzing the value of our goodwill and other intangible assets with indefinite lives, the revision could result in a non-cash impairment charge that could have a material impact on our financial results. As of December 31, 2012 and 2011, we performed our annual review of goodwill and indefinite-lived intangible assets and concluded that no impairment existed for our reporting unit during any of the periods presented. No impairment charges have been required to date.

We evaluate long-lived assets, including identifiable intangible assets and other assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Events or changes in circumstances that could result in an impairment review include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for our overall business, and significant negative industry or economic trends. Impairment is recognized when the asset is not recoverable and the carrying amount of an asset exceeds its fair value as calculated on a discounted cash flow basis. If an event occurs that would cause us to revise our estimates and assumptions used in analyzing the value of our property and equipment or our finite-lived intangibles and other assets, that revision could result in a non-cash impairment charge that could have a material impact on our financial results. As of December 31, 2012 and 2011, there were no indicators that our long-lived assets were impaired.

Investments

Short-term and long-term investments at December 31, 2012 and 2011 were as follows:

	December 31,	
(in thousands)	**2012**	**2011**
Short-term investments	$ 49,276	$ 29,688
Long-term investments	12,823	
Total investments	$ 62,099	$ 29,688

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Our short-term and long-term investments, classified as available-for-sale securities, consist primarily of marketable securities such as corporate bonds, municipal bonds and commercial paper. We determine the appropriate classification of our investments at the time of purchase and reevaluate such determination at each balance sheet date. All securities classified as short-term investments have contractual maturities of less than twelve months. All securities classified as long-term investments have contractual maturities greater than twelve months.

Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of stockholders equity (deficit). Any premiums or discounts are amortized or accreted, respectively, to maturity as a component of other income (expense) in our consolidated statements of income. Cash flows from the principal amount of purchases, sales and maturities of available-for-sale securities are classified as cash flows from investing activities. Any amount of premium on purchased securities and discount on matured and sold securities and the related amortization and accretion are classified as cash flows from operating activities in our consolidated statements of cash flows. During 2012, we reclassified the purchased premium and matured discount on investments from cash flows from investing activities to cash flows from operating activities in our consolidated statements of cash flows for the prior periods presented to conform to the current period presentation which impacted cash flows from operations and investing but had no impact on total cash flows.

The cost of securities sold is based on the specific-identification method. In determining if and when a decline in fair value is judged to be other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value and the intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair market value. Declines in fair value deemed other-than-temporary are included as a component of other income (expense). We have not recorded any other-than-temporary impairments related to marketable securities. See Note 4 for a summary of our investments.

Fair Value Measurements

We apply the authoritative guidance on fair value measurements for financial assets and liabilities that are measured at fair value on a recurring basis and non-financial assets and liabilities, such as goodwill, indefinite-lived intangible assets and property, plant and equipment that are measured at fair value on a non-recurring basis.

The guidance establishes a three-tiered fair value hierarchy that prioritizes inputs to valuation techniques used in fair value calculations. The three levels of inputs are defined as follows:

Level 1: Unadjusted quoted prices for identical assets or liabilities in active markets accessible by us.

Level 2: Inputs that are observable in the marketplace other than those inputs classified as Level 1.

Level 3: Inputs that are unobservable in the marketplace and significant to the valuation.

We determine the fair value of our available-for-sale securities based on inputs obtained from multiple pricing vendors, who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, we classify all of our available-for-sale securities as being valued using Level 2 inputs. The valuation techniques used to determine the fair value of our financial instruments having Level 2 inputs are derived from unadjusted, non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models. Our procedures include controls to ensure that appropriate fair values are recorded by a review of the valuation methods and assumptions.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

We began classifying our available-for-sale securities as being valued using Level 2 inputs in the fourth quarter of 2012 and have reclassified our balances at December 31, 2011 as being valued using Level 2 inputs rather than Level 1 inputes to conform to the current period presentation. The change in fair value classification from Level 1 inputs to Level 2 inputs had no impact on the recorded fair values of our available-for-sale securities in our previously reported consolidated financial statements. See Note 5 for a summary of our financial instruments and acquisition related contingent considerations accounted for at fair value on a recurring basis. The carrying amounts reported in our consolidated balance sheets for cash, accounts receivable, accounts payable and other accrued expenses approximate fair value due to relatively short periods to maturity.

Contingent Consideration

Contingent consideration, which includes earnout payments in connection with our acquisitions, is recognized at fair value on the acquisition date and remeasured each reporting period with subsequent adjustments recognized in our consolidated statements of income. We estimate the fair value of contingent consideration liabilities based on certain milestones of the acquired companies and estimated probabilities of achievement and discount the liabilities to present value using our pre-tax cost of debt. Contingent consideration is valued using significant inputs that are not observable in the market which are defined as Level 3 inputs pursuant to fair value measurement accounting. We believe our estimates and assumptions are reasonable, however, there is significant judgment involved. At each reporting date, the contingent consideration liability is revalued to estimated fair value.

Changes in the fair value of contingent consideration liabilities may result from changes in discount periods, changes in the timing and amount of sales and/or other specific milestone estimates and changes in probability assumptions with respect to the likelihood of achieving the various earnout criteria. We reflect changes in fair value due to probability changes as accrued earnout (gains) losses in total operating expenses and changes in fair value due to the passage of time as an expense in total other income (expense) in our consolidated statements of income. These changes could cause a material impact to, and volatility in our operating results. Earnout payments are reflected in cash flows from financing activities and the changes in fair value are reflected in cash flows from operating activities in our consolidated statements of cash flows.

Previously, we classified acquisition related earnout payments as cash flows from investing activities in our consolidated statement of cash flows as they related to acquisitions; however, we now believe it is more appropriate to classify earnout payments within cash flows from financing activities as the delayed payments for acquisitions are more analogous to financing activities. As such, we have reclassified the earnout payments made during the prior periods from cash flows from investing activities to cash flows from financing activities in our consolidated statement of cash flows to conform to current period presentation.

Derivative Instruments

We utilize purchased foreign currency forward contracts to minimize our foreign exchange exposure on certain foreign balance sheet positions denominated in currencies other than the Euro. We do not use forward contracts for trading or speculative purposes. Our use of foreign currency forward exchange contracts is intended to principally offset gains and losses associated with these exposures. Therefore, the notional amounts and currencies underlying our foreign currency forward contracts will fluctuate period to period as they are principally dependent on the balances of the balance sheet positions maintained by our international entities that are denominated in currencies other than the Euro.

These foreign currency forward contracts are not designated as hedging instruments, and the gain or loss on the derivatives is recognized in our consolidated statements of income as other income (expense). The fair value

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

of our outstanding foreign currency forward contracts in a gain position is recorded within prepaid and other current assets and the fair value of contracts in a loss position is recorded within accrued liabilities in our consolidated balance sheets. The maturities of the forward contracts are generally less than three months. See Note 6 for further discussion of our derivative instruments.

Accounts Receivable

Accounts receivable represent trade receivables from customers when we have provided software licenses and/or software maintenance agreements and we have not yet received payment. We present accounts receivable net of an allowance for doubtful accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. In doing so, we consider the current financial condition of the customer, the specific details of the customer account, the age of the outstanding balance and the current economic environment. Any change in the assumptions used in analyzing a specific account receivable might result in an additional allowance for doubtful accounts being recognized in the period in which the change occurs. We have historically had insignificant write-offs related to bad debts.

Property and Equipment

We record property and equipment at cost and depreciate them using the straight-line method over their estimated useful lives as follows:

	Useful Life (in years)
Equipment and other	5
Furniture and fixtures	5 - 7
Software	3 - 5
Leasehold improvements	Lesser of lease term or useful life

Upon retirement or sale of property and equipment, we remove the cost of assets disposed of and any related accumulated depreciation from our accounts and credit or charge any resulting gain or loss to operating expense. We expense repairs and maintenance as they are incurred.

Costs related to software developed or obtained for internal use are included in property and equipment and are depreciated on a straight line basis over the useful life of the software. Costs incurred during the preliminary planning and evaluation stage of the project and during the post implementation operational stage are expensed as incurred. Costs incurred during the application development stage of the project are capitalized.

