NETSCOUT SYSTEMS INC
Form 10-Q
November 08, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission file number 000-26251

NETSCOUT SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	04-2837575
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

310 Littleton Road, Westford, MA 01886
(978) 614-4000

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files.) YES x NO ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer ¨

Non-accelerated filer ¨

Smaller reporting company ¨ Emerging growth company ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x
The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of October 31, 2018 was 77,704,724.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2018
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Unless the context suggests otherwise, references in this Quarterly Report on Form 10-Q, or Quarterly Report, to "NetScout," the "Company," "we," "us," and "our" refer to NetScout Systems, Inc. and, where appropriate, our consolidated subsidiaries.

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

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Cautionary Statement Concerning Forward-Looking Statements

In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking statements under Section 21E of the Securities Exchange Act of 1934, as amended, and other federal securities laws. These forward-looking statements involve risks and uncertainties. These statements relate to future events or our future financial performance and are identified by terminology such as "may," "will," "could," "should," "expects," "plans," "intends," "seeks," "anticipates," "believes," "estimates," "potential" or "continue," or the negative of such terms or other comparable terminology. These statements are only predictions. You should not place undue reliance on these forward-looking statements. Actual events or results may differ materially due to competitive factors and other factors, including those referred to in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended March 31, 2018, filed with the Securities and Exchange Commission, and elsewhere in this Quarterly Report. These factors may cause our actual results to differ materially from any forward-looking statement. We are under no duty to update any of these forward-looking statements after the date of this Quarterly Report or to conform these statements to actual results or revised expectations.

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PART I: FINANCIAL INFORMATION
Item 1. Unaudited Financial Statements
NetScout Systems, Inc.
Consolidated Balance Sheets
(In thousands, except share and per share data)

	September 30, 2018 (Unaudited)	March 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	$ 332,183	$ 369,821
Marketable securities	119,935	77,941
Accounts receivable and unbilled costs, net of allowance for doubtful accounts of $1,209 and $1,991 at September 30, 2018 and March 31, 2018, respectively	184,156	213,438
Inventories and deferred costs	30,985	34,774
Prepaid income taxes	25,143	22,932
Prepaid expenses and other current assets (related party balances of $1,468 and $3,187 at September 30, 2018 and March 31, 2018, respectively)	27,429	33,502
Total current assets	719,831	752,408
Fixed assets, net	63,617	52,511
Goodwill	1,712,962	1,712,764
Intangible assets, net	720,949	831,374
Deferred income taxes	5,640	6,685
Other assets	20,006	12,866
Total assets	$ 3,243,005	$ 3,368,608
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable (related party balances of $366 and $369 at September 30, 2018 and March 31, 2018, respectively)	$ 22,102	$ 30,133
Accrued compensation	54,258	46,552
Accrued other	32,364	33,164
Income taxes payable	210	1,526
Deferred revenue and customer deposits	230,098	301,925
Total current liabilities	339,032	413,300
Other long-term liabilities	20,449	8,308
Deferred tax liability	135,738	151,563
Accrued long-term retirement benefits	34,053	35,246
Long-term deferred revenue and customer deposits	77,135	91,409
Long-term debt	600,000	600,000
Total liabilities	1,206,407	1,299,826
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Preferred stock, $0.001 par value:		
5,000,000 shares authorized; no shares issued or outstanding at September 30, 2018 and March 31, 2018	—	—
Common stock, $0.001 par value:		
	119	117

300,000,000 shares authorized; 119,231,287 and 117,744,913 shares issued and 77,704,724 and 80,270,023 shares outstanding at September 30, 2018 and March 31, 2018, respectively		
Additional paid-in capital	2,796,695	2,665,120
Accumulated other comprehensive income	555	2,895
Treasury stock at cost, 41,526,563 and 37,474,890 shares at September 30, 2018 and March 31, 2018, respectively	(1,102,481)	(995,843)
Retained earnings	341,710	396,493
Total stockholders' equity	2,036,598	2,068,782
Total liabilities and stockholders' equity	$ 3,243,005	$ 3,368,608

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

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NetScout Systems, Inc.
Consolidated Statements of Operations
(In thousands, except per share data)
(Unaudited)

