

NETSCOUT SYSTEMS INC  
Form 10-Q  
February 05, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

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**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0000-26251

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**NETSCOUT SYSTEMS, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**310 Littleton Road, Westford, MA 01886**

**(978) 614-4000**

**04-2837575**  
(IRS Employer  
Identification No.)

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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  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of the registrant's common stock, par value \$0.001 per share, as of February 2, 2007 was 32,029,006.

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**NETSCOUT SYSTEMS, INC.**

**FORM 10-Q**

**FOR THE QUARTER ENDED DECEMBER 31, 2006**

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|   | <b>December 31,<br/>2006</b> | <b>March 31,<br/>2006</b> |
|---|------------------------------|---------------------------|
| <b>Assets</b>   |                              |                           |
| Current assets:   |                              |                           |
| Cash and cash equivalents   | \$ 70,151                    | \$ 61,676                 |
| Marketable securities   | 14,130                       | 19,810                    |
| Accounts receivable, net of allowance for doubtful accounts of \$8 and \$44 at December 31, 2006 and March 31, 2006, respectively | 16,468                       | 16,765                    |
| Inventories   | 4,426                        | 2,816                     |
| Refundable income taxes   | 300                          | 985                       |
| Deferred income taxes   | 2,909                        | 2,896                     |
| Restricted cash   |                              | 1,339                     |
| Prepaid expenses and other current assets   | 3,285                        | 3,119                     |
| <b>Total current assets</b>   | <b>111,669</b>               | <b>109,406</b>            |
| Fixed assets, net   | 8,069                        | 7,577                     |
| Goodwill  | 36,561                       | 36,561                    |
| Acquired intangible assets, net   | 586                          | 1,015                     |
| Capitalized software development costs, net   | 211                          | 312                       |
| Deferred income taxes   | 5,050                        | 4,889                     |
| Long-term marketable securities   | 10,813                       | 5,979                     |
| Other assets  | 71                           | 16                        |
| <b>Total assets</b>   | <b>\$ 173,030</b>            | <b>\$ 165,755</b>         |
| <b>Liabilities and Stockholders Equity</b>  |                              |                           |
| Current liabilities:  |                              |                           |
| Accounts payable  | \$ 2,799                     | \$ 2,727                  |
| Accrued compensation  | 7,211                        | 8,635                     |
| Accrued other   | 2,365                        | 2,325                     |
| Income taxes payable  | 936                          |                           |
| Deferred acquisition payment  |                              | 1,339                     |
| Deferred revenue  | 21,369                       | 21,382                    |
| <b>Total current liabilities</b>  | <b>34,680</b>                | <b>36,408</b>             |
| Other long-term liabilities   | 1,054                        | 1,157                     |
| Deferred revenue  | 1,606                        | 1,599                     |
| <b>Total liabilities</b>  | <b>37,340</b>                | <b>39,164</b>             |

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### Commitments and contingencies (Note 8)

#### Stockholders' equity:

Preferred stock, \$0.001 par value: 5,000,000 shares authorized; no shares issued or outstanding at December 31, 2006 and March 31, 2006

Common stock, \$0.001 par value: 150,000,000 shares authorized; 36,244,531 and 35,488,019 shares issued and 31,836,627 and 31,284,796 shares outstanding at December 31, 2006 and March 31, 2006, respectively

|  |          |          |
|--|----------|----------|
| Additional paid-in capital   | 120,394  | 120,057  |
| Accumulated other comprehensive loss   | (54)     | (122)    |
| Deferred compensation  |          | (4,434)  |
| Treasury stock at cost, 4,407,904 and 4,203,223 shares at December 31, 2006 and March 31, 2006, respectively | (27,890) | (26,490) |
| Retained earnings  | 43,204   | 37,545   |

|                            |         |         |
|----------------------------|---------|---------|
| Total stockholders' equity | 135,690 | 126,591 |
|----------------------------|---------|---------|

|  |            |            |
|--|------------|------------|
| Total liabilities and stockholders' equity | \$ 173,030 | \$ 165,755 |
|--|------------|------------|

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

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## NetScout Systems, Inc.

## Condensed Consolidated Statements of Operations

(In thousands, except per share data)

(Unaudited)

|  | Three Months Ended<br>December 31, |                 | Nine Months Ended<br>December 31, |                 |
|--|------------------------------------|-----------------|-----------------------------------|-----------------|
|  | 2006                               | 2005            | 2006                              | 2005            |
| <b>Revenue:</b>  |                                    |                 |                                   |                 |
| Product  | \$ 16,366                          | \$ 16,274       | \$ 46,351                         | \$ 46,389       |
| Service  | 10,133                             | 8,637           | 28,803                            | 25,489          |
| License and royalty  |                                    |                 |                                   | 184             |
| <b>Total revenue</b>   | <b>26,499</b>                      | <b>24,911</b>   | <b>75,154</b>                     | <b>72,062</b>   |
| <b>Cost of revenue:</b>  |                                    |                 |                                   |                 |
| Product (1)  | 4,528                              | 4,754           | 12,766                            | 13,680          |
| Service (1)  | 1,416                              | 1,175           | 3,998                             | 3,609           |
| <b>Total cost of revenue</b>   | <b>5,944</b>                       | <b>5,929</b>    | <b>16,764</b>                     | <b>17,289</b>   |
| <b>Gross profit</b>  | <b>20,555</b>                      | <b>18,982</b>   | <b>58,390</b>                     | <b>54,773</b>   |
| <b>Operating expenses:</b>   |                                    |                 |                                   |                 |
| Research and development (1)   | 4,782                              | 4,380           | 13,690                            | 13,633          |
| Sales and marketing (1)  | 11,253                             | 10,054          | 32,112                            | 29,608          |
| General and administrative (1)   | 2,571                              | 2,266           | 6,913                             | 6,762           |
| Amortization of acquired intangible assets   | 39                                 | 39              | 116                               | 110             |
| In-process research and development  |                                    |                 |                                   | 143             |
| <b>Total operating expenses</b>  | <b>18,645</b>                      | <b>16,739</b>   | <b>52,831</b>                     | <b>50,256</b>   |
| <b>Income from operations</b>  | <b>1,910</b>                       | <b>2,243</b>    | <b>5,559</b>                      | <b>4,517</b>    |
| <b>Interest and other income, net</b>  | <b>917</b>                         | <b>687</b>      | <b>3,004</b>                      | <b>1,770</b>    |
| <b>Income before income tax expense and cumulative effect of accounting change</b> | <b>2,827</b>                       | <b>2,930</b>    | <b>8,563</b>                      | <b>6,287</b>    |
| <b>Income tax expense</b>  | <b>844</b>                         | <b>1,043</b>    | <b>2,973</b>                      | <b>2,294</b>    |
| <b>Income before cumulative effect of accounting change</b>                        | <b>1,983</b>                       | <b>1,887</b>    | <b>5,590</b>                      | <b>3,993</b>    |
| <b>Cumulative effect of accounting change, net of taxes of \$42</b>                |                                    |                 | <b>69</b>                         |                 |
| <b>Net income</b>  | <b>\$ 1,983</b>                    | <b>\$ 1,887</b> | <b>\$ 5,659</b>                   | <b>\$ 3,993</b> |
| <b>Basic net income per share</b>  | <b>\$ 0.06</b>                     | <b>\$ 0.06</b>  | <b>\$ 0.18</b>                    | <b>\$ 0.13</b>  |
| <b>Diluted net income per share</b>  | <b>\$ 0.06</b>                     | <b>\$ 0.06</b>  | <b>\$ 0.17</b>                    | <b>\$ 0.13</b>  |
| <b>Shares used in computing:</b>   |                                    |                 |                                   |                 |
| <b>Basic net income per share</b>  | <b>31,735</b>                      | <b>31,106</b>   | <b>31,626</b>                     | <b>30,972</b>   |
| <b>Diluted net income per share</b>  | <b>33,026</b>                      | <b>31,736</b>   | <b>32,925</b>                     | <b>31,600</b>   |

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(1) Share-based compensation expenses included in these amounts are as follows:

|  |    |     |    |     |    |       |    |     |
|--|----|-----|----|-----|----|-------|----|-----|
| Cost of product revenue  | \$ | 10  | \$ |     | \$ | 30    | \$ |     |
| Cost of service revenue  |    | 12  |    |     |    | 37    |    |     |
| Research and development   |    | 135 |    | 73  |    | 366   |    | 215 |
| Sales and marketing  |    | 140 |    | 24  |    | 442   |    | 68  |
| General and administrative                                       |    | 60  |    | 49  |    | 202   |    | 57  |
| Total share-based compensation expense, before income tax effect | \$ | 357 | \$ | 146 | \$ | 1,077 | \$ | 340 |

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

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## NetScout Systems, Inc.

## Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

|   | Nine Months Ended<br>December 31, |          |
|---|-----------------------------------|----------|
|   | 2006                              | 2005     |
| <b>Cash flows from operating activities:</b>  |                                   |          |
| Net income  | \$ 5,659                          | \$ 3,993 |
| Adjustments to reconcile net income to cash provided by operating activities:                   |                                   |          |
| Depreciation and amortization   | 2,735                             | 2,751    |
| In-process research and development   |                                   | 143      |
| Loss on disposal of fixed assets  | 31                                | 139      |
| Inventory write-down  |                                   | 124      |
| Share-based compensation expense associated with equity awards                                  | 1,077                             | 340      |
| Cumulative effect of accounting change  | (111)                             |          |
| Deferred income taxes   | (174)                             | 1,909    |
| Changes in assets and liabilities net of the effects of the acquisition of Quantiva's business: |                                   |          |
| Accounts receivable, net  | 297                               | (7,112)  |
| Inventories   | (1,610)                           | (1,131)  |
| Refundable income taxes   | 685                               | 80       |
| Prepaid expenses and other current assets   | (155)                             | 784      |
| Other assets  | (55)                              | (10)     |
| Accounts payable  | 72                                | 298      |
| Accrued compensation and other expenses   | (1,487)                           | 1,506    |
| Income taxes payable  | 936                               |          |
| Deferred revenue  | (6)                               | 773      |
| Net cash provided by operating activities   | 7,894                             | 4,587    |
| <b>Cash flows from investing activities:</b>  |                                   |          |
| Purchase of marketable securities   | (43,569)                          | (56,519) |
| Proceeds from maturity of marketable securities   | 44,472                            | 62,274   |
| Purchase of fixed assets  | (1,486)                           | (2,826)  |
| Capitalized expenditures for internal use software  | (1,227)                           | (815)    |
| Acquisition of Quantiva's business  |                                   | (9,463)  |
| Capitalized software development costs  | (15)                              | (84)     |
| Net cash used in investing activities   | (1,825)                           | (7,433)  |
| <b>Cash flows from financing activities:</b>  |                                   |          |
| Proceeds from issuance of common stock  | 2,917                             | 2,054    |
| Purchase of treasury shares   | (1,400)                           |          |
| Tax benefit from stock options exercised  | 889                               |          |
| Net cash provided by financing activities   | 2,406                             | 2,054    |
| Net increase (decrease) in cash and cash equivalents  | 8,475                             | (792)    |
| Cash and cash equivalents, beginning of period  | 61,676                            | 57,070   |



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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents, end of period | \$ 70,151 | \$ 56,278 |
|--|-----------|-----------|

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

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**NetScout Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements**

**(In thousands, except share and per share data)**

**(Unaudited)**

**1. Basis of Presentation**

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

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

**2. Share-Based Compensation**

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

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

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

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

Prior to the adoption of SFAS 123R, the Company provided the disclosures required under SFAS 123, as amended by SFAS No. 148,

Accounting for Stock-Based Compensation Transition and Disclosures. Forfeitures of awards were recognized as they occurred. Previously reported amounts have not been restated. The pro forma information for the three and nine months ended December 31, 2005 was as follows:

|  | Three Months Ended<br>December 31,<br>2005 | Nine Months Ended<br>December 31,<br>2005 |
|--|--|---|
| Net income as reported   | \$ 1,887                                   | \$ 3,993                                  |
| Add: share-based compensation under APB No. 25, net of tax   | 92   | 215                                       |
| Deduct: share-based employee compensation expense determined under fair value-based methods for all awards, net of tax | (576)                                      | (2,048)                                   |
| Pro forma net income   | \$ 1,403                                   | \$ 2,160                                  |
| Basic net income per share:  |  |   |
| As reported  | \$ 0.06                                    | \$ 0.13                                   |
| Pro forma  | \$ 0.05                                    | \$ 0.07                                   |
| Diluted net income per share:  |  |   |
| As reported  | \$ 0.06                                    | \$ 0.13                                   |
| Pro forma  | \$ 0.04                                    | \$ 0.07                                   |

**Impact of the Adoption of SFAS 123R**

The Company adopted SFAS 123R using the modified prospective transition method beginning April 1, 2006. Accordingly, during the three and nine months ended December 31, 2006, the Company recorded share-based compensation expense for awards granted prior to but not yet vested as of April 1, 2006 as if the fair value method required for pro forma disclosure under SFAS 123 were in effect for expense recognition purposes, but adjusted for estimated forfeitures. The Company recorded a pre-tax cumulative benefit of accounting change of \$111 related to estimating forfeitures for restricted stock units that were unvested as of April 1, 2006. For share-based awards granted after April 1, 2006, the Company recognized compensation expense based on the estimated grant date fair value method required under SFAS 123R. For all awards, the Company has recognized compensation expense using a straight-line amortization method. As SFAS 123R requires that share-based compensation expense be based on awards that are ultimately expected to vest, estimated share-based compensation for the three and nine months ended December 31, 2006 has been reduced for estimated forfeitures.