Capitalized Software

Costs incurred in the research and development of our products are expensed as incurred, except for certain software development costs. We expense costs associated with the development of computer software to be marketed prior to the establishment of technological feasibility and capitalize them from the point technological

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

feasibility is reached until the product is ready for general availability. At December 31, 2012 and 2011, we had unamortized capitalized software development costs of $0.4 million and $0.2 million, respectively, related to localizing our products.

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. Capitalized localization product costs are included in intangible assets and other, net in our consolidated balance sheets and are amortized over their estimated useful life, generally three to five years. Amortization of capitalized software development costs is included in cost of license revenue in our consolidated statements of income and was insignificant for the years ended December 31, 2012, 2011 and 2010.

Website Development Costs

We capitalize certain direct costs to develop functionality as well as certain upgrades and enhancements that are probable to result in additional functionality to our website. The costs incurred in the preliminary stages of development are expensed as incurred. Once an application has reached the development stage, costs are capitalized until the software is substantially complete and ready for its intended use. Capitalized website development costs are recorded in intangible assets and other, net in our consolidated balance sheets and amortized over their estimated useful life, generally three years, as general and administrative expenses in our consolidated statements of income. Capitalized website development costs at December 31, 2012 and 2011 were insignificant.

Long-Term Debt

On December 13, 2005, we entered into credit agreements with an investment management firm pursuant to which we borrowed $85.0 million on a first lien note, or First Lien Note, and $25.0 million on a second lien note, or Second Lien Note, and collectively the Notes. We amortize debt issuance costs over the term of the associated debt. In March 2010, we repaid the $19.1 million outstanding principal balance on our First Lien Note and wrote-off $0.2 million of debt issuance costs associated with the note. In May 2010, we fully repaid the $25.0 million outstanding principal balance on our Second Lien Note and wrote-off the remaining $0.1 million of debt issuance costs. The amortization and write-off of debt issuance costs of $0.4 million were included in interest expense for the year ended December 31, 2010.

Contingencies

We account for claims and contingencies in accordance with authoritative guidance that requires we record an estimated loss from a claim or loss contingency when information available prior to issuance of our consolidated financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of our consolidated financial statements and the amount of the loss can be reasonably estimated. If we determine that it is reasonably possible but not probable that an asset has been impaired or a liability has been incurred or if the amount of a probable loss cannot be reasonably estimated, then in accordance with the authoritative guidance, we disclose the amount or range of estimated loss if the amount or range of estimated loss is material. Accounting for claims and contingencies requires us to use our judgment. We consult with legal counsel on those issues related to litigation and seek input from other experts and advisors with respect to matters in the ordinary course of business. See Note 14 for a discussion of contingencies.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Revenue Recognition

We derive substantially all of our revenue from the licensing of our software products and from the sale of annual maintenance agreements for these products. We typically include one year of maintenance as part of the initial purchase price of each software offering and then sell renewals of this maintenance agreement. In accordance with current guidance, we recognize revenue for software, maintenance and other services when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is probable. Our return policy generally does not allow our customers to return software products.

License Revenue. We consider delivery of our software to have occurred and recognize revenue from the sale of perpetual licenses to our software when risk of loss transfers to the customer, reseller or distributor, which is generally upon electronic transfer of the license key that provides immediate availability of the product to the purchaser.

We sell licenses to our software products through our direct sales force and through our distributors and other resellers. Our distributors and resellers do not carry inventory of our software and we generally require them to specify the end-user of the software at the time of the order. If the distributor or reseller does not provide end-user information, then we will generally not fulfill the order. Our distributors and resellers have no rights of return or exchange for software that they purchase from us and payment for these purchases is due to us without regard to whether the distributors or resellers collect payment from their customers. We account for sales incentives to customers, resellers or distributors as a reduction of revenue at the time we recognize the revenue from the related product sale. We report revenue net of any sales tax collected.

We generally use a purchase order, an authorized credit card, an electronic or manually signed license agreement, or the receipt of a cash payment as evidence of an arrangement. Sales through resellers and distributors are typically evidenced by a reseller or distributor agreement, together with purchase orders or authorized credit cards on a transaction-by-transaction basis.

Because our software is generally sold with maintenance, we calculate the amount of revenue allocated to the software license by determining the fair value of the maintenance and subtracting it from the total invoice or contract amount. We establish vendor-specific objective evidence, or VSOE, of the fair value of maintenance services by the standard published list pricing for our maintenance renewals since we generally charge list prices for our maintenance renewals.

Maintenance and Other Revenue. We derive maintenance revenue from fees for software maintenance services. We recognize maintenance revenue ratably on a daily basis over the contract period. Customers with maintenance agreements are entitled to receive unspecified upgrades or enhancements to new versions of their software products on a when-and-if-available basis. Other revenue consists primarily of subscription revenue which is recognized ratably on a daily basis over the contract period. Other revenue for the years ended December 31, 2012, 2011 and 2010 was insignificant.

Deferred Revenue

Deferred revenue consists of billings or payments received in advance of revenue recognition from maintenance fees and training services. We generally bill maintenance agreements annually in advance for services to be performed over a 12-month period. Customers have the option to purchase maintenance renewals for periods other than 12 months. We initially record the amounts to be paid under maintenance agreements as deferred revenue and recognize these amounts ratably on a daily basis over the term of the maintenance agreement. We record deferred revenue that will be recognized during the succeeding 12-month period as current deferred revenue and the remaining portion is recorded as long-term deferred revenue.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Cost of Revenue

Cost of License Revenue. Cost of license revenue consists primarily of amortization of acquired developed product technologies and third party software license royalties. Third party software license royalties are amortized based on the number of units issued. Amortization of acquired developed product technologies and third party software license royalties included in cost of license revenue was as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Acquired developed product technologies	$ 7,300	$ 3,652	$ 1,730
Third party software licenses	791	438	187

Cost of Maintenance and Other Revenue. Cost of maintenance and other revenue consists of compensation and benefits related to personnel providing customer support and an allocation of facilities and other overhead costs, including depreciation.

Advertising

We expense advertising costs as incurred. Advertising expense is included in sales and marketing expenses in our consolidated statements of income.

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Advertising expense	$ 3,360	$ 2,704	$ 3,798

Leases

We lease facilities worldwide and certain equipment under non-cancelable lease agreements. The terms of some of our lease agreements provide for rental payments on a graduated basis. We recognize rent expense on a straight-line basis over the lease period and accrue rent expense incurred but not paid.

Income Taxes

We use the liability method of accounting for income taxes as set forth in the authoritative guidance for accounting for income taxes. Under this method, we recognize deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the respective carrying amounts and tax basis of our assets and liabilities.

The guidance on accounting for uncertainty in income taxes prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. We accrue interest and penalties related to unrecognized tax benefits as a component of income tax expense. There was an insignificant amount accrued for interest and penalties related to unrecognized tax benefits as of December 31, 2012 and 2011.

We establish valuation allowances when necessary to reduce deferred tax assets to the amounts expected to be realized. On a quarterly basis, we evaluate the need for, and the adequacy of, valuation allowances based on the expected realization of our deferred tax assets. The factors used to assess the likelihood of realization include our latest forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

We intend either to invest our non-U.S. earnings permanently in foreign operations or to remit these earnings to our U.S. entities in a tax-free manner. For this reason, we do not record federal income taxes on the undistributed earnings of our foreign subsidiaries.

Stock-Based Compensation

We have granted our employees and directors stock-based incentive awards. These awards are in the form of stock options, restricted stock and restricted stock units. We measure stock-based compensation expense for all share-based awards granted based on the estimated fair value of those awards on the date of grant. The fair values of stock option awards are estimated using a Black-Scholes valuation model. The fair value of restricted stock and restricted stock unit awards is determined using the fair market value of our common stock based on the quoted market price on the date of grant, or intrinsic value.