	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Six Months Ended September 30, 2018	Six Months Ended September 30, 2017
Revenue:				
Product	$110,753	$142,973	$207,680	$251,632
Service	113,044	113,890	221,228	230,987
Total revenue	223,797	256,863	428,908	482,619
Cost of revenue:				
Product (related party balances of $0, $0, $0 and $245, respectively)	34,492	44,371	67,457	80,833
Service (related party balances of $146, $259, $320 and $288, respectively)	29,488	29,872	58,550	59,972
Total cost of revenue	63,980	74,243	126,007	140,805
Gross profit	159,817	182,620	302,901	341,814
Operating expenses:				
Research and development (related party balances of $0, $0, $2 and $3, respectively)	55,959	58,509	111,422	117,475
Sales and marketing (related party balances of $0, $0, $0 and $2, respectively)	72,051	77,266	150,183	162,627
General and administrative (related party balances of $2, $700, $15 and $944, respectively)	25,294	29,495	51,353	59,367
Amortization of acquired intangible assets	17,981	18,298	41,446	36,681
Restructuring charges	2,472	291	3,619	458
Impairment of intangible assets	—	—	35,871	—
Loss on divestiture of business	9,177	—	9,177	—
Total operating expenses	182,934	183,859	403,071	376,608
Loss from operations	(23,117)	(1,239)	(100,170)	(34,794)
Interest and other expense, net:				
Interest income	1,293	410	2,233	890
Interest expense	(6,427)	(2,565)	(12,315)	(5,116)
Other expense	(812)	(1,168)	(557)	(2,232)
Total interest and other expense, net	(5,946)	(3,323)	(10,639)	(6,458)
Loss before income tax benefit	(29,063)	(4,562)	(110,809)	(41,252)
Income tax benefit	(2,635)	(2,094)	(21,877)	(14,562)
Net loss	$(26,428)	$(2,468)	$(88,932)	$(26,690)
Basic net loss per share	$(0.34)	$(0.03)	$(1.12)	$(0.30)
Diluted net loss per share	$(0.34)	$(0.03)	$(1.12)	$(0.30)
Weighted average common shares outstanding used in computing:				
Net loss per share - basic	78,631	88,589	79,490	89,878
Net loss per share - diluted	78,631	88,589	79,490	89,878

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

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

	Three Months Ended		Six Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net loss	$(26,428)	$(2,468)	$(88,932)	$(26,690)
Other comprehensive income (loss):				
Cumulative translation adjustments	559	2,495	(2,149)	3,630
Changes in market value of investments:				
Changes in unrealized gains (losses), net of (benefit) taxes of ($20), $8, $9 and $5, respectively	(5)	13	23	9
Total net change in market value of investments	(5)	13	23	9
Changes in market value of derivatives:				
Changes in market value of derivatives, net of (benefit) taxes of ($14), $153, ($140) and $343, respectively	(45)	262	(438)	566
Reclassification adjustment for net gains (losses) included in net loss, net of taxes (benefit) of $49, ($143), $72 and ($139), respectively	153	(236)	224	(228)
Total net change in market value of derivatives	108	26	(214)	338
Other comprehensive income (loss)	662	2,534	(2,340)	3,977
Total comprehensive income (loss)	$(25,766)	$66	$(91,272)	$(22,713)

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

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

	Six Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net loss	$(88,932)	$(26,690)
Adjustments to reconcile net loss to cash provided by operating activities, net of the effects of acquisitions:		
Depreciation and amortization	74,558	75,209
Loss on divestiture of business	7,390	—
Loss on disposal of fixed assets	174	421
Deal-related compensation expense and accretion charges	76	76
Share-based compensation expense	30,383	22,829
Accretion of contingent consideration	(10)	—
Impairment of intangible assets	35,871	—
Deferred income taxes	(22,289)	(17,335)
Other (gains) losses	(208)	732
Changes in assets and liabilities		
Accounts receivable and unbilled costs	29,325	82,280
Due from related party	1,719	554
Inventories	892	(1,048)
Prepaid expenses and other assets	4,751	(1,668)
Accounts payable	(9,518)	(8,092)
Accrued compensation and other expenses	15,413	(8,080)
Due to related party	(3)	168
Income taxes payable	(1,759)	1,769
Deferred revenue	(45,127)	(49,064)
Net cash provided by operating activities	32,706	72,061
Cash flows from investing activities:		
Purchase of marketable securities	(136,019)	(57,776)
Proceeds from maturity of marketable securities	94,057	155,741
Purchase of fixed assets	(12,207)	(7,554)
Payments related to the divestiture of business	(2,911)	—
Purchase of intangible assets	—	(505)
(Increase) decrease in deposits	(97)	30
Acquisition of businesses, net of cash acquired	—	(8,334)
Contingent purchase consideration	—	523
Capitalized software development costs	—	(110)
Net cash (used in) provided by investing activities	(57,177)	82,015
Cash flows from financing activities:		
Issuance of common stock under stock plans	2	—
Payment of contingent consideration	(523)	(660)
Treasury stock repurchases	—	(200,000)
Tax withholding on restricted stock units	(9,854)	(11,027)
Net cash used in financing activities	(10,375)	(211,687)