Under the provisions of SFAS 123R, the Company recorded \$357 and \$1.1 million of share-based compensation, net of taxes, in operations in the accompanying Consolidated Condensed Statements of Operations for the three and nine months ended December 31, 2006, respectively. Share-based compensation capitalized in conjunction with our costs related to internally developed software and software for internal use was immaterial.

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The impact on the Company's results of operating income, net income and earnings per share from the adoption of SFAS 123R for the three and nine months ended December 31, 2006 was as follows:

|   | Three Months Ended<br>December 31,<br>2006 |      | Nine Months Ended<br>December 31,<br>2006 |       |
|---|--|------|---|-------|
| Stock options                                       | \$   | (41) | \$  | (118) |
| Impact on operating income                          |  | (41) |   | (118) |
| Cumulative effect of accounting change              |  |      |   | 111   |
| Impact after cumulative effect of accounting change | \$   | (41) | \$  | (7)   |
| Impact on net income                                | \$   | (26) | \$  | (4)   |
| Impact on earnings per share:                       |  |      |   |       |
| Basic   | \$   | 0.00 | \$  | 0.00  |
| Diluted   | \$   | 0.00 | \$  | 0.00  |

Total share-based compensation recorded in the Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2006 and 2005 was as follows:

|   | Three Months Ended<br>December 31, |        | Nine Months Ended<br>December 31, |        |
|---|------------------------------------|--------|-----------------------------------|--------|
|   | 2006                               | 2005   | 2006                              | 2005   |
| Cost of revenue - Product                       | \$ 10                              | \$     | \$ 30                             | \$     |
| Cost of revenue - Service                       | 12                                 |        | 37                                |        |
| Research and development                        | 135                                | 73     | 366                               | 215    |
| Sales and marketing                             | 140                                | 24     | 442                               | 68     |
| General and administrative                      | 60                                 | 49     | 202                               | 57     |
| Less non-employee compensation                  | (30)                               | (23)   | (44)                              | (71)   |
| Total employee share based compensation expense | \$ 327                             | \$ 123 | \$ 1,033                          | \$ 269 |

**Valuation Assumptions**

For the three and nine months ended December 31, 2006 and 2005, respectively, the fair value of share-based awards for employee stock option awards and employee stock purchases made under our ESPP were estimated on the date of grant using the Black-Scholes option pricing model with the assumptions below. No option grants were given during the nine months ended December 31, 2006. There was no activity for the ESPP in the nine months ended December 31, 2006 due to the suspension of the ESPP (see Note 9).

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|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | December 31, 2006  | December 31, 2005 | December 31, 2006 | December 31, 2005 |
| <b>Option Plans</b>                      |                    |                   |                   |                   |
| Expected option term                     |                    |                   |                   | 5 years           |
| Weighted average risk-free interest rate |                    |                   |                   | 4.0%              |
| Expected volatility                      |                    |                   |                   | 95%               |
| Dividend yield                           |                    |                   |                   |                   |
| Weighted average fair value              | \$                 | \$                | \$                | \$ 3.32           |

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

|  | Three Months<br>Ended<br>December 31, |      | Nine Months Ended<br>December 31, |           |
|--|---------------------------------------|------|-----------------------------------|-----------|
|  | 2006                                  | 2005 | 2006                              | 2005      |
| <b>Employee Stock Purchase Plan</b>      |                                       |      |                                   |           |
| Expected option term                     |                                       |      |                                   | 0.5 years |
| Weighted average risk-free interest rate |                                       |      |                                   | 3.20%     |
| Expected volatility                      |                                       |      |                                   | 59%       |
| Dividend yield                           |                                       |      |                                   |           |
| Weighted average fair value              | \$                                    | \$   | \$                                | \$ 1.23   |

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

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

**Restricted Stock Units**

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

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

On September 14, 2005, the Company granted share-based awards to non-employee members of the Company's Board of Directors. These awards consisted of 33,210 restricted stock units, which vested on the date of the 2006 annual meeting of the stockholders. The restricted stock units do not have an exercise price. The gross value of these awards at December 31, 2006 was approximately \$180. In addition, the Company paid each member of the Board of Directors \$20 upon issuance of the underlying shares in conjunction with the vesting and payout of the restricted stock units to defray personal taxes related to the issuance. The Company recognized the expense related to these payments over a period equal to the vesting period of the restricted stock units, which was one year. Operating expenses related to these tax defrayment payments for the three and nine months ended December 31, 2006, was \$0 and \$55, respectively.

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

On September 13, 2006, the Company granted share-based awards to non-employee members of the Company's Board of Directors. These awards consisted of 20,685 restricted stock units, which vest on the date of the next annual meeting of the stockholders, provided that during such time, such directors attend at least 75% of the meetings of the Board and any committee of the Board, collectively, of which such directors are members. In the event that the foregoing attendance requirements are not met, the restricted stock units will not vest until the third anniversary of the date of grant. The restricted stock units do not have an exercise price. The gross value of these awards at December 31, 2006 was approximately \$150. In addition, the Company will pay each member of the Board of Directors \$20 upon issuance of the underlying shares in conjunction with the vesting and payout of the restricted stock units to defray personal taxes related to the issuance. The Company is recognizing the expense related to these payments over a period equal to the vesting period of the restricted stock units, which is one year. Operating expenses related to these tax defrayment payments for the three and nine months ended December 31, 2006, were \$25 and \$29, respectively.

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

**Share-Based Payment Award Activity**

The following table summarizes share-based payment award activity for the three and nine months ended December 31, 2006:

|                                    | Stock Options          |  | Restricted Stock Units |                                      |
|------------------------------------|------------------------|--|------------------------|--------------------------------------|
|                                    | Number<br>of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Number of<br>Awards    | Weighted<br>Average<br>Fair<br>Value |
| Outstanding-September 30, 2006     | 3,724,601              | \$ 6.25                                  | 796,776                | \$ 5.97                              |
| Granted                            |                        | \$                                       | 20,128                 | \$ 7.37                              |
| Exercised (Options)/Issued (RSU s) | (204,135)              | \$ 5.05                                  | (42,428)               | \$ 7.87                              |
| Canceled                           | (39,628)               | \$ 18.08                                 | (31,572)               | \$ 6.53                              |
| Outstanding-December 31, 2006      | 3,480,838              | \$ 6.19                                  | 742,904                | \$ 5.87                              |
| Outstanding-March 31, 2006         | 4,189,844              | \$ 6.08                                  | 842,528                | \$ 6.14                              |
| Granted                            |                        | \$                                       | 85,894                 | \$ 7.62                              |
| Exercised (Options)/Issued (RSU s) | (629,376)              | \$ 4.64                                  | (127,136)              | \$ 8.51                              |
| Canceled                           | (79,630)               | \$ 12.82                                 | (58,382)               | \$ 6.61                              |
| Outstanding-December 31, 2006      | 3,480,838              | \$ 6.19                                  | 742,904                | \$ 5.87                              |

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

The following table summarizes share-based payment award activity for the three and nine months ended December 31, 2005:

|                                    | Stock Options    |                                 | Restricted Stock Units |                             |
|------------------------------------|------------------|---------------------------------|------------------------|-----------------------------|
|                                    | Number of Shares | Weighted Average Exercise Price | Number of Awards       | Weighted Average Fair Value |
| Outstanding-September 30, 2005     | 4,519,939        | \$ 6.02                         | 187,555                | \$ 4.37                     |
| Granted                            |                  | \$                              | 8,865                  | \$ 5.64                     |
| Exercised (Options)/Issued (RSU s) | (150,985)        | \$ 4.17                         |                        | \$                          |
| Canceled                           | (80,878)         | \$ 6.91                         |                        | \$                          |
| Outstanding-December 31, 2005      | 4,288,076        | \$ 6.07                         | 196,420                | \$ 4.42                     |
| Outstanding-March 31, 2005         | 4,700,743        | \$ 6.01                         |                        | \$                          |
| Granted                            | 168,950          | \$ 4.49                         | 196,420                | \$ 4.42                     |
| Exercised (Options)/Issued (RSU s) | (337,551)        | \$ 4.23                         |                        | \$                          |
| Canceled                           | (244,066)        | \$ 6.40                         |                        | \$                          |
| Outstanding-December 31, 2005      | 4,288,076        | \$ 6.07                         | 196,420                | \$ 4.42                     |

The following table summarizes information about options outstanding and exercisable at December 31, 2006:

| Range of Exercise Prices | Number of Shares | Outstanding  |                                 | Exercisable      |                                 |
|--------------------------|------------------|--|---------------------------------|------------------|---------------------------------|
|                          |                  | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price | Number of Shares | Weighted Average Exercise Price |
| \$1.27 to 2.50           | 71,691           | 1.1  | \$ 2.39                         | 71,691           | \$ 2.39                         |
| \$3.01 to 5.00           | 1,686,370        | 3.9  | \$ 4.19                         | 1,599,483        | \$ 4.20                         |
| \$5.04 to 7.40           | 788,684          | 5.5  | \$ 5.75                         | 749,159          | \$ 5.72                         |
| \$7.60 to 11.25          | 710,874          | 6.3  | \$ 8.23                         | 710,874          | \$ 8.23                         |
| \$13.44 to 14.94         | 93,031           | 3.3  | \$ 13.72                        | 93,031           | \$ 13.72                        |
| \$15.13 to 18.50         | 66,000           | 4.0  | \$ 15.32                        | 66,000           | \$ 15.32                        |
| \$21.25 to 28.94         | 64,188           | 3.4  | \$ 25.34                        | 64,188           | \$ 25.34                        |
|                          | 3,480,838        | 4.7  | \$ 6.19                         | 3,354,426        | \$ 6.24                         |

The aggregate intrinsic values of stock options and restricted stock units as of December 31, 2006 and 2005 were as follows:



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|                            | December 31,<br>2006 | December 31,<br>2005 |
|----------------------------|----------------------|----------------------|
| Options:                   |                      |                      |
| Outstanding (1)            | \$ 9,355             | \$ 3,163             |
| Exercisable (1)            | \$ 8,912             | \$ 2,703             |
| Restricted Stock Units (2) | \$ 6,166             | \$ 1,070             |

- (1) The aggregate intrinsic values in this table were calculated based on the positive difference between the closing market value of the Company's common stock on December 31, 2006 (\$8.30) and 2005 (\$5.45) and the exercise price of the underlying options.

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

(2) The aggregate intrinsic values in this table were calculated based on the closing market value of the Company's common stock on December 31, 2006 (\$8.30) and 2005 (\$5.45) for the underlying restricted stock units. Information regarding cash proceeds received, intrinsic value realized and income tax benefit realized resulting from share-based awards and stock option exercises was as follows:

|                             | <b>Three Months Ended<br/>December 31,<br/>2006</b> | <b>Nine Months Ended<br/>December 31,<br/>2006</b> |
|-----------------------------|---|--|
| Cash proceeds received      | \$ 1,031  | \$ 2,918   |
| Intrinsic value realized    | \$ 873  | \$ 3,139   |
| Income tax benefit realized | \$ 562  | \$ 889   |

As of December 31, 2006, the total unrecognized compensation cost related to stock options was \$310, which is expected to be recognized over a weighted-average period of 2.2 years.

The total fair value of restricted stock units vested during the three and nine months ended December 31, 2006 was \$98 and \$1,086, respectively. As of December 31, 2006, the total unrecognized compensation cost related to restricted stock unit awards was \$2,670, which is expected to be amortized over a weighted-average period of 3.0 years.