We estimated the fair value for options at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Year Ended December 31,		
	2012	**2011**	**2010**
Expected dividend yield	0.0%	0.0%	0.0%
Volatility	54.2%	54.8%	59.4%
Risk-free rate of return	0.8-1.4%	1.1-2.7%	1.5-2.9%
Expected life	6.14 years	6.00 years	6.02 years

We have not paid and do not anticipate paying cash dividends on our common stock; therefore, we assume the expected dividend yield to be zero. Since we were a private entity prior to our IPO in May 2009 with no historical data regarding the volatility of our own common stock price, we based the expected volatility on the historical and implied volatility of comparable companies from a representative industry peer group. We determined expected volatility of options granted using an average of the historical volatility measures of this peer group of companies. We based the risk-free rate of return on the average U.S. treasury yield curve for five- and seven-year terms for the years ended December 31, 2012, 2011 and 2010. As allowed under current guidance, we have elected to apply the simplified method in developing our estimate of expected life for plain vanilla stock options by using the midpoint between the vesting date and contractual termination date since we do not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time our common stock has been publicly traded. For all dates, we granted employees options at exercise prices equal to the fair value of the underlying common stock on the date of grant, which is the closing price of our common stock as reported by the NYSE.

The reduction in income before income taxes due to stock-based compensation expense and the related income tax benefits were as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Reduction in income before income taxes due to stock-based compensation	$ 15,264	$ 10,690	$ 10,880
Income tax benefit related to stock-based compensation	4,197	2,557	2,722

An excess tax benefit arises when the tax deduction related to a stock option award is greater than the award s original grant date fair value pursuant to the authoritative guidance. For financial reporting purposes, this excess tax benefit is not recorded as a tax benefit in our consolidated statements of income and is instead treated as additional paid-in capital in our consolidated balance sheets.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Tax benefits and excess tax benefits from the exercise of stock option awards were as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Tax benefit from the exercise of stock option awards	$ 12,051	$ 8,429	$ 32,060
Excess tax benefit from the exercise of stock option awards	10,486	6,359	26,748

These excess tax benefits are a reduction to our cash payments related to income taxes and must be reported as cash flows from financing activities in our consolidated statements of cash flows.

Earnings Per Share

We computed basic earnings per share available to common stockholders by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the reporting period. We computed diluted earnings per share similarly to basic earnings per share except that it reflects the potential dilution that could occur if dilutive securities or other obligations to issue common stock were exercised or converted into common stock.

Concentrations of Risks

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and cash equivalents, short-term and long-term investments and accounts receivable. We consider all highly liquid investments with original maturities of three months or less to be cash equivalents. Our cash and cash equivalents consisted of the following:

	December 31,	
(in thousands)	**2012**	**2011**
Demand deposit accounts	$ 82,195	$ 30,371
Money market funds	97,507	92,336
Total cash and cash equivalents	$ 179,702	$ 122,707

Our cash deposited with banks in demand deposit accounts may exceed the amount of insurance provided on these deposits. Our cash equivalents invested in money market funds are not insured and we are therefore at risk of losing our full investment. Generally, we may withdraw our cash deposits and redeem our invested cash equivalents upon demand. We strive to maintain our cash deposits and invest in money market funds with multiple financial institutions of reputable credit and therefore bear minimal credit risk.

We provide credit to distributors, resellers and direct customers in the normal course of business. We generally extend credit to new customers based upon industry reputation and existing customers based upon prior payment history. The following distributors represented more than 10% of our revenue:

	Year Ended December 31,		
	2012	**2011**	**2010**
Distributor A	*%	*%	10.0%
Distributor B	10.2	11.9	12.4

* Represented less than 10% of our revenue

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

At December 31, 2012 and 2011, no distributor, reseller or direct customer represented more than 10% of our outstanding accounts receivable balance. We do not believe that our business is substantially dependent on either distributor or that the loss of either relationship would have a material adverse effect on our business.

2. Acquisitions

2012 Acquisitions

In January 2012, we acquired certain assets of EminentWare, Inc., or EminentWare, a provider of patch management software. We released SolarWinds Patch Manager, based on the products acquired from EminentWare, which added patch management capabilities to our systems and application management product portfolio.

In April 2012, we acquired certain assets of Rove Mobile, Inc., or Rove, a provider of mobile IT management software. We acquired the Mobile Admin product from Rove, which allows IT administrators to monitor and manage their corporate IT infrastructure from mobile devices.

In July 2012, we acquired the assets related to the Web Help Desk software product from MacsDesign, LLC, or MacsDesign, for approximately $20.0 million in cash. By acquiring these assets, we increased our product offerings to include IT help desk software that solves problems around IT-specific ticketing, change management and asset management.

In August 2012, we acquired Athena Security, Inc., or Athena, a provider of firewall analytics and management software. We released SolarWinds Firewall Security Manager, based on the acquired Athena technology, which allows IT administrators to address key issues in managing firewalls and router security management.

In December 2012, we acquired Rhino Software, Inc., or RhinoSoft, a provider of file transfer management software products. We released SolarWinds Serv-U Managed File Transfer Server and SolarWinds FTP Voyager, based on the acquired RhinoSoft technology, which are secure managed file transfer solutions that allows IT administrators to monitor the movement and transfers of sensitive company materials and business-critical information.

We recorded $48.0 million of goodwill for our 2012 acquisitions of which $27.4 million is deductible for tax purposes. The acquisitions were financed with available cash and we incurred $1.0 million in acquisition related costs, which are included in general and administrative expense for the year ended December 31, 2012. The weighted average amortization period for the intangible assets was 5.1 years.

We allocated the purchase price for our 2012 acquisitions as follows:

	Fair Value (in thousands)	Useful Life (in years)
Intangible assets:		
Developed product technologies	$ 19,112	5
Customer relationships	4,264	4 - 5
Non-competition covenant	551	4 - 6
In process research and development	1,889	
Goodwill	48,040	
Deferred revenue	(2,498)	
Net other liabilities	(3,056)	
Total purchase price, net of cash acquired	$ 68,302	

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Pro forma information for the acquisitions has not been provided because the impact of the historical financials on our revenues, net income and earnings per share is not material. We have integrated the acquired businesses into our broader IT infrastructure management business eliminating overlapping processes and expenses and integrating the products and sales efforts. Therefore, there are no separate revenue and earnings for the acquisitions since their respective integration into our business model. Our consolidated financial statements include the operating results of these acquired businesses from the effective date of each acquisition. We recognize revenue on the acquired products in accordance with our revenue recognition policy as described above in Note 1.

2011 Acquisitions

In January 2011, we acquired Hyper9, Inc., or Hyper9 for approximately $23.0 million in cash and contingent consideration ranging from $0 to $7.0 million based on sales milestones for the one year period after the closing of the acquisition. Hyper9 increased our product offerings to include virtualization management software and eliminated the normal time to market required to develop a new software product. In February 2012, we paid approximately $3.5 million of cash upon the achievement of these sales milestones related to the acquisition. In 2011, we also incurred $0.7 million in acquisition related expenses for Hyper9. The acquisition was financed with available cash. The weighted average amortization period for the intangible assets acquired was 6.8 years. Goodwill is not deductible for tax purposes.

In July 2011, we acquired TriGeo Network Security, Inc., or TriGeo, for approximately $35.5 million in cash. By acquiring TriGeo, we increased our product offerings to include log and event management software. In 2011, we incurred $0.2 million in acquisition related costs for TriGeo. The acquisition was financed with available cash. The weighted average amortization period for the intangible assets acquired was 6.3 years. Goodwill is not deductible for tax purposes.

In October 2011, we acquired DNS Enterprise, Inc., or DNS, a provider of free tools and inexpensive subscription-based tools used by a community of system administrators, application administrators, network engineers and IT professionals.

In December 2011, we acquired certain assets of privately-held DameWare Development LLC, or DameWare, for $40.0 million in cash. DameWare increased our product offerings to include remote system management and administration software tools and eliminated the normal time to market required to develop new software products. We incurred $0.5 million in acquisition related costs for DameWare. The acquisition was financed with available cash. The weighted average amortization period for the intangible assets acquired was 6.6 years. The goodwill recorded is deductible for tax purposes.