Effect of exchange rate changes on cash and cash equivalents	(3,515)	4,299
Net decrease in cash and cash equivalents	(38,361)	(53,312)
Cash and cash equivalents and restricted cash, beginning of period	370,731	305,726
Cash and cash equivalents and restricted cash, end of period	$332,370	$252,414
Supplemental disclosures:		
Non-cash transactions:		
Transfers of inventory to fixed assets	$2,152	$5,556
Additions to property, plant and equipment included in accounts payable	$1,929	$(417)
Tenant improvement allowance	$10,171	$—
Issuance of common stock under employee stock plans	$7,575	$8,603
Contingent consideration related to acquisition	$—	$523
Fair value of contingent consideration received as partial consideration for divestiture of business	$2,257	$—

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

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NetScout Systems, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

The accompanying unaudited interim consolidated financial statements have been prepared by NetScout Systems, Inc. (NetScout or the Company). Certain information and footnote disclosures normally included in financial statements prepared under United States generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, the unaudited interim consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the Company's financial position, results of operations and cash flows. The year-end consolidated balance sheet data was derived from the Company's audited financial statements, but does not include all disclosures required by GAAP. The results reported in these unaudited interim consolidated financial statements are not necessarily indicative of results that may be expected for the entire year. All significant intercompany accounts and transactions are eliminated in consolidation.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company’s Annual Report on Form 10-K for the fiscal year ended March 31, 2018 filed with the Securities and Exchange Commission on May 21, 2018.

Certain amounts for the three and six months ended September 30, 2017 have been reclassified to conform to the current period presentation. These reclassifications had no effect on the reported results of operations.

Recent Accounting Pronouncements

In August 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2018-15, Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (ASU 2018-15). This ASU clarifies the accounting treatment for implementation costs for cloud computing arrangements (hosting arrangements) that is a service contract. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within that fiscal year. The Company adopted ASU 2018-15 effective July 1, 2018. The adoption has had an immaterial impact to the consolidated financial statements for the three months ended September 30, 2018.

In August 2018, the FASB issued ASU 2018-14, Compensation – Retirement Benefits – Defined Benefit Plans – General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans. This ASU adds, modifies and clarifies several disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. This guidance is effective for fiscal years ending after December 15, 2020. ASU 2018-14 is effective for NetScout beginning April 1, 2021. Early adoption is permitted. The Company is currently assessing the effect that ASU 2018-14 will have on its financial position, results of operations, and disclosures.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. ASU 2018-13 adds, modifies and removes several disclosure requirements relative to the three levels of inputs used to measure fair value in accordance with Topic 820, Fair Value Measurement. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within that fiscal year. ASU 2018-13 is effective for NetScout beginning April 1, 2020. Early adoption is permitted. The Company is currently assessing the effect that ASU 2018-13 will have on its financial position, results of operations, and disclosures.

In February 2018, the FASB issued ASU 2018-02, Reclassification of Certain Tax Effects From Accumulated Other Comprehensive Income (ASU 2018-02). ASU 2018-02 amends ASC 220, Income Statement - Reporting Comprehensive Income, to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (Tax Legislation). In addition, under the ASU 2018-02, the Company may be required to provide certain disclosures regarding stranded tax effects. ASU 2018-02 is effective for years beginning after December 15, 2018, and interim periods within those fiscal years. ASU 2018-02 is effective for NetScout beginning April 1, 2019. Early adoption is permitted. The Company does not believe the adoption of ASU 2018-02 will have a material impact on its consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815), Targeted Improvements to Accounting for Hedging Activities (ASU 2017-12). ASU 2017-12 provides guidance to better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The amendments expand and refine hedge accounting for both non-financial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. This standard is effective for financial statements issued for fiscal years beginning after December 15, 2018, with early adoption permitted. ASU 2017-12 is effective for the Company