**3. Cash, Cash Equivalents and Marketable Securities**

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents and those investments with original maturities greater than three months are considered to be marketable securities. Cash equivalents and short-term marketable securities are stated at cost plus accrued interest, which approximates fair value. Long-term marketable securities are stated at fair value based on quoted market prices. Cash equivalents and marketable securities consist primarily of money market instruments and U.S. Treasury bills.

**Marketable Securities**

The following is a summary of marketable securities held by NetScout at December 31, 2006, with maturity dates of January 2007 through December 2008:

|   | <b>Amortized<br/>Costs</b> | <b>Unrealized<br/>Losses</b> | <b>Fair<br/>Value</b> |
|---|----------------------------|------------------------------|-----------------------|
| U.S. government and municipal obligations | \$ 26,102                  | \$ (54)                      | \$ 26,048             |
| Less restricted investment                | 1,118                      | (13)                         | 1,105                 |
| Marketable securities                     | \$ 24,984                  | \$ (41)                      | \$ 24,943             |

The following is a summary of marketable securities as classified between short and long-term for December 31, 2006:

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|                                  |           |
|----------------------------------|-----------|
| Short-term marketable securities | \$ 14,130 |
| Long-term marketable securities  | 10,813    |
| Total marketable securities      | \$ 24,943 |

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

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

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

The following is a summary of marketable securities as classified between short and long-term for March 31, 2006:

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

**Restricted Investment**

The Company has a restricted investment account related to a deferred compensation plan of \$1.1 million, which is currently included in prepaid expenses and other current assets. As of December 31, 2006 and March 31, 2006, there were unrealized losses of \$13 and \$24, respectively, recorded as other comprehensive income (loss), net of \$0 tax.

**4. Inventories**

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

|                 | December 31,<br>2006 | March 31,<br>2006 |
|-----------------|----------------------|-------------------|
| Raw materials   | \$ 2,993             | \$ 2,213          |
| Work in process | 47                   | 102               |
| Finished goods  | 1,386                | 501               |
|                 | \$ 4,426             | \$ 2,816          |

**5. Acquisition**

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

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

The total purchase price was approximately \$9.5 million and was paid in cash. Cash paid included \$1.3 million to be held in escrow for sixteen months from the date of the acquisition. Cash held in escrow was recorded as Restricted cash on the balance sheet, with a corresponding liability reported as Deferred acquisition payment. In August 2006, upon the sixteenth month anniversary of the acquisition, the \$1.3 million of cash held in escrow and all interest earned on the balance was paid to Quantiva's successor, which reduced the restricted cash and corresponding liability balances to \$0. The escrow account was established to satisfy potential claims and obligations that could arise subsequent to the acquisition. No claims have arisen as of December 31, 2006. The purchase price includes capitalized acquisition costs of approximately \$166 consisting of legal, consulting and accounting services. The acquisition was accounted for using the purchase method of accounting in accordance with SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. The total purchase price of \$9.5 million was allocated to the tangible and intangible assets acquired based on the Company's estimates of fair values at the time of acquisition as follows:

|   |           |              |
|---|-----------|--------------|
| Current assets  | \$        | 7            |
| Fixed assets  |           | 26           |
| Intangible assets                                       |           | 1,708        |
| Goodwill  |           | 7,722        |
| <b>Total purchase price including acquisition costs</b> | <b>\$</b> | <b>9,463</b> |

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

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

|                                     |                 |                    |
|-------------------------------------|-----------------|--------------------|
| Software                            | \$ 1,255        | 3-year useful life |
| Non-compete agreements              | 310             | 2-year useful life |
| In-process research and development | 143             |                    |
|                                     | <b>\$ 1,708</b> |                    |

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

**6. Goodwill & Acquired Intangible Assets****Goodwill**

The carrying amount of goodwill was \$36.6 million as of December 31, 2006 and 2005, respectively. The Company's goodwill resulted from the acquisition of NextPoint Networks, Inc. in July 2000 and substantially all of the assets of Quantiva on April 14, 2005 (see Note 5). The

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Company recorded \$7.7 million of goodwill at the acquisition date related to Quantiva. In accordance with SFAS No. 142, goodwill is not amortized, but instead is

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

reviewed for impairment at least annually or more frequently when events and circumstances occur indicating that the recorded goodwill may be impaired. If the book value of the Company's enterprise exceeds its fair value for a sustained period, the implied fair value of goodwill will be compared with the carrying amount of goodwill. If the carrying amount of goodwill exceeds the implied fair value, an impairment loss will be recorded in an amount equal to that excess.

**Acquired Intangible Assets**

The carrying amount of acquired intangible assets was \$586 and \$1.0 million as of December 31, 2006 and March 31, 2006, respectively. Intangible assets acquired in a business combination are recorded under the purchase method of accounting at their estimated fair values at the date of acquisition. The Company amortizes acquired intangible assets over their estimated useful lives on a straight-line basis. Acquired intangible assets consist of the following as of December 31, 2006 and March 31, 2006, respectively:

|                        | December 31, 2006 |                             |        | March 31, 2006 |                             |          |
|------------------------|-------------------|-----------------------------|--------|----------------|-----------------------------|----------|
|                        | Cost              | Accumulated<br>Amortization | Net    | Cost           | Accumulated<br>Amortization | Net      |
| Software               | \$ 1,255          | \$ 714                      | \$ 541 | \$ 1,255       | \$ 401                      | \$ 854   |
| Non-Compete Agreements | 310               | 265                         | 45     | 310            | 149                         | 161      |
|                        | \$ 1,565          | \$ 979                      | \$ 586 | \$ 1,565       | \$ 550                      | \$ 1,015 |

Amortization of acquired software, that is included as cost of product revenue, was \$104 and \$104, \$312 and \$296 for the three and nine months ended December 31, 2006 and 2005, respectively. Amortization of non-compete agreements, that is included as operating expense, was \$39 and \$39, \$116 and \$110 for the three and nine months ended December 31, 2006 and 2005, respectively.

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

|                               |        |
|-------------------------------|--------|
| 2007 (remaining three months) | \$ 144 |
| 2008                          | 425    |
| 2009                          | 17     |
| Total                         | \$ 586 |

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

**7. Capitalized Software Development Costs and Purchased Software**

Costs incurred in the research and development of the Company's products are expensed as incurred, except for certain software development costs. Costs associated with the development of software products are expensed prior to the establishment of technological feasibility (as defined by SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed) and capitalized thereafter until the



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related software products are available for first customer shipment. During the fiscal year ended March 31, 2004, the Company capitalized \$1.3 million of software development costs. These capitalized software development costs were fully amortized as of December 31, 2005. Amortization of these capitalized software development costs

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**NetScout Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(In thousands, except share and per share data)**

**(Unaudited)**

was \$221 for the nine months ending December 31, 2005. During the fiscal year ended March 31, 2006, the Company met technological feasibility for its *nGenius* Performance Analytics product. As of December 31, 2006, capitalized software development costs for the Analytics product totaled \$327. Beginning in April 2006, the Company commenced amortization of capitalized software development costs for the Analytics product over its estimated economic life that approximates two years. Amortization of capitalized software development costs for the Analytics product was \$41 and \$116 for the three months and nine months ending December 31, 2006, respectively.

The Company also capitalizes purchased software in accordance with SFAS No. 86. During the fiscal year ended March 31, 2006, the Company capitalized \$1.3 million of purchased software obtained in connection with the acquisition of substantially all of the assets of Quantiva. Purchased software is recorded under acquired intangible assets (see Notes 5 and 6).

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

**8. Commitments and Contingencies**

From time to time the Company is subject to legal proceedings and claims in the ordinary course of business. On December 14, 2006, Diagnostic Systems Corporation ( DSC ) filed a lawsuit against the Company and five other co-defendants in the United States District Court for the Central District of California claiming patent infringement. The complaint seeks damages in an unspecified amount and injunctive relief. In the lawsuit, DSC alleges that the Company is infringing United States Patent No. 5,701,400, and No. 5,537,590. The Company believes these claims have no merit and it will defend the lawsuit vigorously. No amounts have been accrued related to these claims. In the opinion of management, the amount of ultimate expense with respect to any current legal proceedings and claims will not have a significant adverse effect on the Company's financial position or results of operations.

**Guarantor's Agreements**

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

Contracts that the Company enters into in the ordinary course of business may contain standard indemnification provisions. Pursuant to these agreements, the Company may agree to defend any third party claims brought against a partner or direct customer claiming infringement of such third party's (i) U.S. patent

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**NetScout Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(In thousands, except share and per share data)**

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and/or EU or other selected countries' patents, (ii) Berne convention member country copyright, and/or (iii) U.S., EU and/or OHIM trademark or intellectual property rights. Moreover, this indemnity may require the Company to pay any damages awarded against the partner or direct customer in such type of lawsuit as well as reimburse the partner or direct customer for any reasonable attorney's fees incurred by them from the lawsuit.

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

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

**9. Material Transactions Affecting Stockholders' Equity**  
**Restricted Stock**

On April 14, 2005, the Company granted share-based awards to employees who were former employees of Quantiva and to a consultant who was a former consultant of Quantiva, a company that sold substantially all of its assets to the Company (see Note 5). These awards consisted of grants of 154,345 restricted stock units, which vest over two years. The Company recorded the intrinsic value and the fair value of the restricted stock units granted to former employees as deferred compensation and recognized the current period expense in accordance with EITF 96-18. The Company recorded the current period expense for the restricted stock units granted to the consultant to stockholders' equity in accordance with EITF 96-18. The Company estimated the fair value of these restricted stock units using a per share value of \$4.14, which represented the closing price of the Company's common stock on the date of grant. Upon the grant of the restricted stock units to employees, deferred compensation for the fair market value of the restricted stock units was recorded within stockholders' equity and will be subsequently amortized as compensation expense over the vesting period. The restricted stock units issued to the consultant of Quantiva will be marked-to-market at each reporting date until vested with changes being charged to compensation expense on a pro-rata basis over the vesting period. The aggregate intrinsic value of these awards at December 31, 2006 was approximately \$703. Amortization expense related to these grants for the three and nine months ended December 31, 2006 and 2005 was \$79 and \$87 and \$234 and \$249, respectively.

On September 14, 2005, the Company granted share-based awards to non-employee members of the Company's Board of Directors. These awards consisted of 33,210 restricted stock units, which vested on the date of the 2006 annual meeting of the stockholders. The restricted stock units do not have an exercise price. The gross value of these awards at December 31, 2006 was approximately \$180. In addition, the Company paid each member of the Board of Directors \$20 upon issuance of the underlying shares in conjunction with the vesting and payout of the restricted stock units to defray personal taxes related to the issuance. The Company recognized the expense related to these payments over a period equal to the vesting period of the restricted stock units, which was one year. Operating expenses related to these tax defrayment payments for the three and nine months ended December 31, 2006, was \$0 and \$55, respectively.

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

On September 13, 2006, the Company granted share-based awards to non-employee members of the Company's Board of Directors. These awards consisted of 20,685 restricted stock units, which vest on the date of the next annual meeting of the stockholders, provided that during such time, such directors attend at least 75% of the meetings of the Board and any committee of the Board, collectively, of which such directors are members. In the event that the foregoing attendance requirements are not met, the restricted stock units will not vest until the third anniversary of the date of grant. The restricted stock units do not have an exercise price. The gross value of these awards at December 31, 2006 was approximately \$150. In addition, the Company will pay each member of the Board of Directors \$20 upon issuance of the underlying shares in conjunction with the vesting and payout of the restricted stock units to defray personal taxes related to the issuance. The Company is recognizing the expense related to these payments over a period equal to the vesting period of the restricted stock units, which is one year. Operating expenses related to these tax defrayment payments for the three and nine months ended December 31, 2006, was \$25 and \$29.

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

**Stock Options**

On April 14, 2005, the Company granted share-based awards to certain former consultants of Quantiva, a company that sold substantially all of its assets to the Company (see Note 5). These awards consisted of options to purchase 20,000 shares of the Company's common stock, which vest over a four-year period, and have an exercise price of \$4.14 per share. The Company recorded the current period expense for the stock options granted to the consultants to stockholders' equity. Compensation expense (benefit) related to these options for the three and nine months ended December 31, 2006 and 2005 was \$16 and \$8 and \$23 and \$29 respectively. The Company calculated the fair value and related compensation expense in accordance with EITF 96-18. These options will be marked-to-market at each reporting date until exercised with changes being charged to compensation expense on a pro-rata basis over the expected vesting period with any unexpensed amounts included in deferred compensation.