We allocated the purchase prices for the material acquisitions completed during 2011 as follows:

	Total Fair Value	Hyper9 Fair Value	TriGeo Fair Value	DameWare Fair Value	Useful Life (in years)
		(in thousands)			
Intangible assets:					
Developed product technologies	$ 28,509	$ 7,978	$ 12,240	$ 8,291	7
Customer relationships	9,661	560	3,439	5,662	4 - 6
Trademarks	1,619			1,619	7
Non-competition covenant	1,302	462	365	475	3 - 5
Goodwill	63,234	14,663	24,618	23,953	
Deferred revenue	(2,918)	(258)	(2,660)		
Net other assets (liabilities)	1,026	3,533	(2,507)		
Total purchase price, net of cash acquired	$ 102,433	$ 26,938	$ 35,495	$ 40,000	

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Notes to Consolidated Financial Statements (Continued)

2010 Acquisition

On January 26, 2010, we acquired certain of the assets of Tek-Tools, Inc., or Tek-Tools, for the following: (i) $26.0 million in cash; (ii) 362,138 shares of our common stock with a value of approximately $7.4 million based on the closing price of our common stock as reported on the New York Stock Exchange on January 26, 2010; (iii) $2.0 million of cash and 90,535 shares of our common stock with a value of approximately $1.8 million based on the closing price of our common stock on the date of the acquisition, each was held in escrow as security for breaches of representations and warranties, covenants and certain other expressly enumerated matters by Tek-Tools and its stockholders; (iv) $2.0 million of cash being withheld to be paid upon the achievement of sales milestones of the acquired business during calendar year 2010; and (v) $2.0 million of cash being withheld to be paid upon the receipt of certain third party consents. The acquisition was financed with available cash and issuance of equity. In February 2011, we paid $4.0 million of cash upon the achievement of certain performance criteria related to the acquisition.

Tek-Tools provided us an immediate product offering of storage and virtualized server infrastructures that was missing from our product offerings and eliminated the normal time to market required to develop a new software product. The weighted average amortization period for the intangible assets acquired was 6.7 years. We also incurred acquisition related costs of approximately $0.4 million. The goodwill recorded is deductible for tax purposes.

We allocated the purchase price for Tek-Tools as follows:

	Tek-Tools Fair Value (in thousands)	Useful Life (in years)
Intangible assets:		
Developed product technologies	$ 9,571	7
Customer relationships	5,330	6
Trademarks	2,922	7
Non-competition covenant	295	5
Goodwill	25,190	
Deferred revenue	(2,380)	
Net other assets	36	
Total purchase price	$ 40,964	

3. Goodwill and Intangible Assets

Goodwill

The following table reflects the changes in goodwill for the years ended December 31, 2012 and 2011:

(in thousands)	
Balance at December 31, 2010	$ 40,424
Acquisitions	70,592
Foreign currency translation and other adjustments	(270)
Balance at December 31, 2011	$ 110,746

Acquisitions	48,040
Foreign currency translation and other adjustments	(185)
Balance at December 31, 2012	$ 158,601

The goodwill from acquisitions resulted primarily from our expectations that we will now be able to offer our customers additional products in new markets. Additionally, we expect the acquisitions will attract new customers for our entire line of products.

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Intangible Assets

Intangible assets consisted of the following at December 31, 2012 and 2011:

(in thousands)	December 31, 2012 Gross Carrying Amount	December 31, 2012 Accumulated Amortization	December 31, 2012 Net	December 31, 2011 Gross Carrying Amount	December 31, 2011 Accumulated Amortization	December 31, 2011 Net
Developed product technologies	$ 59,095	$ (12,461)	$ 46,634	$ 40,904	$ (6,266)	$ 34,638
Customer relationships	21,590	(8,108)	13,482	17,394	(2,962)	14,432
Intellectual property	1,193	(422)	771	1,058	(309)	749
Trademarks	6,564	(3,441)	3,123	6,740	(1,725)	5,015
Non-competition covenant	2,355	(632)	1,723	1,797	(229)	1,568
In process research and development	1,887		1,887			
Total intangible assets	$ 92,684	$ (25,064)	$ 67,620	$ 67,893	$ (11,491)	$ 56,402

Intangible asset amortization expense was as follows:

(in thousands)	Year Ended December 31, 2012	2011	2010
Intangible asset amortization expense	$ 15,007	$ 7,170	$ 3,170

As of December 31, 2012, we estimate aggregate intangible asset amortization expense to be as follows:

(in thousands)	
2013	$ 16,918
2014	17,146
2015	14,771
2016	10,824
2017	5,881

The expected amortization expense is an estimate. Actual amounts of amortization expense may differ from estimated amounts due to additional intangible asset acquisitions, changes in foreign currency exchange rates, impairment of intangible assets, accelerated amortization of intangible assets and other events. We had $0.6 million of trademarks recorded with an indefinite life that are not amortized at December 31, 2012 and 2011.

4. Investments

Our cash equivalents as of December 31, 2012 and 2011 consisted of money market funds. Our short-term and long-term investments as of December 31, 2012 and 2011 consisted of corporate bonds, municipal bonds and

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

commercial paper. The following table summarizes our short-term and long-term available-for-sale securities as of December 31, 2012 and 2011:

(in thousands)	December 31, 2012 Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	December 31, 2011 Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term investments:								
Available-for-sale securities:								
Corporate bonds	$ 22,206	$ 16	$ (14)	$ 22,208	$ 16,561	$	$ (15)	$ 16,546
Municipal bonds	11,604		(3)	11,601	7,153		(3)	7,150
Commercial paper	15,465	2		15,467	5,991	2	(1)	5,992
Total short-term investments	$ 49,275	$ 18	$ (17)	$ 49,276	$ 29,705	$ 2	$ (19)	$ 29,688
Long-term investments:								
Available-for-sale securities:								
Corporate bonds	$ 11,704	$ 35	$ (10)	$ 11,729	$	$	$	$
Municipal bonds	1,095		(1)	1,094				
Total long-term investments	$ 12,799	$ 35	$ (11)	$ 12,823	$	$	$	$

The following table summarizes the fair value of our available-for-sale securities with unrealized losses aggregated by type of investment instrument and length of time those securities have been in a continuous unrealized loss position:

(in thousands)	Less Than 12 Months Fair Value	Gross Unrealized Losses	12 Months or Greater Fair Value	Gross Unrealized Losses	Total Fair Value	Gross Unrealized Losses
As of December 31, 2012						
Corporate bonds	$ 20,167	$ (24)	$	$	$ 20,167	$ (24)
Municipal bonds	12,695	(4)			12,695	(4)
	$ 32,862	$ (28)	$	$	$ 32,862	$ (28)

(in thousands)	Less Than 12 Months Fair Value	Gross Unrealized Losses	12 Months or Greater Fair Value	Gross Unrealized Losses	Total Fair Value	Gross Unrealized Losses
As of December 31, 2011						
Corporate bonds	$ 14,456	$ (15)	$	$	$ 14,456	$ (15)
Municipal bonds	7,150	(3)			7,150	(3)
Commercial paper	2,000	(1)			2,000	(1)

	$ 23,606	$	(19)	$	$	$ 23,606	$	(19)

The following table summarizes the contractual underlying maturities of our available-for-sale securities as of December 31, 2012:

(in thousands)	**Cost**	**Fair Value**
Due in one year or less	$ 49,275	$ 49,276
Due after one year through five years	12,799	12,823
	$ 62,074	$ 62,099

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

5. Fair Value Measurements

The following table summarizes the fair value of our financial assets and liabilities that were measured on a recurring basis as of December 31, 2012 and 2011:

(in thousands)	Fair Value Measurements at December 31, 2012 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Fair Value Measurements at December 31, 2011 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:								
Cash equivalents:								
Money market funds	$ 97,507	$	$	$ 97,507	$ 92,336	$	$	$ 92,336
Total cash equivalents	97,507			97,507	92,336			92,336
Short-term investments:								
Corporate bonds		22,208		22,208		16,546		16,546
Municipal bonds		11,601		11,601		7,150		7,150
Commercial paper		15,467		15,467		5,992		5,992
Total short-term investments		49,276		49,276		29,688		29,688
Long-term investments:								
Corporate bonds		11,729		11,729				
Municipal bonds		1,094		1,094				
Total long-term investments		12,823		12,823				
Total assets	$ 97,507	$ 62,099	$	$ 159,606	$ 92,336	$ 29,688	$	$ 122,024
Liabilities:								
Accrued earnout	$	$	$ 121	$ 121	$	$	$ 3,513	$ 3,513
Total liabilities	$	$	$ 121	$ 121	$	$	$ 3,513	$ 3,513

Contingent Consideration

A reconciliation of the beginning and ending balances of acquisition related accrued earnouts using significant unobservable inputs (Level 3) for year ended December 31, 2012 follows:

(in thousands)	
Accrued earnout liability as of December 31, 2011	$ 3,513

Acquisition date fair value of contingent consideration		1,547
Change in fair value of contingent consideration		(496)
Payment of contingent consideration		(4,443)
Accrued earnout liability as of December 31, 2012	$	121

In February 2012, we paid approximately $3.5 million of cash upon the achievement of sales milestones in relation to the Hyper9 acquisition. In September 2012, we also paid $1.0 million in acquisition related contingent consideration upon the completion of engineering deliverables associated with a 2012 acquisition. This payment represented the maximum potential earnout payable.

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

The following table summarizes the quantitative information including the unobservable inputs related to our acquisition related accrued earnout as of December 31, 2012:

Quantitative Information about Level 3 Fair Value Measurements

(in thousands)	Fair Value at December 31, 2012	Valuation Technique	Unobservable Input	Range (Input Used)
Accrued earnout (1)	$ 121	Expected present value	Probability of achieving earnout objectives per the purchase agreement	0% - 100%(5%)
			Pre-tax cost of debt	4.6%

(1) Acquisition related contingent consideration of $2.5 million to be paid if new license sales during the one-year earnout measurement period equal or exceed the milestone specified in the purchase agreement.

At each reporting date, the contingent consideration liability is revalued to estimated fair value and changes in the estimates used to determine the probabilities could result in a change to the fair value measurement.

6. Derivative Instruments

As of December 31, 2012 and December 31, 2011, we did not have any forward contracts outstanding. The effect of derivative instruments not designated as hedging instruments in our consolidated statements of income is summarized below:

(in thousands)	Gains (Losses) Recognized in Net Income on Derivatives			
Derivatives not Designated as Hedging Instruments	Location of Gain (Loss) Recognized in Net Income	Year Ended December 31, 2012	2011	2010
Foreign exchange contracts	Other income, net	$ (24)	$	$

7. Property and Equipment

Property and equipment, including software, consisted of the following at December 31, 2012 and 2011:

(in thousands)	December 31, 2012	2011
Equipment and other	$ 7,849	$ 6,639
Furniture and fixtures	3,416	2,750
Software	1,185	2,047
Leasehold improvements	3,398	2,442
	$ 15,848	$ 13,878
Less: Accumulated depreciation and amortization	(7,506)	(6,537)

Property and equipment, net	$ 8,342	$ 7,341

Depreciation and amortization expense on property and equipment for the years ended December 31, 2012, 2011 and 2010 was as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Depreciation and amortization expense	$ 2,985	$ 2,597	$ 2,126

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

8. Accrued Liabilities

Accrued liabilities at December 31, 2012 and 2011 were as follows:

	December 31,	
(in thousands)	**2012**	**2011**
Payroll-related accruals	$ 11,635	$ 7,089
Other accrued expenses	2,591	2,353
Total accrued liabilities	$ 14,226	$ 9,442

9. Stockholders Equity and Stock-Based Compensation

Common Stock and Preferred Stock

As set by our certificate of incorporation, the Company has authorized capital stock of 133,000,000 shares with a par value of $0.001 per share, comprised of 123,000,000 shares of common stock and 10,000,000 shares of preferred stock.

2005 Stock Plan

Our Amended and Restated Stock Incentive Plan, or 2005 Stock Plan, was adopted by our board of directors and approved by our stockholders on December 14, 2005. Our 2005 Stock Plan provides for the grant of incentive stock options, nonstatutory stock options and restricted stock to our employees, directors and consultants. Our ability to grant any future equity awards under the 2005 Stock Plan was terminated in May 2009 following the consummation of our IPO. As of December 31, 2012, options to purchase 1,292,171 shares of common stock were outstanding under the 2005 Stock Plan. Our 2005 Stock Plan will continue to govern the terms and conditions of the outstanding equity awards granted under the 2005 Stock Plan.

The standard form of option agreement under the 2005 Stock Plan provides that options will vest over four years with 25% of the options vesting on the first anniversary of the vesting commencement date and the remainder vesting ratably on a monthly basis over the remaining period, subject to continued service through each applicable date and have a ten year contractual term. Under our 2005 Stock Plan, our board of directors, or its designated committee, has the authority to grant options with early exercise rights, subject to our repurchase right that lapses as the shares vest on the original vesting schedule, and to provide for accelerated vesting.

Our 2005 Stock Plan provides that our board of directors, or its designated committee, shall equitably and proportionally adjust or substitute outstanding options upon certain events, including, without limitation, changes in our capitalization through stock splits, recapitalizations, mergers or consolidations. In lieu of an adjustment, our board of directors, or its designated committee, may terminate and cancel outstanding options in exchange for a cash payment or other consideration to the optionholder upon certain corporate events, including a change of control. The payment must equal the amount paid per share in connection with the event less the applicable exercise price per share for each cancelled option subject to exercise.

2008 Stock Plan

Our board of directors adopted and our stockholders approved our 2008 Equity Incentive Plan, or 2008 Stock Plan, in May 2008. Our 2008 Stock Plan provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, or the Code, to our employees and any parent and subsidiary corporations employees, and for the grant of nonstatutory stock options, restricted

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

stock, restricted stock units, stock appreciation rights, performance shares and performance units to our employees, directors and consultants and our parent and subsidiary corporations employees and consultants. All equity awards that have been granted following our IPO were granted under our 2008 Stock Plan. As of December 31, 2012, stock-based incentive awards of 2,928,697 were outstanding and 10,298,837 shares of common stock were reserved for future grants under the 2008 Stock Plan.

The exercise price of an option granted under our 2008 Stock Plan must be at least equal to the fair market value of our common stock on the date of grant unless granted pursuant to a transaction described in, and in a manner consistent with, Section 424(a) of the Code. Options and restricted stock units granted under our 2008 Stock Plan generally vest over three to four years with the first tranche of the options vesting on the first anniversary of the vesting commencement date and the remainder vesting ratably on a monthly basis over the remaining period, subject to continued service through each applicable date. The term of an incentive stock option granted under our 2008 Stock Plan may not exceed ten years, except that, with respect to any participant who owns 10% or more of the voting power of all classes of our outstanding stock as of the grant date, the term must not exceed five years and the exercise price must equal at least 110% of the fair market value on the grant date unless granted pursuant to a transaction described in, and in a manner consistent with, Section 424(a) of the Code.