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beginning April 1, 2019. The Company is currently assessing the potential impact of the adoption of ASU 2017-12 on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) Section A - Leases: Amendments to the FASB Accounting Standards Codification (ASU 2016-02), its new standard on accounting for leases. This update requires the recognition of leased assets and lease obligations by lessees for those leases currently classified as operating leases under existing lease guidance. Short term leases with a term of 12 months or less are not required to be recognized. The update also requires disclosure of key information about leasing arrangements to increase transparency and comparability among organizations. In July 2018, the FASB issued ASU 2018-11, Leases (Topic 842): Targeted Improvements and ASU 2018-10, Codification Improvements to Topic 842, Leases. ASU 2016-02 and the subsequent modifications are identified as ASC 842. ASC 842 will be effective for fiscal years beginning after December 15, 2018, including interim periods within such fiscal years. ASC 842 requires a modified retrospective transition method with the option to elect a package of practical expedients. Early adoption is permitted. The Company expects the adoption to increase the assets and liabilities recorded on its consolidated balance sheet and increase the level of disclosures related to leases. In addition, the Company is in the process of identifying appropriate changes to its accounting policies, information technology systems, business processes, and related internal controls to support recognition and disclosure requirements under ASC 842. The Company expects to design any necessary changes to its business processes, controls and systems in the near future and implement the changes over the remainder of fiscal year 2019. ASC 842 is effective for the Company beginning April 1, 2019.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: Topic 606 (Topic 606). Topic 606 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and requires entities to recognize revenue when control of the promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The Company adopted Topic 606 as of April 1, 2018 using the modified retrospective transition method. Please refer to Note 2, "Revenue Recognition" for further details.

NOTE 2 – REVENUE RECOGNITION

Revenue from Contracts with Customers

In May 2014, the FASB issued Topic 606, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. Topic 606 replaced most existing revenue recognition guidance under GAAP. The new standard introduces a five-step process to be followed in determining the amount and timing of revenue recognition. It also provides guidance on accounting for costs incurred to obtain or fulfill contracts with customers and establishes disclosure requirements which are more extensive than those required under prior GAAP.

Topic 606 became effective for the Company on April 1, 2018. The Company elected to use the modified retrospective transition approach. Therefore, the comparative financial information has not been restated and continues to be reported under the accounting standards in effect for those periods.

Revenue Recognition Policy

The Company exercises judgment and uses estimates in connection with determining the amounts of product and service revenues to be recognized in each accounting period.

The Company derives revenues primarily from the sale of network management tools and security solutions for service provider and enterprise customers, which include hardware, software and service offerings. The majority of its product sales consist of hardware products with embedded software that are essential to providing customers the intended functionality of the solutions. The Company also sells stand-alone software solutions to provide customers with enhanced functionality. In addition, the Company sells hardware bundled with a software license.

The Company accounts for revenue once a legally enforceable contract with a customer has been approved by the parties and the related promises to transfer products or services have been identified. A contract is defined by the Company as an arrangement with commercial substance identifying payment terms, each party's rights and obligations regarding the products or services to be transferred and collection is probable. Customer contracts may include promises to transfer multiple products and services to a customer. Determining whether the products and services are considered distinct performance obligations that should be accounted for separately or as one combined performance obligation may require significant judgment. Revenue is recognized when control of the products or services are transferred to the Company's customers, in an amount that reflects the consideration the Company expects to be entitled to in exchange for products and services.

Product revenue is recognized upon shipment, provided a legally enforceable contract exists, control has passed to the customer, and in the case of software products, when the customer has the rights and ability to access the software, and collection of the related receivable is probable. If any significant obligations to the customer remain post-delivery, typically involving obligations relating to installation and acceptance by the customer, revenue recognition is deferred until such

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obligations have been fulfilled. The Company's service offerings include installation, integration, extended warranty and maintenance services, post-contract customer support, stand-ready software-as-a-service (SAAS) and other professional services including consulting and training. The Company generally provides software and/or hardware support as part of product sales. Revenue related to the initial bundled software and hardware support is recognized ratably over the support period. In addition, customers can elect to purchase extended support agreements for periods after the initial software/hardware warranty expiration. Support services generally include rights to unspecified upgrades (when and if available), telephone and internet-based support, updates, bug fixes and hardware repair and replacement. Consulting services are recognized upon delivery or completion of performance depending on the terms of the underlying contract. SAAS services are recognized ratably over the contract term beginning on the commencement of services. Reimbursements of out-of-pocket expenditures incurred in connection with providing consulting services are included in services revenue, with the offsetting expense recorded in cost of service revenue. Training services include on-site and classroom training. Training revenues are recognized upon delivery of the training.