Fair value of the stock options was calculated using the Black-Scholes option-pricing model with the following weighted average assumptions for all periods:

|                         |       |
|-------------------------|-------|
| Dividend yield          | None  |
| Expected volatility     | 95%   |
| Risk-free interest rate | 3.99% |
| Expected life (years)   | 5     |

**Acceleration of Stock Option Vesting Period**

On May 4, 2005, the Board of Directors of the Company approved the acceleration of vesting of all stock options issued on or before December 31, 2004 that became exercisable on or after April 1, 2006, so that all such options became fully exercisable on March 31, 2006. Such options had been granted under the Company's equity compensation plans and are held by the Company's officers and employees, including its executive officers. The exercise prices of substantially all of these options were in excess of the then current market price of the Company's common stock and thus were considered out-of-the-money as of the modification date. Options to purchase 621,234 shares of common stock or 39% of the Company's outstanding unvested options (of which 7% of the Company's outstanding unvested options are held by the Company's executive officers) were subject to



**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

the acceleration. The weighted average exercise price of the options subject to the acceleration is \$5.62. As a result of the acceleration, the Company recorded \$14 of deferred compensation within stockholder's equity, which was fully amortized over the remaining vesting periods during the fiscal year ended March 31, 2006 as compensation expense.

**Employee Stock Purchase Plan**

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

**10. Treasury Stock**

On September 17, 2001, the Company announced an open market stock repurchase program to purchase up to one million shares of outstanding Company common stock, subject to market conditions and other factors. Any purchases under the Company's stock repurchase program may be made from time to time without prior notice. Through June 30, 2006, the Company had repurchased 158,000 shares of common stock under this original program. On July 26, 2006, the Company announced that it had expanded the existing open market stock repurchase program to enable the Company to purchase up to an additional three million shares of the Company's outstanding common stock, bringing the total number of shares authorized for repurchase to 3,842,000 shares. During the three and nine months ended December 31, 2006, the Company repurchased 53,000 and 205,000 additional shares of common stock, respectively.

**11. Net Income Per Share**

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

|   | Three Months Ended<br>December 31, |            | Nine Months Ended<br>December 31, |            |
|---|------------------------------------|------------|-----------------------------------|------------|
|   | 2006                               | 2005       | 2006                              | 2005       |
| <b>Basic:</b>                                 |                                    |            |                                   |            |
| Net income                                    | \$ 1,983                           | \$ 1,887   | \$ 5,659                          | \$ 3,993   |
| Weighted average common shares<br>outstanding | 31,734,903                         | 31,106,425 | 31,625,872                        | 30,972,386 |
| Basic net income per share                    | \$ 0.06                            | \$ 0.06    | \$ 0.18                           | \$ 0.13    |
| <b>Diluted:</b>                               |                                    |            |                                   |            |
| Net income                                    | \$ 1,983                           | \$ 1,887   | \$ 5,659                          | \$ 3,993   |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Weighted average common shares<br>outstanding | 31,734,903 | 31,106,425 | 31,625,872 | 30,972,386 |
| Weighted average stock options                | 1,073,081  | 508,212    | 1,094,725  | 526,684    |
| Weighted average restricted stock units       | 217,931    | 121,055    | 204,675    | 100,811    |
| Diluted weighted average shares               | 33,025,915 | 31,735,692 | 32,925,272 | 31,599,881 |
| Diluted net income per share                  | \$ 0.06    | \$ 0.06    | \$ 0.17    | \$ 0.13    |

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## NetScout Systems, Inc.

## Notes to Condensed Consolidated Financial Statements (Continued)

(In thousands, except share and per share data)

(Unaudited)

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

|                        | Three Months Ended<br>December 31, |                  | Nine Months Ended<br>December 31, |                  |
|------------------------|------------------------------------|------------------|-----------------------------------|------------------|
|                        | 2006                               | 2005             | 2006                              | 2005             |
| Stock options          | 556,419                            | 1,555,518        | 1,044,702                         | 1,610,514        |
| Restricted stock units |                                    |                  | 11,132                            |                  |
| <b>Total</b>           | <b>556,419</b>                     | <b>1,555,518</b> | <b>1,055,834</b>                  | <b>1,610,514</b> |

**12. Other Comprehensive Income**

Other comprehensive income consists of unrealized gains and losses on marketable securities and restricted investments. Other comprehensive income for the three and nine months ended December 31, 2006 and 2005 is as follows:

|   | Three Months Ended<br>December 31, |                 | Nine Months Ended<br>December 31, |                 |
|---|------------------------------------|-----------------|-----------------------------------|-----------------|
|   | 2006                               | 2005            | 2006                              | 2005            |
| Net income  | \$ 1,983                           | \$ 1,887        | \$ 5,659                          | \$ 3,993        |
| Unrealized gains on cash equivalent, marketable securities and restricted investments, net of \$0 tax | 6                                  | 10              | 68                                | 26              |
| <b>Other comprehensive income</b>   | <b>\$ 1,989</b>                    | <b>\$ 1,897</b> | <b>\$ 5,727</b>                   | <b>\$ 4,019</b> |

**13. Geographic Information**

Total revenue was distributed geographically as follows:

|                           | Three Months Ended<br>December 31, |           | Nine Months Ended<br>December 31, |           |
|---------------------------|------------------------------------|-----------|-----------------------------------|-----------|
|                           | 2006                               | 2005      | 2006                              | 2005      |
| North America             | \$ 22,391                          | \$ 19,392 | \$ 61,502                         | \$ 57,216 |
| Europe Middle East Africa | 2,707                              | 4,197     | 8,850                             | 10,842    |
| Asia-Pacific              | 1,401                              | 1,322     | 4,802                             | 4,004     |



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\$ 26,499      \$ 24,911      \$ 75,154      \$ 72,062

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

### **14. Recently Issued Accounting Pronouncements**

In March 2006, the Emerging Issues Task Force ( EITF ) reached a consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the

**Table of Contents****NetScout Systems, Inc.****Notes to Condensed Consolidated Financial Statements (Continued)****(In thousands, except share and per share data)****(Unaudited)**

Income Statement (that is, Gross versus Net Presentation) that entities may adopt a policy of presenting taxes in the income statement on either a gross or net basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. EITF 06-3 is effective for fiscal years beginning after December 15, 2006. Taxes within the scope of this EITF consensus would include taxes that are imposed on a revenue transaction between a seller and a customer, for example, sales taxes, use taxes, value-added taxes, and some types of excise taxes. EITF 06-3 will not impact the method for recording these sales taxes in the Company's consolidated financial statements as the Company presents sales net of any and all taxes and will continue to do so.

In July 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ), which prescribes a recognition threshold and measurement attribute, as well as criteria for subsequently recognizing, derecognizing and measuring uncertain tax positions for financial statement purposes. FIN 48 also requires expanded disclosure with respect to the uncertainty in income tax assets and liabilities. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be recognized as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The Company is currently evaluating the impact of adopting the provisions of FIN 48 in fiscal 2008.

In September 2006, the FASB issued SFAS No.157, Fair Value Measurements ( SFAS 157 ). SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, with early adoption permitted. The Company is currently assessing the impact of adopting SFAS 157 but does not expect that it will have a material effect on its consolidated financial position or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin ( SAB ) 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. SAB 108 is effective for fiscal years ending after November 15, 2006. In the third quarter of fiscal 2007, the Company completed its assessment of the impact of adopting SAB 108, and has determined that this adoption will not have a material effect on its consolidated financial position or results of operations.

**15. Subsequent Events**

On January 3, 2007 the Company announced that Narendra V. Popat, the Chairman of the Board of Directors and Secretary of the Company, would be retiring effective January 19, 2007. The Company and Mr. Popat entered into a separation agreement effective January 19, 2007, whereupon Mr. Popat became an advisor, through January 2010, to the Company's Chief Executive Officer. The separation agreement provides for the payment of severance of \$16 per month, along with continued health and dental benefits, until Mr. Popat, now age 57, reaches the age of 65. Should Mr. Popat die before the age of 65, the balance of any such severance payments due Mr. Popat would be paid to his estate in one lump sum payment equal to the net present value of such remaining monthly payments. During the fourth quarter of fiscal year 2007, the Company will record a pre-tax charge of \$1.3 million, representing the net present value of expected future severance and benefit payments.

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**NetScout Systems, Inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(In thousands, except share and per share data)**

**(Unaudited)**

On January 3, 2007, the Company announced that Anil K. Singhal, the President and Chief Executive Office of the Company, would also assume the role of Chairman of the Board, effective as of January 19, 2007. In conjunction with his additional responsibilities the Company entered into a new employment agreement with Mr. Singhal, which provides that he will receive a base salary of at least \$300. The employment agreement provides for a three-year term commencing January 19, 2007 with automatic one-year renewals. During the term of this agreement, Mr. Singhal will also be eligible to receive an annual bonus based on company performance and individual objectives. The employment agreement is terminable at will by either party, and provides that if the Company elects not to renew the agreement for any reason, or if Mr. Singhal's employment is terminated by NetScout without cause, by Mr. Singhal at any time following the consummation of a sale of the Company, or upon the death or disability of Mr. Singhal, Mr. Singhal, or his estate, is entitled to receive in a lump sum, a payment equal to the net present value of \$16 per month for a period of 7 years. If Mr. Singhal terminates his employment with the Company for any reason prior to the consummation of a sale of the Company, he is entitled to such lump sum payment for the period for which his severance benefits have vested (not to exceed 7 years). Mr. Singhal shall also receive continued health and dental benefits during such period. Mr. Singhal's severance benefits will vest at a rate of 1.5 years for every year of future service, prorated for any partial year. The Company has projected its future payments under this agreement at approximately \$1.4 million, with benefit payments estimated to commence in fiscal year 2012. The Company's accrued cost for this unfunded retirement obligation was \$0 as of December 31, 2006. Estimated pre-tax expense of approximately \$1.3 million, representing the present value of this future obligation, will be recognized ratably over the vesting period of approximately 4 years and 8 months beginning in the fourth quarter of fiscal year 2007.

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**Table of Contents*****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following information should be read in conjunction with the unaudited condensed consolidated financial information and the notes thereto included in this Quarterly Report on Form 10-Q. In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements that involve risks and uncertainties. You should not place undue reliance on these forward-looking statements. Actual events or results may differ materially due to competitive factors and other factors discussed in Item 1A. *Risk Factors* and elsewhere in this Quarterly Report. These factors may cause our actual results to differ materially from any forward-looking statement.

***Overview***

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

NetScout was incorporated in 1984 as a consulting services company. In 1992, we began to develop, manufacture and market our first infrastructure performance management products. Our operations have been financed principally through cash provided by operations. In addition, NetScout completed an initial public offering of 3,000,000 shares of common stock in August 1999.

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

For the nine months ended December 31, 2006, our total revenue increased \$3.1 million to \$75.2 million compared to \$72.1 million of total revenue for the nine months ended December 31, 2005. In addition, our cost of revenue decreased by \$500,000 to \$16.8 million for the nine months ended December 31, 2006 compared to \$17.3 million for the nine months ended December 31, 2005. Gross profit at \$58.4 million, or 77.7% of revenue, for the nine months ended December 31, 2006 increased from \$54.8 million, or 76.0% of revenue, for the nine months ended December 31, 2005. Our gross margin is primarily impacted by the mix and volume of product and service revenue. We realize significantly higher gross margins on service revenue relative to product revenue. Service revenue for the nine months ended December 31, 2006 increased \$3.3 million, or 13.0%, to \$28.8 million from \$25.5 million for the nine months ended December 31, 2005.

For the nine months ended December 31, 2006, our total operating expenses, which include research and development, sales and marketing, general and administrative expenses, amortization of intangibles and in-process research and development expenses, were \$52.8 million, increasing by \$2.5 million compared to the \$50.3 million of total operating expenses in the nine months ended December 31, 2005. The primary contributors to this increase in operating expenses were \$1.0 million in share-based compensation expenses as well as additional investment in sales and marketing through increased headcount and incentive compensation. Net income for the nine months ended December 31, 2006 increased by \$1.7 million to \$5.7 million compared to net income of \$4.0 million for the nine months ended December 31, 2005. This increase is primarily due to an increase in gross profit of \$3.6 million, resulting from the \$3.1 million increase in revenue and a favorable change in revenue mix, combined with an increase of \$1.2 million in interest income and other expense, net due to higher interest rates and increased cash, partially offset by the increase in operating expenses of \$2.5 million and an increase of \$680,000 in income tax expense due to higher income before tax.