Option grant activity under the 2005 and 2008 Stock Plans were as follows:

	Number of Shares Outstanding	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Weighted-Average Remaining Contractual Term (in years)
Outstanding balances at December 31, 2011	3,581,631	$ 12.01		
Options granted	883,302	34.43		
Options exercised	(1,142,188)	9.29		
Options forfeited	(69,145)	27.17		
Outstanding balances at December 31, 2012	3,253,600	$ 18.78		
Options exercisable at December 31, 2012	1,876,912	$ 11.74	$ 76,417	6.14
Options vested and expected to vest at December 31, 2012	2,988,138	$ 17.81	$ 103,801	7.02

Additional information regarding options follows (in thousands except for per share amounts):

	Year Ended December 31,		
	2012	2011	2010
Weighted-average grant date fair value per share of options granted during the period	$ 17.63	$ 12.03	$ 10.22
Aggregate intrinsic value of options exercised during the period	38,952	26,247	73,182
Aggregate fair value of options vested during the period	8,506	8,484	8,454

The total unrecognized stock-based compensation expense related to unvested stock options and subject to recognition in future periods was $14.4 million as of December 31, 2012 and we expect to recognize this expense over a weighted-average period of 2.91 years.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Restricted Stock Units

The following table summarizes restricted stock unit activity under the 2008 Stock Plan:

	Number of Units Outstanding	Weighted-Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value (in thousands)	Weighted-Average Remaining Contractual Term (in years)
Unvested balances at December 31, 2011	587,168	$ 20.30		
Restricted stock units granted	579,690	30.23		
Restricted stock units vested	(168,784)	20.41		
Restricted stock units forfeited	(30,806)	22.60		
Unvested balances at December 31, 2012	967,268	$ 26.16	$ 50,733	8.59

The aggregate fair value of restricted stock units vested during the years ended December 31, 2012 and 2011 was $3.4 million and $1.1 million, respectively. There was no vesting of restricted stock units in 2010. The total unrecognized stock-based compensation expense related to unvested restricted stock units and subject to recognition in future periods was $13.3 million as of December 31, 2012 and we expect to recognize this expense over a weighted-average period of 2.93 years.

For restricted stock units granted, the number of shares issued on the date the restricted stock units vest is net of the minimum statutory withholding requirements that we pay in cash to the appropriate taxing authorities on behalf of our employees. During 2012, we withheld and retired approximately 45,000 shares to satisfy $1.5 million of employees tax obligations. During 2011, we withheld and retired approximately 15,000 shares to satisfy $0.3 million of employees tax obligations. These shares are treated as common stock repurchases in our consolidated financial statements as of December 31, 2012 and 2011.

10. Earnings Per Share

We computed basic earnings per share using the weighted-average number of our common shares outstanding during the reporting period. We adjusted diluted earnings per share for the after-tax impact of incremental shares that would be available for issuance upon the assumed exercise of stock options and vesting of restricted stock units.

A reconciliation of the number of shares in the calculation of basic and diluted earnings per share follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Basic earnings per share			
Numerator:			
Net income	$ 81,343	$ 62,443	$ 44,746
Denominator:			
Weighted-average common shares outstanding used in computing basic earnings per share	74,166	72,812	68,664

Diluted earnings per share			
Numerator:			
Net income	$ 81,343	$ 62,443	$ 44,746
Denominator:			
Weighted-average shares used in computing basic earnings per share	74,166	72,812	68,664
Add options and restricted stock units to purchase common stock	1,869	1,601	4,198
Weighted-average shares used in computing diluted earnings per share	76,035	74,413	72,862

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

Dilution from assumed exercises of stock options and vesting of restricted stock units is dependent upon several factors, including the market price of our common stock. The following stock-based incentive awards were outstanding but were not included in the computation of diluted earnings per share because the average market price of the underlying stock did not exceed the sum of the exercise price, unrecognized compensation expense and the excess tax benefit and thus the results would have been antidilutive:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Antidilutive shares	305	1,267	1,362

The calculation of diluted earnings per share requires us to make certain assumptions related to the use of proceeds that would be received upon the assumed exercise of stock options and vesting of restricted stock units. These assumed proceeds include the excess tax benefit that we receive upon assumed exercises of stock options and vesting of restricted stock units.

On August 2, 2010, our board of directors approved a share repurchase program, authorizing us to purchase up to $25.0 million of our outstanding common stock. We were authorized to make purchases in the open market and purchases were funded from available working capital. The share repurchase program was completed in August 2010, and we repurchased 1.7 million shares of our common stock for an aggregate purchase price of $25.0 million. Shares were retired upon repurchase. In accordance with authoritative guidance, we account for repurchases of our common stock by charging any excess of cost over par value entirely to additional paid-in capital in absence of retained earnings.

11. Employee Benefit Plan

In October 2008, we established a 401(k) matching program for all eligible employees. We match an amount equal to 100% of the employee s contributions for the first 3%, and 50% for the next 2% of the employee s total eligible compensation. The total contributions per participant per year were limited to $17,000 for 2012 and $16,500 for 2011 and 2010. We, as sponsor of the plan, use an independent third party to provide administrative services to the plan. We have the right to terminate the plan at any time. Employees are fully vested in all contributions to the plan. Our expense related to the plan was as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Employee benefit plan expense	$ 1,637	$ 1,138	$ 806

12. Related Party Transactions

On August 31, 2006, we entered into a license agreement with NetSuite Inc. Our President and Chief Executive Officer became a member of NetSuite s Board of Directors in September 2006. Under the terms of the agreement, we paid the following amounts for the use of their services:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
NetSuite expense	$ 639	$ 560	$ 496

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

13. Income Taxes

U.S. and international components of income before income taxes were as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
U.S.	$ 83,188	$ 67,774	$ 51,422
International	31,331	17,029	9,728
Income before income taxes	$ 114,519	$ 84,803	$ 61,150

Income tax expense was composed of the following:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Current:			
Federal	$ 32,300	$ 18,800	$ 17,452
State	927	624	294
International	937	820	841
	34,164	20,244	18,587
Deferred:			
Federal	(489)	1,779	(1,990)
State	(20)	(3)	13
International	(479)	340	(206)
	(988)	2,116	(2,183)
	$ 33,176	$ 22,360	$ 16,404

The difference between the income tax expense derived by applying the federal statutory income tax rate to our income before income taxes and the amount recognized in our consolidated financial statements is as follows:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Expense derived by applying the federal statutory income tax rate to income before income taxes	$ 40,081	$ 29,681	$ 21,402
State taxes, net of federal benefit	582	403	238
Permanent items	(275)	712	427
Domestic production activities deduction	(1,609)	(1,705)	
Research and experimentation tax credits		(2,026)	(3,011)
Stock-based compensation	503	182	(148)
Effect of foreign operations	(6,106)	(4,887)	(2,504)

$ 33,176	$ 22,360	$ 16,404

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

The components of the net deferred tax amounts recognized in the accompanying consolidated balance sheets were:

(in thousands)	December 31, 2012	December 31, 2011
Deferred tax assets:		
Allowance for doubtful accounts	$ 33	$ 35
Accrued expenses	1,141	839
Stock-based compensation	5,428	3,625
Deferred revenue	684	699
Net operating loss	5,622	8,276
Research and experimentation credits	454	1,032
Total deferred tax assets	13,362	14,506
Deferred tax liabilities:		
Property and equipment	716	836
Prepaid expenses	894	652
Intangibles	9,942	8,965
Foreign royalty	243	340
Total deferred taxes liabilities	11,795	10,793
Net deferred tax asset	$ 1,567	$ 3,713

At December 31, 2012 and 2011, we had net operating loss carry forwards for U.S. federal income tax purposes of approximately $15.9 million and $20.1 million, respectively, which have been reduced due to IRC Section 382 limitations. These U.S. federal net operating losses are available to offset future U.S. federal taxable income, if any, and begin to expire at various dates from 2026 through 2031.

At December 31, 2012 and 2011, we had research and experimentation tax credit carry forwards of approximately $0.5 million and $1.0 million, respectively, which are available to offset future U.S. federal income tax, if any. These U.S. federal tax credits begin to expire in 2021.

The federal research and experimentation tax credit was extended by the signing of the American Taxpayer Relief Act of 2012, or the Act, on January 2, 2013. The Act retroactively extended this tax credit from January 1, 2012 through December 31, 2013. Since the Act was enacted during 2013, the income tax benefit related to the 2012 research and experimentation tax credit will be reflected in our results of operations for the quarter ended March 31, 2013.

We establish valuation allowances when necessary to reduce deferred tax assets to amounts expected to be realized. As of December 31, 2012 and 2011, we have not recorded a valuation allowance as it is more likely than not that the deferred tax assets will be realized.