Generally, the Company's contracts are accounted for individually. However, when contracts are closely interrelated and dependent on each other, it may be necessary to account for two or more contracts as one to reflect the substance of the group of contracts.

Bundled arrangements are concurrent customer purchases of a combination of our product and service offerings that may be delivered at various points in time. The Company allocates the transaction price among the performance obligations in an amount that depicts the relative standalone selling prices (SSP) of each obligation. Judgment is required to determine the SSP for each distinct performance obligation. The Company uses a range of amounts to estimate SSP when it sells each of the products and services separately based on the element's historical pricing. The Company also considers its overall pricing objectives and practices across different sales channels and geographies, and market conditions. Generally, the Company has established SSP for a majority of its service elements based on historical standalone sales. In certain instances, the Company has established SSP for services based upon an estimate of profitability and the underlying cost to fulfill those services. Further, for certain service engagements, the Company considers quoted prices as part of multi element arrangements of those engagements as a basis for establishing SSP. SSP has been established for product elements as the average or median selling price the element was recently sold for, whether sold alone or sold as part of a multiple element transaction. The Company reviews sales of the product elements on a quarterly basis and updates, when appropriate, its SSP for such elements to ensure that it reflects recent pricing experience. The Company's products are distributed through its direct sales force and indirect distribution channels through alliances with resellers and distributors. Revenue arrangements with resellers and distributors are recognized on a sell-in basis; that is, product is delivered to the reseller or distributor. The Company records consideration given to a reseller or distributor as a reduction of revenue to the extent they have recorded revenue from the reseller or distributor. With limited exceptions, the Company's return policy does not allow product returns for a refund. Returns have been insignificant to date. In addition, the Company has a history of successfully collecting receivables from its resellers and distributors.

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Financial Statement Impact of Adoption

The cumulative impact of applying Topic 606 to all contracts with outstanding performance obligations as of April 1, 2018 was recorded as an adjustment to retained earnings as of the adoption date. As a result of applying the modified retrospective approach to adopt the new standard, the following adjustments were made to accounts on the consolidated balance sheet at April 1, 2018 (in thousands):

	Balance at March 31, 2018	Adjustments from Adopting Topic 606	Balance at April 1, 2018
ASSETS:			
Accounts receivable and unbilled costs	$213,438	$ 1,195	$214,633
Prepaid expenses and other current assets	33,502	4,626	38,128
Other assets	12,866	4,748	17,614
LIABILITIES:			
Deferred revenue and customer deposits	301,925	(30,227)	271,698
Deferred tax liability	151,563	7,899	159,462
Long-term deferred revenue and customer deposits	91,409	(1,252)	90,157
STOCKHOLDERS' EQUITY:			
Retained earnings	396,493	34,149	430,642

In connection with the adoption of Topic 606, the Company increased its retained earnings by $34.1 million, due to uncompleted contracts at April 1, 2018, of which $34.9 million of revenue will not be recognized in future periods under the new standard. The Company capitalized $7.1 million of incremental sales commission costs on the adoption date directly related to obtaining customer contracts and is amortizing these costs as it satisfies the underlying performance obligations, which for certain contracts can include anticipated renewal periods. As of April 1, 2018, the acceleration of revenue that was deferred under prior guidance was primarily attributable to no longer requiring the separation of promised goods or services, such as software licenses, technical support, specified and unspecified upgrade rights on the basis of vendor specific objective evidence, and the impact of allocating the transaction price to the software performance obligations in the contract on a relative basis using standalone selling price rather than allocating under the residual method, which allocates the entire arrangement discount to the delivered performance obligations. In addition, revenue from perpetual licenses and associated hardware with extended payment terms and term licenses are now recognized when control is transferred to the customer, the point in time when the customer can use and benefit from the license. Previously the Company recognized revenue over the term of the agreements as payments became due or earlier if prepaid.

The net change in deferred income taxes of $7.9 million is primarily due to the deferred tax effects resulting from the adjustment to retained earnings for the cumulative effect of applying Topic 606 to active contracts as of the adoption date.