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We are focused on expanding our operating margins through revenue growth coupled with appropriate expense control. During the nine months ended December 31, 2006, we began shipping two new products, our *nGenius* Analytics and our new *nGenius* Application Fabric Monitor based upon our next generation Application Fabric Performance Management architecture. These products are market-leading solutions that proactively identify and resolve performance problems faster and assure business service reliability in increasingly complex, high-speed networks. The *nGenius* Analytics product adds intelligent early warning capabilities to our solution set, and is based on a sophisticated behavior modeling technology for which we have recently been granted a U.S. patent. In addition, we have achieved certified integrations between our nGenius Performance Management System and HP OpenView Network Node Manager, HP OpenView Operations, and IBM Tivoli NetView. These integrations enable *nGenius* Performance Manager and nGenius Analytics to provide highly qualified, proactive alarms of network and application performance anomalies to the leading enterprise management consoles, helping customers prevent, recognize and resolve operational problems faster, improving IT efficiency and business service reliability. The *nGenius* Application Fabric Monitor represents a new class of instrumentation, combining the capabilities of our *nGenius* Probe and *nGenius* Flow Recorder products in a single high capacity, high performance platform that puts us in a superior cost-to-capability position versus our key competitors.

### ***Critical Accounting Policies***

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements requires us to make significant estimates and judgments that affect the amounts reported in our consolidated financial statements and the accompanying notes. These items are regularly monitored and analyzed by management for changes in facts and circumstances, and material changes in these estimates could occur in the future. Changes in estimates are recorded in the period in which they become known. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from our estimates.

While all of our accounting policies impact the consolidated financial statements, certain policies are viewed to be critical. Critical accounting policies are those that are both most important to the portrayal of our financial condition and results of operations and that require management's most subjective or complex judgments and estimates. We consider the following accounting policies to be critical in fully understanding and evaluating our financial results:

revenue recognition;

allowance for doubtful accounts receivable;

valuation of inventories;

valuation of goodwill and acquired intangible assets;

capitalization of software development costs, purchased software and internal use software;

share-based compensation; and

income taxes.

Please refer to the critical accounting policies set forth in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006, filed with the SEC on June 5, 2006, for a description of all critical accounting policies except for a description of our stock-based compensation critical accounting policy, set forth below, which was implemented upon our adoption of SFAS No. 123(R) on April 1, 2006, the beginning of our 2007 fiscal year.



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***Share-based Compensation***

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

Based on historical experience the Company has assumed an annualized forfeiture rate of 0% for awards granted to its two most senior executives and directors, and a 12% forfeiture rate for its remaining employees. The Company will record additional expense if the actual forfeitures are lower than estimated and will record a recovery of prior expense if the actual forfeitures are higher than estimated. The cumulative effect of the accounting change resulted in pre-tax income of \$111,000 and was recognized in the statement of operations for the nine-month period ended December 31, 2006.

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

**Table of Contents****Results of Operations**

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

|   | Three Months Ended<br>December 31, |              | Nine Months Ended<br>December 31, |              |
|---|------------------------------------|--------------|-----------------------------------|--------------|
|   | 2006                               | 2005         | 2006                              | 2005         |
| <b>Revenue:</b>   |                                    |              |                                   |              |
| Product   | 61.8%                              | 65.3%        | 61.7%                             | 64.4%        |
| Service   | 38.2                               | 34.7         | 38.3                              | 35.3         |
| License and royalty   |                                    |              |                                   | 0.3          |
| <b>Total revenue</b>  | <b>100.0</b>                       | <b>100.0</b> | <b>100.0</b>                      | <b>100.0</b> |
| <b>Cost of revenue:</b>   |                                    |              |                                   |              |
| Product   | 17.1                               | 19.1         | 17.0                              | 19.0         |
| Service   | 5.3                                | 4.7          | 5.3                               | 5.0          |
| <b>Total cost of revenue</b>  | <b>22.4</b>                        | <b>23.8</b>  | <b>22.3</b>                       | <b>24.0</b>  |
| <b>Gross margin</b>   | <b>77.6</b>                        | <b>76.2</b>  | <b>77.7</b>                       | <b>76.0</b>  |
| <b>Operating expenses:</b>  |                                    |              |                                   |              |
| Research and development  | 18.1                               | 17.6         | 18.2                              | 18.9         |
| Sales and marketing   | 42.5                               | 40.3         | 42.7                              | 41.1         |
| General and administrative  | 9.7                                | 9.1          | 9.2                               | 9.4          |
| Amortization of acquired intangible assets                                  | 0.1                                | 0.2          | 0.2                               | 0.2          |
| In-process research and development   |                                    |              |                                   | 0.2          |
| <b>Total operating expenses</b>   | <b>70.4</b>                        | <b>67.2</b>  | <b>70.3</b>                       | <b>69.8</b>  |
| Income from operations  | 7.2                                | 9.0          | 7.4                               | 6.2          |
| Interest income and other expenses, net                                     | 3.5                                | 2.8          | 4.0                               | 2.5          |
| Income before income tax expense and cumulative effect of accounting change | 10.7                               | 11.8         | 11.4                              | 8.7          |
| Income tax expense  | 3.2                                | 4.2          | 4.0                               | 3.2          |
| Cumulative effect of accounting change, net of taxes                        |                                    |              | .1                                |              |
| <b>Net income</b>   | <b>7.5%</b>                        | <b>7.6%</b>  | <b>7.5%</b>                       | <b>5.5%</b>  |

**Three Months Ended December 31, 2006 and 2005****Revenue**

Product revenue consists of sales of our hardware products and licensing of our software products. Service revenue consists of customer support agreements, consulting and training. License and royalty revenue consists of royalties under license agreements by original equipment manufacturers that incorporate components of our data collection technology into their own products or reproduce and sell our software products. No one customer or indirect channel partner accounted for more than 10% of our total revenue during the three months ended December 31, 2006 and 2005.



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|               | 2006      |              | 2005      |              | Change   |     |
|---------------|-----------|--------------|-----------|--------------|----------|-----|
|               | Dollars   | % of Revenue | Dollars   | % of Revenue | \$       | %   |
| Revenue:      |           |              |           |              |          |     |
| Product       | \$ 16,366 | 62%          | \$ 16,274 | 65%          | \$ 92    | 1%  |
| Service       | 10,133    | 38           | 8,637     | 35           | 1,496    | 17% |
| Total Revenue | \$ 26,499 | 100%         | \$ 24,911 | 100%         | \$ 1,588 | 6%  |

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*Product.* The 1%, or \$92,000, increase in product revenue, which includes hardware and software products, was primarily due to an increase of approximately 18% in average selling price per unit due to product mix offset by a decrease of approximately 16% in unit sales during the three month period ended December 31, 2006. The decrease in unit sales and the increase in average selling price were due to sales of higher capacity products, including some of our new product introductions. These higher capacity products are often deployed in smaller numbers by our customers in place of a larger deployment of smaller, lower priced products, resulting in higher average selling prices, lower unit volumes and higher transaction sizes.

*Service.* The 17%, or \$1.5 million, increase in service revenue was primarily due to an increase in the number of customer support agreements attributable to new product sales generated during the last 12 months, combined with continued renewals of customer support agreements from our expanding installed base. Certain older probe products were removed from service eligibility during fiscal years 2007 and 2006.

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

|                      | Three Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |                  |                 |                 |           |
|----------------------|--|-----------------|------------------|-----------------|-----------------|-----------|
|                      | 2006   |                 | 2005             |                 | Change          |           |
|                      |  | % of<br>Revenue |                  | % of<br>Revenue | \$              | %         |
| Indirect             | \$ 16,222  | 61%             | \$ 14,454        | 58%             | \$ 1,768        | 12%       |
| Direct               | 10,277   | 39              | 10,457           | 42              | (180)           | (2%)      |
| <b>Total Revenue</b> | <b>\$ 26,499</b>   | <b>100%</b>     | <b>\$ 24,911</b> | <b>100%</b>     | <b>\$ 1,588</b> | <b>6%</b> |

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

Total revenue was distributed geographically as follows:

|                           | Three Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |                  |                 |                 |           |
|---------------------------|--|-----------------|------------------|-----------------|-----------------|-----------|
|                           | 2006   |                 | 2005             |                 | Change          |           |
|                           |  | % of<br>Revenue |                  | % of<br>Revenue | \$              | %         |
| <b>Geographic mix:</b>    |  |                 |                  |                 |                 |           |
| North America             | \$ 22,391  | 84%             | \$ 19,392        | 78%             | \$ 2,999        | 15        |
| <b>International:</b>     |  |                 |                  |                 |                 |           |
| Europe Middle East Africa | 2,707  | 10              | 4,197            | 17              | (1,490)         | (36%)     |
| Asia Pacific              | 1,401  | 6               | 1,322            | 5               | 79              | 6%        |
| Subtotal International:   | 4,108  | 16              | 5,519            | 22              | (1,411)         | (26%)     |
| <b>Total Revenue</b>      | <b>\$ 26,499</b>   | <b>100%</b>     | <b>\$ 24,911</b> | <b>100%</b>     | <b>\$ 1,588</b> | <b>6%</b> |

Revenue from sales to customers outside North America decreased 26% primarily as a result of a 36% decline in EMEA revenue. EMEA went through a sales force restructuring in fiscal 2006 that has not yet yielded sustained results, particularly in the mainland Europe region. We expect revenue from sales to customers outside North America to continue to account for a significant portion of our total revenue in the future.



**Table of Contents****Cost of Revenue and Gross Profit**

Cost of product revenue consists primarily of material components, personnel expenses, media duplication, manuals, packaging materials, licensed technology fees, overhead and amortization of capitalized software. Cost of service revenue consists primarily of personnel, material, overhead and support costs.

|   | 2006      |              | 2005      |              | Change   |      |
|---|-----------|--------------|-----------|--------------|----------|------|
|   | \$        | % of Revenue | \$        | % of Revenue | \$       | %    |
| <b>Three Months Ended<br/>December 31,<br/>(Dollars in Thousands)</b> |           |              |           |              |          |      |
| Cost of revenue   |           |              |           |              |          |      |
| Product   | \$ 4,528  | 17%          | \$ 4,754  | 19%          | \$ (226) | (5%) |
| Service   | 1,416     | 5            | 1,175     | 5            | 241      | 21%  |
| Total cost of revenue   | \$ 5,944  | 22%          | \$ 5,929  | 24%          | \$ 15    | %    |
| <b>Gross profit:</b>  |           |              |           |              |          |      |
| Product \$  | \$ 11,838 | 45%          | \$ 11,520 | 46%          | \$ 318   | 3%   |
| Product %   | 72%       |              | 71%       |              |          |      |
| Service \$  | \$ 8,717  | 33%          | \$ 7,462  | 30%          | \$ 1,255 | 17%  |
| Service %   | 86%       |              | 86%       |              |          |      |
| Total gross profit \$   | \$ 20,555 |              | \$ 18,982 |              | \$ 1,573 | 8%   |
| Total gross margin %  | 78%       |              | 76%       |              | 2%       |      |

*Product.* The 5%, or \$226,000, decrease in cost of product revenue was primarily due to a decrease of approximately 16% in unit sales during the three month period ended December 31, 2006 offset by an increase of approximately 7% in average cost per unit due to product mix. The product gross margin percentage increased by 1-point from 71% to 72% for the three months ended December 31, 2006 and 2005, respectively, due to the mix of higher margin products.

*Service.* The 21%, or \$241,000, increase in cost of service revenue was primarily due to a \$158,000 increase in personnel costs associated with our customer support group. The 17%, or \$1.3 million, increase in service gross profit corresponds with the 17%, or \$1.5 million, increase in service revenue, offset by the 21%, or \$241,000, increase in cost of services.

*Gross profits.* Our gross profit in absolute dollars increased 8%, or \$1.6 million. This increase was due to higher revenue and improved revenue mix, combined with the \$226,000, or 5%, decrease in product costs offset by the \$241,000, or 21%, increase in service costs. The net effect of the combined increases in revenue and increases in cost of revenue was a 2-point improvement in gross margin percentage from December 31, 2005 to December 31, 2006.