We do not record federal income taxes on the undistributed earnings of our foreign subsidiaries that we consider to be permanently reinvested in foreign operations.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

The cumulative amount of these undistributed earnings and the estimated amount of the unrecognized deferred tax liability associated with these undistributed earnings, which includes a benefit related to foreign tax credits generated by the repatriation of foreign earnings, would be approximately as follows:

	December 31,		
(in thousands)	**2012**	**2011**	**2010**
Cumulative amount of these undistributed earnings	$ 70,256	$ 40,403	$ 22,312
Estimated amount of the unrecognized deferred tax liability associated with undistributed earnings	23,838	11,703	6,491

Gross unrecognized tax benefits, all of which, if recognized, would affect our effective tax rate were as follows:

	December 31,		
(in thousands)	**2012**	**2011**	**2010**
Gross unrecognized tax benefits	$ 8,776	$ 3,992	$ 1,396

Our policy is to include interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of December 31, 2012 and 2011, there was an insignificant amount accrued for interest and penalties related to unrecognized tax benefits.

The aggregate changes in the balance of our gross unrecognized tax benefits, excluding accrued interest, were as follows:

	Year End December 31,		
(in thousands)	**2012**	**2011**	**2010**
Balance, beginning of year	$ 3,992	$ 1,396	$ 445
Increases for tax positions related to the current year	4,890	1,092	951
Increases for tax positions related to prior years		1,504	
Decreases for tax positions related to prior years	(106)		
Reductions due to lapsed statute of limitations			
Balance, end of year	$ 8,776	$ 3,992	$ 1,396

It is reasonably possible that our unrecognized tax benefits could change over the next twelve months due to the completion of the IRS audit mentioned below. We do not expect any change would be significant.

We file U.S., state and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2008 through 2011 tax years generally remain open and subject to examination by federal and foreign tax authorities. The 2008 through 2011 tax years generally remain open and subject to examination by the state tax authorities. We are currently under audit by the U.S. Internal Revenue Service, or IRS, for the tax years ended December 31, 2008, 2009 and 2010, and we are not certain when the IRS audit will conclude. Besides the United States, we are not currently under audit in any taxing jurisdictions.

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

14. Commitments and Contingencies

Leases

At December 31, 2012, future minimum lease payments under noncancellable operating leases were as follows:

(in thousands)	
2013	$ 4,488
2014	4,065
2015	3,607
2016	2,007
2017	758
Thereafter	5,296
Total minimum lease payments	$ 20,221

Rent expense for the years ended December 31, 2012, 2011 and 2010 was as follows:

	Year ended December 31,		
(in thousands)	2012	2011	2010
Rent expense	$ 4,136	$ 3,956	$ 4,314

In conjunction with our existing corporate building lease agreement, we entered into a letter of credit agreement totaling $2.0 million. As of December 31, 2012, the letter of credit was unused.

Outstanding Obligations

Aggregated outstanding purchase orders that represented purchases of software license and support fees, marketing activities, accounting, legal and contractor fees, corporate health insurance costs and computer hardware and software were as follows:

	December 31,	
(in thousands)	2012	2011
Outstanding purchase orders	$ 8,177	$ 5,344

Legal Proceedings

From time to time, we have been and may be involved in various legal proceedings arising from our ordinary course of business. In the opinion of management, there was not at least a reasonable possibility we may have incurred a material loss, or a material loss in excess of a recorded accrual, with respect to loss contingencies. However, the outcome of litigation is inherently uncertain. Therefore, although management considers the likelihood of such an outcome to be remote, if one or more of these legal matters were resolved against us in the same reporting period for amounts in excess of management s expectations, our consolidated financial statements could be materially adversely affected.

Uniloc Cases

Uniloc USA, Inc. and parent and/or affiliates have brought two lawsuits against the Company and have brought a series of lawsuits against numerous software companies around the world.

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

On September 13, 2010, Uniloc USA, Inc. and Uniloc (Singapore) Private Limited (Uniloc) brought a lawsuit against the Company and several other defendants in the United States District Court for the Eastern District of Texas (Eastern District of Texas). The complaint filed by Uniloc alleges that the Company and each of the other fifteen named defendants software infringe U.S. patent 5,490,216 (216 Patent) allegedly owned by Uniloc. Uniloc alleges that the Company s software, specifically its license key system, infringes upon its patent that utilizes a system for activating software products through a registration process. In September 2011, another company, Sureloc, Inc. (Sureloc) claimed that it owns the 216 Patent. As a result, on November 3, 2011, Uniloc and its affiliates filed a lawsuit in the Superior Court of the State of California against Sureloc, Patrick Rooney, and Does 1-100 (the Sureloc case), seeking, among other things, a declaratory judgment that Uniloc and not Sureloc, is the exclusive owner of the 216 Patent. Once the Eastern District of Texas was informed of the Sureloc case, all Uniloc cases that were pending before the Eastern District of Texas were stayed on December 1, 2011. Subsequently, Uniloc and Sureloc settled their dispute regarding ownership of the 216 Patent, and the Sureloc case was dismissed with prejudice on September 25, 2012. On January 25, 2013, the Eastern District of Texas lifted the stay of all Uniloc cases and set the cases for a status conference on February 25, 2013. Because this lawsuit continues to only be in the initial stages, it is not possible to reliably predict the outcome of the litigation. Therefore, we cannot currently estimate the loss, if any, associated with the litigation. We intend to contest the claims associated with this lawsuit vigorously.

On March 30, 2012, Uniloc Luxembourg, S.A. and Uniloc USA, Inc. brought a lawsuit against the Company and several other defendants in the United States District Court for the Eastern District of Texas (Eastern District of Texas). The complaint filed by Uniloc alleges that the Company and each of the other fifteen named defendants software infringe U.S. patent 7,024,696 (696 Patent) allegedly owned by Uniloc. Uniloc alleges that the Company s software, specifically its license key system, infringes upon its patent that utilizes a system for activating software products through a registration process. Because this lawsuit is in its early stages, it is not possible to reliably predict the outcome of the litigation. Therefore, we cannot currently estimate the loss, if any, associated with the litigation. We intend to contest the claims associated with this lawsuit vigorously.

Achates Case

On June 22, 2011, Achates Reference Publishing, Inc. (Achates) brought a lawsuit against SolarWinds, Inc. and several other defendants in the United States District Court for the Eastern District of Texas. The complaint filed by Achates alleges that SolarWinds, Inc. and each of the other twelve named defendants software infringe U.S. Patent No. 5,982,889 (889 Patent) and U.S. Patent No. 6,173,403 (403 Patent), which are allegedly owned by Achates. Achates alleges that SolarWinds, Inc. s Engineer Suite family of software infringes upon the 889 and 403 Patents by employing activation technology. Achates has brought a series of lawsuits against numerous software companies around the world. Currently, it is not possible to reliably predict the outcome of the litigation. Therefore, we cannot currently estimate the loss, if any, associated with the litigation. We intend to contest the claims associated with this lawsuit vigorously.

Registration Rights

We entered into an agreement in 2005 providing certain of our stockholders with rights to have their shares of our common stock registered under the Securities Act of 1933, if requested by a majority of the holders of the shares.

Contingent Consideration

Our acquisitions may include contingent consideration payments based on future sales or product milestones of acquired products. We estimate the fair value of contingent consideration liabilities based on certain milestones of the acquired companies and estimated probabilities of achievement and discount the liabilities to present value using our pre-tax cost of debt. See Note 5 for a further discussion of accrued earnouts related to our acquisitions.

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SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

15. Operating Segment and Geographic Information

We operate as a single segment. Our chief operating decision-maker is considered to be our Chief Executive Officer. The chief operating decision-maker allocates resources and assesses performance of the business at the consolidated level.

The authoritative guidance for disclosures about segments of an enterprise establishes standards for reporting information about operating segments. It defines operating segments as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. Our Chief Executive Officer reviews financial information including new licenses sales and maintenance renewals for purposes of allocating resources and evaluating financial performance. We have one business activity, and there are no segment managers who are held accountable for operating results or components below the consolidated unit level. Accordingly, we considered ourselves to be in a single operating and reporting segment structure.