**Operating Expenses**

|   | 2006     |              | 2005     |              | Change |     |
|---|----------|--------------|----------|--------------|--------|-----|
|   | \$       | % of Revenue | \$       | % of Revenue | \$     | %   |
| <b>Three Months Ended<br/>December 31,<br/>(Dollars in Thousands)</b> |          |              |          |              |        |     |
| Research and development  | \$ 4,782 | 18%          | \$ 4,380 | 18%          | \$ 402 | 9%  |
| Sales and marketing   | 11,253   | 42%          | 10,054   | 40%          | 1,199  | 12% |
| General and administrative  | 2,571    | 10%          | 2,266    | 9%           | 305    | 13% |
| Amortization of acquired intangible assets                            | 39       | %            | 39       | %            |        | %   |

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|                          |           |     |           |     |          |     |
|--------------------------|-----------|-----|-----------|-----|----------|-----|
| Total Operating Expenses | \$ 18,645 | 70% | \$ 16,739 | 67% | \$ 1,906 | 11% |
|--------------------------|-----------|-----|-----------|-----|----------|-----|

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*Research and development.* Research and development expenses consist primarily of personnel expenses, fees for outside consultants, overhead and related expenses associated with the development of new products and the enhancement of existing products.

The 9%, or \$402,000, increase in research and development expenses was primarily due to a \$307,000 increase in incentive compensation, an increase of \$74,000 in non-recurring engineering and a \$49,000 increase in share-based compensation due to the adoption of SFAS 123R offset by a \$59,000 decrease in employee related expenses due to decreased headcount. Average headcount in research and development was 105 and 110 for the three months ended December 31, 2006 and 2005, respectively.

*Sales and marketing.* Sales and marketing expenses consist primarily of personnel expenses, overhead and other expenses associated with selling activities and marketing programs such as trade shows, seminars, advertising and new product launch activities.

The 12%, or \$1.2 million, increase in total sales and marketing expenses was primarily due to a \$735,000 increase in employee related expenses primarily due to increased sales compensation, a \$286,000 increase in sales travel, a \$63,000 increase in trade show expenses primarily due to the participation in two additional trade shows in the third quarter of fiscal year 2007, and a \$116,000 increase in share-based compensation due to the adoption of SFAS 123R, offset by a \$53,000 decrease in sales recruitment expenses mainly due to higher turnover during the three months ended December 31, 2005. Average headcount in sales and marketing was 149 and 147 for the three months ended December 31, 2006 and 2005, respectively.

*General and administrative.* General and administrative expenses consist primarily of personnel expenses for executive, financial, legal and human resource employees, overhead and other corporate expenditures.

The 13%, or \$305,000, increase in general and administrative expenses was primarily due to a \$107,000 increase in employee related expenses mainly due to incentive compensation, a \$29,000 increase in travel, a \$39,000 increase in legal fees, a \$69,000 increase in work performed by consultants related to internal control reviews and investor relations and an \$11,000 increase in share-based compensation expenses due to the adoption of SFAS 123R. Average headcount in general and administrative was 53 and 55 for the three months ended December 31, 2006 and 2005, respectively.

*Amortization of acquired intangible assets.* Amortization of acquired intangible assets was \$39,000 for the three months ended December 31, 2006 and 2005, respectively due to non-compete agreements related to the acquisition of substantially all of the assets of Quantiva in the first quarter of fiscal 2006.

*Interest and other income, net.* Interest and other income, net includes interest earned on our cash, cash equivalents, marketable securities and restricted investments, gain (loss) on disposal of equipment and interest expense.

|                                | Three Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |        |                 |        |     |
|--------------------------------|--|-----------------|--------|-----------------|--------|-----|
|                                | 2006   |                 | 2005   |                 | Change |     |
|                                |  | % of<br>Revenue |        | % of<br>Revenue | \$     | %   |
| Interest and other income, net | \$ 917   | 4%              | \$ 687 | 3%              | \$ 230 | 33% |

The 33%, or \$230,000, increase in interest and other income, net was primarily due to an increase in cash, cash equivalents and marketable securities combined with higher market interest rates being paid on these instruments this year as opposed to last year.

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*Income tax expense.* We estimate our income tax expense based on our estimated annual effective tax rate. The estimated annual effective tax rate as of December 31, 2006 for fiscal year 2007 is 35.5%, compared to an estimated annual effective tax rate of 36.7% as of December 31, 2005 for fiscal year 2006. Generally, the estimated annual effective tax rates differ from the federal statutory and state tax rates primarily due to the impact of federal and state tax credits. The estimated effective tax rate for the three months ended December 31, 2006 is 29.8%. The rate for the three months ended December 31, 2006 is approximately 6-points lower than the annual effective tax rate due to adjustments in the third quarter of prior estimates relating to tax deductions and credits in connection with the completion of the fiscal year 2006 tax return, filed during the three months ended December 31, 2006.

|                     | Three Months Ended<br>December 31,<br>(Dollars in Thousands) |         | 2005     |         | Change   |       |
|---------------------|--|---------|----------|---------|----------|-------|
|                     | 2006   | % of    | 2005     | % of    | \$       | %     |
|                     |  | Revenue |          | Revenue |          |       |
| Income tax expenses | \$ 844   | 3%      | \$ 1,043 | 4%      | \$ (199) | (19%) |

*Net income.* Net income for the three months ended December 31, 2006 and 2005 is as follows:

|            | Three Months Ended<br>December 31,<br>(Dollars in Thousands) |         | 2005     |         | Change |    |
|------------|--|---------|----------|---------|--------|----|
|            | 2006   | % of    | 2005     | % of    | \$     | %  |
|            |  | Revenue |          | Revenue |        |    |
| Net income | \$ 1,983   | 7%      | \$ 1,887 | 8%      | \$ 96  | 5% |

The \$96,000 increase in net income was mainly attributable to the increase in gross profit of \$1.6 million, an increase of \$230,000 in interest and other income, net and a decrease of \$199,000 in income tax expense, partially offset by a \$1.1 million increase in employee related expenses mainly due to incentive compensation increases, and an increase in operating share-based compensation expense of \$189,000.

**Nine Months Ended December 31, 2006 and 2005****Revenue**

Product revenue consists of sales of our hardware products and licensing of our software products. Service revenue consists of customer support agreements, consulting and training. License and royalty revenue consists of royalties under license agreements by original equipment manufacturers that incorporate components of our data collection technology into their own products or reproduce and sell our software products. No one customer or indirect channel partner accounted for more than 10% of our total revenue during the nine months ended December 31, 2006 and 2005.

|                     | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |         | 2005      |         | Change   |        |
|---------------------|---|---------|-----------|---------|----------|--------|
|                     | 2006  | % of    | 2005      | % of    | \$       | %      |
|                     |   | Revenue |           | Revenue |          |        |
| Revenue:            |   |         |           |         |          |        |
| Product             | \$ 46,351   | 62%     | \$ 46,389 | 64%     | \$ (38)  | %      |
| Service             | 28,803  | 38      | 25,489    | 36      | 3,314    | 13%    |
| License and royalty |   |         | 184       |         | (184)    | (100%) |
| Total Revenue       | \$ 75,154   | 100%    | \$ 72,062 | 100%    | \$ 3,092 | 4%     |





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*Product.* The \$38,000 decrease in product revenue, which includes hardware and software products, was primarily due to a decrease of approximately 16% in unit sales during the nine month period ended December 31, 2006, offset by an increase of approximately 18% in average selling price per unit due to product mix. The decrease in unit sales and the increase in average selling price were due to sales of higher capacity products, including some of our new product introductions. These higher capacity products are often deployed in smaller numbers by our customers in place of a larger deployment of smaller, lower priced products, resulting in higher average selling prices, lower unit volumes and higher transaction sizes.

*Service.* The 13%, or \$3.3 million, increase in service revenue was primarily due to an increase in the number of customer support agreements attributable to new product sales generated during the last 12 months, combined with continued renewals of customer support agreements from our expanding installed base. Certain older probe products were removed from service eligibility during fiscal years 2007 and 2006.

*License and Royalty.* The \$184,000 decrease in license and royalty revenue was due to the discontinuation of reselling Real Time Monitor by Cisco Systems, Inc. as of February 8, 2005. There will be no future royalty revenue from Cisco related to this reseller agreement.

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

|                      | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |                  |                 |                 |           |
|----------------------|---|-----------------|------------------|-----------------|-----------------|-----------|
|                      | 2006  |                 | 2005             |                 | Change          |           |
|                      | \$  | % of<br>Revenue | \$               | % of<br>Revenue | \$              | %         |
| Indirect             | \$ 46,078   | 61%             | \$ 44,159        | 61%             | \$ 1,919        | 4%        |
| Direct               | 29,076  | 39              | 27,903           | 39              | 1,173           | 4%        |
| <b>Total Revenue</b> | <b>\$ 75,154</b>  | <b>100%</b>     | <b>\$ 72,062</b> | <b>100%</b>     | <b>\$ 3,092</b> | <b>4%</b> |

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

Total revenue was distributed geographically as follows:

|                           | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |                  |                 |                 |           |
|---------------------------|---|-----------------|------------------|-----------------|-----------------|-----------|
|                           | 2006  |                 | 2005             |                 | Change          |           |
|                           | \$  | % of<br>Revenue | \$               | % of<br>Revenue | \$              | %         |
| <b>Geographic mix:</b>    |   |                 |                  |                 |                 |           |
| North America             | \$ 61,502   | 82%             | \$ 57,216        | 79%             | \$ 4,286        | 7%        |
| <b>International:</b>     |   |                 |                  |                 |                 |           |
| Europe Middle East Africa | 8,850   | 12              | 10,842           | 15              | (1,992)         | (18%)     |
| Asia Pacific              | 4,802   | 6               | 4,004            | 6               | 798             | 20%       |
| Subtotal International:   | 13,652  | 18              | 14,846           | 21              | (1,194)         | (8%)      |
| <b>Total Revenue</b>      | <b>\$ 75,154</b>  | <b>100%</b>     | <b>\$ 72,062</b> | <b>100%</b>     | <b>\$ 3,092</b> | <b>4%</b> |



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Revenue from sales to customers outside North America decreased 8% primarily as a result of a sales force restructuring in EMEA during fiscal 2006 that has not yet yielded sustained results in mainland Europe. We expect revenue from sales to customers outside North America to continue to account for a significant portion of our total revenue in the future.

**Cost of Revenue and Gross Profit**

Cost of product revenue consists primarily of material components, personnel expenses, media duplication, manuals, packaging materials, licensed technology fees, overhead and amortization of capitalized software. Cost of service revenue consists primarily of personnel, material, overhead and support costs.

|                        | 2006      |              | 2005      |              | Change   |        |
|------------------------|-----------|--------------|-----------|--------------|----------|--------|
|                        |           | % of Revenue |           | % of Revenue | \$       | %      |
| <b>Cost of revenue</b> |           |              |           |              |          |        |
| Product                | \$ 12,766 | 17%          | \$ 13,680 | 19%          | \$ (914) | (7%)   |
| Service                | 3,998     | 5            | 3,609     | 5            | 389      | 11%    |
| Total cost of revenue  | \$ 16,764 | 22%          | \$ 17,289 | 24%          | \$ (525) | (3%)   |
| <b>Gross profit:</b>   |           |              |           |              |          |        |
| Product \$             | \$ 33,585 | 45%          | \$ 32,709 | 45%          | \$ 876   | 3%     |
| Product %              | 72%       |              | 71%       |              |          |        |
| Service \$             | \$ 24,805 | 33%          | \$ 21,880 | 30%          | \$ 2,925 | 13%    |
| Service %              | 86%       |              | 86%       |              |          |        |
| License and royalty \$ | \$        | %            | \$ 184    | %            | \$ (184) | (100%) |
| License and royalty %  | %         |              | 100%      |              |          |        |
| Total gross profit \$  | \$ 58,390 |              | \$ 54,773 |              | \$ 3,617 | 7%     |
| Total gross margin %   | 78%       |              | 76%       |              | 2%       |        |

*Product.* The 7%, or \$914,000, decrease in cost of product revenue was primarily due to a decrease of approximately 16% in unit sales during the nine months ended December 31, 2006 as compared to the nine months ended December 31, 2005 partially offset by an increase of approximately 2% in average cost per unit due to product mix. The product gross margin percentage increased by 1-point from 71% to 72% due to the mix of higher margin products in the nine months ended December 31, 2006.

*Service.* The 11%, or \$389,000, increase in cost of service revenue was primarily due to a \$273,000 increase in personnel costs mainly due to incentive compensation, a \$73,000 increase in costs to support products under service contracts, and a \$33,000 increase in share-based compensation expenses related to the adoption of SFAS 123R. Service gross profit remained flat at 86% for the nine months ended December 31, 2006.

*Gross profits.* Our gross profit in absolute dollars increased 7%, or \$3.6 million. This increase was partially due to the \$3.3 million increase in service revenue and \$914,000 decrease in product costs, offset by a \$389,000 increase in service costs and the \$184,000 decrease in royalty revenue. The net effect of the combined increases in revenue and decreases in cost and in royalty revenue was a 2-point increase in gross margin percentage.

**Table of Contents****Operating Expenses**

|  | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |                  |                 |                 |           |
|--|---|-----------------|------------------|-----------------|-----------------|-----------|
|  | 2006  |                 | 2005             |                 | Change          |           |
|  |   | % of<br>Revenue |                  | % of<br>Revenue | \$              | %         |
| Research and development                   | \$ 13,690   | 18%             | \$ 13,633        | 19%             | \$ 57           | %         |
| Sales and marketing                        | 32,112  | 43%             | 29,608           | 41%             | 2,504           | 8%        |
| General and administrative                 | 6,913   | 9%              | 6,762            | 9%              | 151             | 2%        |
| Amortization of acquired intangible assets | 116   | %               | 110              | %               | 6               | 5%        |
| In-process research and development        |   | %               | 143              | %               | (143)           | (100%)    |
| <b>Total Operating Expenses</b>            | <b>\$ 52,831</b>  | <b>70%</b>      | <b>\$ 50,256</b> | <b>70%</b>      | <b>\$ 2,575</b> | <b>5%</b> |

*Research and development.* Research and development expenses consist primarily of personnel expenses, fees for outside consultants, overhead and related expenses associated with the development of new products and the enhancement of existing products.

Research and development expenses remained flat with a \$57,000 increase primarily due to an increase of \$101,000 in non-recurring engineering expense and a \$145,000 increase in share-based compensation due to the adoption of SFAS 123R, offset by a decrease in consulting costs, and a decrease in personnel expenses due to reduced headcount. Average headcount in research and development was 107 and 109 for the nine months ended December 2006 and 2005, respectively.

*Sales and marketing.* Sales and marketing expenses consist primarily of personnel expenses, overhead and other expenses associated with selling activities and marketing programs such as trade shows, seminars, advertising and new product launch activities.

The 8%, or \$2.5 million, increase in total sales and marketing expenses was primarily due to a \$1.4 million increase in employee related expenses primarily due to increased headcount and incentive compensation and a \$666,000 increase in sales travel due to increased headcount and increased international travel and a \$373,000 increase in share-based compensation due to the adoption of SFAS 123R. Average headcount in sales and marketing was 152 and 145 for the nine months ended December 31, 2006 and 2005, respectively.

*General and administrative.* General and administrative expenses consist primarily of personnel expenses for executive, financial, legal and human resource employees, overhead and other corporate expenditures.

The 2%, or \$151,000, increase in general and administrative expense was primarily due to a \$146,000 increase in share-based compensation expenses due to the adoption of SFAS 123R, a \$31,000 increase in legal fees, a \$117,000 increase in work performed by consultants related to the implementation of the ERP system, a \$102,000 increase in audit fees and a \$77,000 increase in Board of Director fees, offset by a \$316,000 decrease in personnel expenses mainly due to decreased headcount. Average headcount in general and administrative was 54 and 56 for the nine months ended December 31, 2006 and 2005, respectively.

*Amortization of acquired intangible assets.* Amortization of acquired intangible assets was \$116,000 and \$110,000 for the nine months ended December 31, 2006 and 2005, respectively due to non-compete agreements related to the acquisition of substantially all of the assets of Quantiva in the first quarter of fiscal 2006.

*In-process research and development.* In-process research and development expense in the nine months ended December 31, 2005, \$143,000, represents the various projects and technologies acquired in the acquisition of substantially all of the assets of Quantiva for which technological feasibility had not been established as of the acquisition date and that had no alternative future use.

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*Interest and other income, net.* Interest and other income, net includes interest earned on our cash, cash equivalents, marketable securities and restricted investments, gain (loss) on disposal of equipment and interest expense.

|                                | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |          |                 |          |     |
|--------------------------------|---|-----------------|----------|-----------------|----------|-----|
|                                | 2006  |                 | 2005     |                 | Change   |     |
|                                |   | % of<br>Revenue |          | % of<br>Revenue | \$       | %   |
| Interest and other income, net | \$ 3,004  | 4%              | \$ 1,770 | 3%              | \$ 1,234 | 70% |

The 70%, or \$1.2 million, increase in interest and other income, net was primarily due to an increase in cash, cash equivalents and marketable securities combined with higher market interest rates being paid on these instruments during such period.

*Income tax expense.* We estimate our income tax expense based on our estimated annual effective tax rate. The estimated annual effective tax rate as of December 31, 2006 for fiscal year 2007 is 35.5%, compared to an estimated annual effective tax rate of 36.7% as of December 31, 2005 for fiscal year 2006. Generally, the estimated annual effective tax rates differ from the federal statutory and state tax rates primarily due to the impact of federal and state tax credits. The estimated annual effective tax rate for fiscal year 2007 used at December 31, 2006, decreased from the estimated rate used at September 30, 2006 due to adjustments in the third quarter of prior estimates relating to tax deductions and credits in connection with the completion of the fiscal year 2006 tax return, filed during the three months ended December 31, 2006.

|                    | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |          |                 |        |     |
|--------------------|---|-----------------|----------|-----------------|--------|-----|
|                    | 2006  |                 | 2005     |                 | Change |     |
|                    |   | % of<br>Revenue |          | % of<br>Revenue | \$     | %   |
| Income tax expense | \$ 2,973  | 4%              | \$ 2,294 | 3%              | \$ 679 | 30% |

*Net income.* Net income for the nine months ended December 31, 2006 and 2005 is as follows:

|            | Nine Months Ended<br>December 31,<br>(Dollars in Thousands) |                 |          |                 |          |     |
|------------|---|-----------------|----------|-----------------|----------|-----|
|            | 2006  |                 | 2005     |                 | Change   |     |
|            |   | % of<br>Revenue |          | % of<br>Revenue | \$       | %   |
| Net income | \$ 5,659  | 8%              | \$ 3,993 | 6%              | \$ 1,666 | 42% |

The \$1.7 million, or 42%, increase in net income was mainly attributable to the increase in gross profit of \$3.6 million, an increase of \$1.2 million in interest and other income, net and the cumulative effect of accounting change, net of taxes of \$69,000, partially offset by a \$1.0 million increase in operating salaries mainly due to increased headcount, an increase in operating share-based compensation expense of \$670,000 and an increase in income tax expense of \$679,000.

**Off-Balance Sheet Arrangements**

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

**Table of Contents****Commitment and Contingencies**

From time to time NetScout is subject to legal proceedings and claims in the ordinary course of business. On December 14, 2006, Diagnostic Systems Corporation ( DSC ) filed a lawsuit against us and five other co-defendants in the United States District Court for the Central District of California claiming patent infringement. The complaint seeks damages in an unspecified amount and injunctive relief. In the lawsuit, DSC alleges that we are infringing United States Patent No. 5,701,400, and No. 5,537,590. The Company believes these claims have no merit and it will defend the lawsuit vigorously. No amounts have been accrued related to these claims. In the opinion of management, the amount of ultimate expense with respect to any current legal proceedings and claims will not have a significant adverse effect on NetScout's financial position or results of operations.

On January 3, 2007 the Company announced that Narendra V. Popat, the Chairman of the Board of Directors and Secretary of the Company, would be retiring effective January 19, 2007. The Company and Mr. Popat entered into a separation agreement effective January 19, 2007, whereupon Mr. Popat became an advisor, through January 2010, to the Company's Chief Executive Officer. The separation agreement provides for the payment of severance of \$16,000 per month, along with continued health and dental benefits, until Mr. Popat, now age 57, reaches the age of 65. Should Mr. Popat die before the age of 65, the balance of any such severance payments due Mr. Popat, would be paid to his estate in one lump sum payment equal to the net present value of such remaining monthly payments. During the fourth quarter of fiscal year 2007, the Company will record a pre-tax charge of \$1.3 million, representing the net present value of expected future severance and benefit payments.

On January 3, 2007, the Company announced that Anil K. Singhal, the President and Chief Executive Office of the Company, would also assume the role of Chairman of the Board, effective as of January 19, 2007. In conjunction with his additional responsibilities the Company entered into a new employment agreement with Mr. Singhal, which provides that he will receive a base salary of at least \$300,000. The employment agreement provides for a three-year term commencing January 19, 2007 with automatic one-year renewals. During the term of this agreement, Mr. Singhal will also be eligible to receive an annual bonus based on company performance and individual objectives. The employment agreement is terminable at will by either party, and provides that if the Company elects not to renew the agreement for any reason, or if Mr. Singhal's employment is terminated by NetScout without cause, by Mr. Singhal at any time following the consummation of a sale of the Company, or upon the death or disability of Mr. Singhal, Mr. Singhal, or his estate, is entitled to receive in a lump sum, a payment equal to the net present value of \$16,000 per month for a period of 7 years. If Mr. Singhal terminates his employment with the Company for any reason prior to the consummation of a sale of the Company, he is entitled to such lump sum payment for the period for which his severance benefits have vested (not to exceed 7 years). Mr. Singhal shall also receive continued health and dental benefits during such period. Mr. Singhal's severance benefits will vest at a rate of 1.5 years for every year of future service, prorated for any partial year. The Company has projected its future payments under this agreement at approximately \$1.4 million, with benefit payments estimated to commence in fiscal year 2012. The Company's accrued cost for this unfunded retirement obligation was \$0 as of December 31, 2006. Estimated pre-tax expense of approximately \$1.3 million, representing the present value of this future obligation, will be recognized ratably over the vesting period of approximately 4 years and 8 months beginning in the fourth quarter of fiscal year 2007.

**Liquidity and Capital Resources**

Cash, cash equivalents and marketable securities consist of the following:

|   | December 31, 2006<br>(In Thousands) | March 31, 2006<br>(In Thousands) | Change   |
|---|-------------------------------------|----------------------------------|----------|
| Cash and cash equivalents                         | \$ 70,151                           | \$ 61,676                        | \$ 8,475 |
| Short-term marketable securities                  | 14,130                              | 19,810                           | (5,680)  |
| Long-term marketable securities                   | 10,813                              | 5,979                            | 4,834    |
| Cash, cash equivalents, and marketable securities | \$ 95,094                           | \$ 87,465                        | \$ 7,629 |

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We have a line of credit with a bank, which allows us to borrow up to \$10.0 million for working capital purposes and to obtain letters of credit. Amounts available under the line of credit are a function of eligible accounts receivable, bear interest at the bank's prime rate and are collateralized by our inventory and accounts receivable. As of December 31, 2006, we had a letter of credit secured under the line aggregating \$3.2 million relating to our current principal operating lease for our corporate headquarters. No other amounts were outstanding under the line of credit. Under the agreement, we are required to comply with certain financial covenants, which require that NetScout maintain minimum amounts of liquidity, the most restrictive of which is a minimum tangible net worth of no less than \$70 million. As of December 31, 2006, we were in compliance with all such covenants with a tangible net worth of \$98 million.

Cash and cash equivalents were impacted by the following:

|   | <b>Nine Months Ended<br/>December 31,<br/>(In Thousands)</b> |             |
|---|--|-------------|
|   | <b>2006</b>  | <b>2005</b> |
| Net cash provided by operating activities | \$ 7,894   | \$ 4,587    |
| Net cash used in investing activities     | \$ (1,825)   | \$ (7,433)  |
| Net cash provided by financing activities | \$ 2,406   | \$ 2,054    |

*Net cash provided by operating activities*

Net cash provided by operating activities amounted to \$7.9 million and \$4.6 million during the nine months ended December 31, 2006 and 2005, respectively. The primary sources of operating cash flow in the nine months ended December 31, 2006 included net income of \$5.7 million, the add back of non-cash charges of \$3.6 million and the \$936,000 increase in income taxes payable offset by an increase in inventory of \$1.6 million due to purchases to support anticipated order flow and a decrease in accrued compensation of \$1.5 million mainly as a result of the timing of payments for payroll, commissions and incentive compensation. The primary sources of operating cash flow in the nine months ended December 31, 2005 included net income of \$4.0 million, adjusted to exclude the effects of non-cash charges of \$5.4 million, an increase in accrued compensation and other expenses of \$1.5 million mainly as a result of the timing of payments for payroll, commissions and incentive compensation, and an increase in deferred revenue of \$773,000 mainly due to the timing of our maintenance contract renewals, offset by an increase of \$7.1 million in accounts receivable as a result of the timing of sales within the nine month period ended December 2005.