We based revenue by geography on the billing address of each customer. The following table sets forth revenue and our net long-lived assets by geographic area:

	Year Ended December 31,		
(in thousands)	**2012**	**2011**	**2010**
Revenue			
United States, country of domicile	$ 187,922	$ 139,340	$ 109,110
International	81,042	59,018	43,283
Total revenue	$ 268,964	$ 198,358	$ 152,393

	December 31,		
	2012	**2011**	**2010**
Long-lived assets, net			
United States, country of domicile	$ 62,045	$ 51,966	$ 22,048
International	16,928	13,454	4,827
Total long-lived assets, net	$ 78,973	$ 65,420	$ 26,875

SolarWinds, Inc.

Notes to Consolidated Financial Statements (Continued)

16. Quarterly Results of Operations

The following table sets forth our unaudited quarterly condensed consolidated statements of operations data for each of the eight quarters ended December 31, 2012. The data has been prepared on the same basis as the audited consolidated financial statements and related notes included in this Annual Report on Form 10-K and you should read the following tables in conjunction with such financial statements. The table includes all necessary adjustments, consisting only of normal recurring adjustments that we consider necessary for a fair presentation of this data. The results of historical periods are not necessarily indicative of future results.

(in thousands, except per share data-unaudited)	December 31, 2012	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
Revenue	$ 73,530	$ 71,723	$ 64,040	$ 59,671	$ 55,609	$ 53,948	$ 45,823	$ 42,978
Gross profit	68,264	67,132	59,770	55,398	52,211	50,410	43,256	40,492
Income before income taxes	32,081	31,686	26,962	23,790	23,131	25,879	18,987	16,806
Net income	22,299	22,486	19,427	17,131	16,294	20,888	13,551	11,710
Basic earnings per share	$ 0.30	$ 0.30	$ 0.26	$ 0.23	$ 0.22	$ 0.29	$ 0.19	$ 0.16
Diluted earnings per share	$ 0.29	$ 0.29	$ 0.26	$ 0.23	$ 0.22	$ 0.28	$ 0.18	$ 0.16
Shares used in computation of basic earnings per share	74,550	74,344	74,033	73,743	73,215	72,947	72,719	72,368
Shares used in computation of diluted earnings per share	76,467	76,303	75,848	75,440	74,885	74,457	74,346	74,003

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SOLARWINDS, INC.

FINANCIAL STATEMENT SCHEDULE

SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

	Beginning Balance	Additions (Charge to Expense)	Deductions (Write-offs, net of Recoveries)	Ending Balance
Allowance for doubtful accounts, customers and other:				
Year ended December 31, 2010	$ 149	$ 189	$ 137	$ 201
Year ended December 31, 2011	201	86	95	192
Year ended December 31, 2012	192	269	190	271

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EXHIBIT INDEX

Exhibit Number	Exhibit Title
2.1(1)	Asset Purchase Agreement by and among the Registrant, SolarWinds Worldwide, LLC, SolarWinds Software Europe (Holdings) Limited, SolarWinds Software Europe Limited, Tek-Tools, Inc., the shareholders of Tek-Tools, Inc., and U.S. Bank, National Association, dated January 26, 2010
2.2(2)	Agreement and Plan of Merger by and among SolarWinds, Inc., Timber Acquisition Corp., TriGeo Network Security, Inc., the Shareholders and Michelle Dickman, individually and in her capacity as Representative, dated as of June 20, 2011
2.3(3)	Purchase Agreement dated as of December 15, 2011 by and among SolarWinds Worldwide, LLC, DameWare Development LLC, the Members of DameWare Development LLC and U.S. Bank, National Association
3.1(4)	Amended and Restated Certificate of Incorporation of the Registrant
3.2(5)	Amended and Restated Bylaws of the Registrant
4.1(5)	Specimen Common Stock Certificate of the Registrant
4.2(5)	Stockholders Agreement by and among the Registrant and certain preferred and common stock holders, dated December 13, 2005, with Amendment No. 1 to Stockholders Agreement, dated March 13, 2008
4.3(5)	Registration Rights Agreement by and among the Registrant and certain preferred and common stock holders, dated December 13, 2005, with Amendment No. 1 to the Registration Rights Agreement by and among the Registrant and certain preferred and common stock holders, dated December 20, 2006
4.4(4)	Waiver under Registration Rights Agreement by and among the Registrant and certain preferred and common stock holders, dated October 25, 2009
4.5(5)	Stock Purchase Agreement by and among the Registrant and certain common and preferred stockholders, dated March 14, 2008
10.1(5)	Form of Indemnification Agreement for directors and officers
10.2(5)	Indemnification Agreement by and between the Registrant and Donald C. Yonce, dated July 22, 2008
10.3(5)	Amended and Restated Stock Incentive Plan #
10.4(5)	Form of Stock Option Agreement under Amended and Restated Stock Incentive Plan (Standard Form) #
10.5(5)	Form of Stock Option Agreement under Amended and Restated Stock Incentive Plan (Early Exercise Form) #
10.6(5)	2008 Equity Incentive Plan #
10.7(5)	Form of Stock Option Agreement under 2008 Equity Incentive Plan #
10.8(5)	Form of Restricted Stock Purchase Agreement under 2008 Equity Incentive Plan #
10.9(5)	Form of Restricted Stock Unit Agreement under 2008 Equity Incentive Plan #
10.10(6)	Registrant Bonus Plan #
10.11(7)	Amended and Restated Employment Agreement between SolarWinds Worldwide, LLC and Kevin B. Thompson, dated February 23, 2011 #

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Exhibit Number	Exhibit Title
10.12(8)	Employment Agreement between SolarWinds Worldwide, LLC and Michael J. Berry, dated February 8, 2010 #
10.13(7)	Amendment to Employment Agreement between SolarWinds Worldwide, LLC and Michael J. Berry, dated February 23, 2011 #
10.14(7)	Amended and Restated Employment Agreement between the Registrant, SolarWinds Worldwide, LLC, SolarWinds Australia Pty. Ltd. and Douglas G. Hibberd, dated January 31, 2011 #
10.15A(7)	Amendment to Amended and Restated Employment Agreement between the Registrant, SolarWinds Worldwide, LLC, SolarWinds Australia Pty. Ltd. and Douglas G. Hibberd, dated February 25, 2011 #
10.16(7)	Amended and Restated Employment Agreement between SolarWinds Worldwide, LLC and J. Barton Kalsu, dated February 23, 2011 #
10.17(7)	Amended and Restated Employment Agreement between SolarWinds Worldwide, LLC and Bryan A. Sims, dated February 23, 2011 #
10.18(7)	Amended and Restated Employment Agreement between SolarWinds Worldwide, LLC and Paul Strelzick, dated February 23, 2011 #
10.19(5)	Lease between SolarWinds Worldwide, LLC (as successor in interest to the Registrant) and Brandywine Acquisition Partners, LP, dated as of February 6, 2008
10.20(5)	Second Amendment to Lease between SolarWinds Worldwide, LLC and Brandywine Acquisition Partners, LP, dated as of March 3, 2009
10.21(5)	License Agreement between SolarWinds Worldwide, LLC (as successor in interest to the Registrant) and NetSuite Inc., dated August 31, 2006
10.22(5)	Master Subscription Agreement between SolarWinds Worldwide, LLC (as successor in interest to the Registrant), salesforce.com, inc. and salesforce.com Sarl
21.1	List of subsidiaries of the Registrant
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Calculation Linkbase Document
101.DEF	XBRL Taxonomy Definition Linkbase Document
101.LAB	XBRL Taxonomy Label Linkbase Document
101.PRE	XBRL Taxonomy Presentation Linkbase Document

(1) Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on January 27, 2010.
(2) Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on June 23, 2011.
(3) Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on December 15, 2011.
(4) Incorporated by reference to the Registrant s Registration Statement on Form S-1 (SEC File No. 333-162661) and all amendments thereto declared effective on November 12, 2009.
(5) Incorporated by reference to the Registrant s Registration Statement on Form S-1 (SEC File No. 333-149851) and all amendments thereto declared effective on May 19, 2009.
(6) Incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on May 26, 2010.
(7) Incorporated by reference to the same numbered exhibit to the Registrant s Annual Report on Form 10-K filed on February 25, 2011.
(8) Incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on February 8, 2010.
# Indicates management contract or compensatory plan or arrangement.
* Furnished herewith.