*Net cash used in investing activities*

Cash used in investing activities was \$1.8 million and \$7.4 million for the nine months ended December 31, 2006 and 2005, respectively. For the nine months ended December 31, 2006 and 2005, cash used in investing activities reflects the purchase of marketable securities of \$43.6 million and \$56.5 million, respectively, offset by the proceeds from the maturity of marketable securities due to cash management activities of \$44.5 million and \$62.3 million, respectively, the purchase of fixed assets to support our infrastructure of \$1.5 million and \$2.8 million, respectively, and the capitalized expenditure for internal use of software of \$1.2 million and \$815,000, respectively. We anticipate that our investment in our infrastructure will continue in future quarters. For the nine months ended December 31, 2005, net cash used in investing activities also reflects the acquisition of substantially all the assets of Quantiva for \$9.5 million.

*Net cash provided by financing activities*

Cash provided by financing activities was \$2.4 million and \$2.1 million for the nine months ended December 31, 2006 and 2005, respectively. For the nine months ended December 31, 2006 and 2005, cash provided by financing activities was mainly due to proceeds from the issuance of common stock in connection

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with the exercise of stock options. For the nine months ended December 31, 2006, cash provided by financing activities was also due to a tax benefit from stock options exercised of \$889,000, offset by treasury stock purchases of \$1.4 million.

We believe that our cash balances, marketable securities classified as available-for-sale and any future cash flows generated by operations will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. If demand for our product were to decrease substantially, our ability to generate cash flow sufficient for our short-term working capital and expenditure needs could be materially impacted.

Additionally, a portion of our cash may be used to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies. From time to time, in the ordinary course of business, we evaluate potential acquisitions of such businesses, products or technologies. If our existing sources of liquidity are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or debt securities. The sale of additional equity or debt securities could result in additional dilution to our stockholders.

## **Recently Issued Accounting Pronouncements**

In March 2006, the EITF reached a consensus on EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* that entities may adopt a policy of presenting taxes in the income statement on either a gross or net basis. Gross or net presentation may be elected for each different type of tax, but similar taxes should be presented consistently. EITF 06-3 is effective for fiscal years beginning after December 15, 2006. Taxes within the scope of this EITF consensus would include taxes that are imposed on a revenue transaction between a seller and a customer, for example, sales taxes, use taxes, value-added taxes, and some types of excise taxes. EITF 06-3 will not impact the method for recording these sales taxes in NetScout's consolidated financial statements as NetScout presents sales net of any and all taxes and will continue to do so.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( *FIN 48* ), which prescribes a recognition threshold and measurement attribute, as well as criteria for subsequently recognizing, derecognizing and measuring uncertain tax positions for financial statement purposes. FIN 48 also requires expanded disclosure with respect to the uncertainty in income tax assets and liabilities. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be recognized as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. The company is currently evaluating the impact of adopting the provisions of FIN 48 in fiscal 2008.

In September 2006, the FASB issued SFAS No.157, *Fair Value Measurements* ( *SFAS 157* ). SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, with early adoption permitted. The Company is currently assessing the impact of adopting SFAS 157 but does not expect that it will have a material effect on our consolidated financial position or results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin ( *SAB* ) 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( *SAB 108* ). SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. SAB 108 is effective for fiscal years ending after November 15, 2006. In the third quarter of fiscal 2007, the Company completed its assessment of the impact of adopting SAB 108, and has determined that this adoption will not have a material effect on our consolidated financial position or results of operations.



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***Item 3. Quantitative and Qualitative Disclosures About Market Risk***

We consider all highly liquid marketable securities purchased with a maturity of three months or less to be cash equivalents and those with maturities greater than three months are considered to be marketable securities. Cash equivalents and short-term marketable securities are stated at cost plus accrued interest, which approximates fair value. Long-term marketable securities are stated at fair value based on quoted market prices. Cash equivalents and marketable securities consist primarily of money market instruments and U.S. Treasury bills. NetScout's primary market risk exposures are in the areas of interest rate risk and foreign currency exchange rate risk. We currently do not hedge interest rate exposure, but do not believe that a fluctuation in interest rates would have a material impact on the value of our cash equivalents. NetScout's exposure to interest rates based on outstanding debt has been and is expected to continue to be modest due to the fact that although we currently have a \$10.0 million line of credit with \$3.2 million of letters of credit secured against it, we have no amounts outstanding under the line and no other outstanding interest-bearing debt.

NetScout's exposure to currency exchange rate fluctuations has been limited. All revenue transactions are executed in U.S. dollars. NetScout pays for certain foreign operating expenses such as payroll, rent and office expense in the local currency and, therefore, currency exchange rate fluctuations could have a material and adverse impact on our operating results and financial condition. Currently, NetScout does not engage in foreign currency hedging activities. The impact of currency exchange rate fluctuations on the translation of foreign currency denominated account balances and transactions is recorded in the period incurred.

***Item 4. Controls and Procedures***

As of December 31, 2006, NetScout, under the supervision and with the participation of our management, including the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) promulgated under the Securities Exchange Act of 1934. Based upon that evaluation, our principal executive officer and principal financial officer concluded that, as of December 31, 2006, our disclosure controls and procedures were effective in ensuring that material information relating to NetScout, including its consolidated subsidiaries, required to be disclosed by NetScout 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, including ensuring that such material information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in our internal controls that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II: OTHER INFORMATION**

***Item 1. Legal Proceedings***

From time to time NetScout is subject to legal proceedings and claims in the ordinary course of business. On December 14, 2006, Diagnostic Systems Corporation ( DSC ) filed a lawsuit against us and five other co-defendants in the United States District Court for the Central District of California claiming patent infringement. The complaint seeks damages in an unspecified amount and injunctive relief. In the lawsuit, DSC alleges that we are infringing United States Patent No. 5,701,400, and No. 5,537,590. The Company believes these claims have no merit and it will defend the lawsuit vigorously. No amounts have been accrued for these claims. In the opinion of management, the amount of ultimate expense with respect to any current legal proceedings and claims will not have a significant adverse effect on NetScout's financial position or results of operations.

***Item 1A. Risk Factors***

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended March 31, 2006. The risks discussed in our Annual Report on Form 10-K could materially affect our business, financial condition and future results. The risks described in our Annual Report on Form 10-K are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially and adversely affect our business, financial condition or operating results.

The Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006 have not materially changed, other than the following:

The Risk Factor entitled **Loss of key personnel could adversely impact our business** has been updated to reflect the retirement of our Chairman of the Board and co-founder, Narendra Popat. The Risk Factors entitled **Failure to manage growth properly and to implement enhanced automated systems could adversely impact our business**, and **The effectiveness of our disclosure and internal controls may be limited** have been updated to reflect the change in the anticipated date that our new Enterprise Resource Planning ( ERP ) system will become operational, from fiscal year 2007 to fiscal year 2008.

**Loss of key personnel could adversely impact our business.** During the fourth quarter of fiscal year 2007, Narendra Popat, our Chairman of the Board and co-founder, retired. The Company subsequently named Anil Singhal, our President, Chief Executive Officer and co-founder, as our succeeding Chairman of the Board. Our future success depends to a significant degree on the skills, experience and efforts of Mr. Singhal, and our other executive officers and senior managers to work effectively as a team. The loss of one or more of our key personnel could have a material and adverse impact on our business, operating results and financial condition.

**Failure to manage growth properly and to implement enhanced automated systems could adversely impact our business.** The growth in size and complexity of our business and our customer base has been and will continue to be a challenge to our management and operations. To manage further growth effectively, we must integrate new personnel and manage expanded operations. We must also implement a new ERP system in order to manage the growth and increasing complexity of our business operations and to continue to enhance our internal control over financial reporting in accordance with Sarbanes-Oxley. Our ERP selection process is complete and we began implementation efforts in the first quarter of our fiscal year ending March 31, 2006, with the new ERP system anticipated to be operational during fiscal year 2008. If we are unable to manage our growth effectively, our costs, the quality of our products, the effectiveness of our sales organization and our retention of key personnel, our business, operating results and financial condition could be materially and adversely impacted.

**The effectiveness of our disclosure and internal controls may be limited.** Our disclosure controls and procedures and internal control over financial reporting may not prevent all errors and intentional

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misrepresentations. Any system of internal control can only provide reasonable assurance that all control objectives are met. Some of the potential risks involved could include but are not limited to management judgments, simple errors or mistakes, willful misconduct regarding controls or misinterpretation. There is no guarantee that existing controls will prevent or detect all material issues or that existing controls will be effective in future conditions, which could materially and adversely impact our financial results. Under Section 404 of Sarbanes-Oxley, we are required to evaluate and determine the effectiveness of our internal control over financial reporting. Compliance with this legislation requires management's attention and resources and will continue to cause us to incur significant expense. Management's assessment of our internal control over financial reporting may identify weaknesses that need to be addressed or other matters that may raise concerns for investors. If we determine that we have material weaknesses in our internal control over financial reporting, our results of operations or financial condition may be materially adversely affected or the price of our common stock may decline.

Although we determined that the operating effectiveness of the Company's internal control over financial reporting as of March 31, 2006 was effective, in future years we may encounter problems or delays in completing the implementation of any changes necessary to attain a favorable assessment of our internal control over financial reporting or we may encounter problems or delays in completing the implementation of any required improvements. If in future annual reports we cannot favorably assess the effectiveness of our internal control over financial reporting, or if our independent auditors are unable to provide an unqualified attestation report on our assessment, the price of our common stock may decline.

In order to continue the enhancement of our internal control over financial reporting and to manage the growth and increasing complexity of our business, we are in the process of implementing a new ERP system that is expected to be operational in fiscal year 2008. If we are unable to implement this system successfully, improvements to our internal control over financial reporting could be adversely impacted and this could have a material and adverse impact on our financial results in the future.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the third quarter of fiscal year 2007, the Company repurchased shares of its outstanding common stock pursuant to its open market stock repurchase program further described above in Note 10 to the Condensed Consolidated Financial Statements attached hereto.

The following table provides information about our monthly share repurchases as part of publicly announced programs for the three months ended December 31, 2006.

| Period                                     | Issuer Purchases Of Equity Securities |                              | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|--|---------------------------------------|------------------------------|--|--|
|  | Total Number of Shares Purchased      | Average Price Paid per Share |  |  |
| October 1, 2006 through October 31, 2006   | 20,781                                | \$ 8.00                      | 20,781   | 3,669,219  |
| November 1, 2006 through November 31, 2006 | 31,900                                | \$ 7.89                      | 31,900   | 3,637,319  |
| December 1, 2006 through December 31, 2006 |                                       | \$                           |  | 3,637,319  |

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***Item 5. Other Information***

On February 2, 2007, the Company amended the employment agreement with its President, Chief Executive Officer, and Chairman, Anil Singhal. As a result of the amendment, if the Company elects not to renew the agreement for any reason, or if Mr. Singhal's employment is terminated by the Company without cause, by Mr. Singhal at any time following the consummation of a sale of the Company, or upon the death or disability of Mr. Singhal, Mr. Singhal, or his estate, is entitled to receive in a lump sum, a payment equal to the net present value of \$16,000 per month for a period of 7 years. If Mr. Singhal terminates his employment with the Company for any reason prior to the consummation of the sale of the Company, he is entitled to payment for the period for which his severance benefits have vested (not to exceed 7 years). Mr. Singhal shall also receive continued health and dental benefits during such period. Mr. Singhal's severance benefits will vest at a rate of 1.5 years for every year of future service, prorated for any partial year.

***Item 6. Exhibits***

(a) Exhibits

- 10.1 Amendment No. 1 to Agreement Relating to Employment, dated February 1, 2007, by and between the Company and Anil K. Singhal (filed herewith).
- 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements 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.

NETSCOUT SYSTEMS, INC.

Date: February 5, 2007

/s/ ANIL K. SINGHAL  
**Anil K. Singhal**

**President, Chief Executive Officer and Chairman**

**(Principal Executive Officer)**

Date: February 5, 2007

/s/ DAVID P. SOMMERS  
**David P. Sommers**

**Senior Vice President, General Operations, Chief Financial Officer,  
Treasurer and Secretary  
(Principal Financial Officer)**

Date: February 5, 2007

/s/ JEFFREY R. WAKELY  
**Jeffrey R. Wakely**

**Vice President, Finance and Chief Accounting Officer  
(Principal Accounting Officer)**

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**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
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