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Impact of Topic 606 on Financial Statement Line Items

The impact of adoption of Topic 606 on the Company's consolidated balance sheet at September 30, 2018 and on the Company's consolidated statement of operations for the three and six months ended September 30, 2018 was as follows (in thousands):

	September 30, 2018		
	As Reported	Balance without Adoption of Topic 606	Effect of Change Higher (Lower)
ASSETS:			
Accounts receivable and unbilled costs	$184,156	$181,123	$3,033
Inventories and deferred costs	30,985	31,231	(246)
Prepaid expenses and other current assets	27,429	23,845	3,584
Other assets	20,006	14,315	5,691
LIABILITIES:			
Deferred revenue and customer deposits	230,098	248,632	(18,534)
Deferred tax liability	135,738	129,484	6,254
Long-term deferred revenue and customer deposits	77,135	88,683	(11,548)
STOCKHOLDERS' EQUITY:			
Retained earnings	341,710	314,246	27,464

	Three Months Ended September 30, 2018			Six Months Ended September 30, 2018		
	As Reported	Balance without Adoption of Topic 606	Effect of Change Higher (Lower)	As Reported	Balance without Adoption of Topic 606	Effect of Change Higher (Lower)
Total revenues	$223,797	$215,993	$ 7,804	$428,908	$419,346	$ 9,562
Total cost of revenue	63,980	63,734	246	126,007	125,761	246
Sales and marketing expense	72,051	71,672	379	150,183	149,197	986
Income tax provision	(2,635)	(3,286)	651	(21,877)	(23,522)	1,645
Net loss	(26,428)	(32,956)	6,528	(88,932)	(95,617)	6,685
Basic net loss per share	$(0.34)	$(0.42)	$ 0.08	$(1.12)	$(1.20)	$ 0.08
Diluted net loss per share	$(0.34)	$(0.42)	$ 0.08	$(1.12)	$(1.20)	$ 0.08

The adoption of Topic 606 had no impact to net cash provided by or used in operating, investing and financing activities on the Company’s consolidated statements of cash flows during the six months ended September 30, 2018.

Performance Obligations

Customer contracts may include promises to transfer multiple products and services to a customer. Determining whether the products and services are considered distinct performance obligations that should be accounted for separately or as one combined performance obligation may require significant judgment. The transaction price is allocated among performance obligations in bundled contracts in an amount that depicts the relative standalone selling prices of each obligation.

For contracts involving distinct hardware and software licenses, the performance obligations are satisfied at a point in time when control is transferred to the customer. For standalone maintenance and post-contract support (PCS) the performance obligation is satisfied ratably over the contract term as a stand-ready obligation. For consulting and training services, the performance obligation may be satisfied over the contract term as a stand-ready obligation, satisfied over a period of time as those services are delivered, or satisfied at the completion of the service when control has transferred or the services have expired unused.

Payments for hardware, software licenses, one-year maintenance, PCS and consulting services, are typically due up front with payment terms of 30 to 90 days. However, the Company does have contracts pursuant to which billings occur ratably over a period of years following the transfer of control for the contracted performance obligations. Payments on multi-year

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maintenance, PCS and consulting services are typically due in annual installments over the contract term. The Company did not have any material variable consideration such as obligations for returns, refunds or warranties at September 30, 2018.

At September 30, 2018, the Company had total deferred revenue of $307.2 million, which represents the aggregate total contract price allocated to undelivered performance obligations. The Company expects to recognize $230.1 million, or 75%, of this revenue during the next 12 months, and expects to recognize the remaining $77.1 million, or 25%, of this revenue thereafter.

Because of NetScout's revenue recognition policies, there are circumstances for which the Company does not recognize revenue relating to sales transactions that have been billed, but the related account receivable has not been collected. While the receivable represents an enforceable obligation, for balance sheet presentation purposes, the Company has not recognized the deferred revenue or the related account receivable and no amounts appear in the consolidated balance sheets for such transactions. The aggregate amount of unrecognized accounts receivable and deferred revenue was $10.0 million and $20.0 million at September 30, 2018 and March 31, 2018, respectively. NetScout expects that the amount of billed and unbilled deferred revenue will change from quarter to quarter for several reasons, including the specific timing, duration and size of large customer support and service agreements, varying billing cycles of such agreements, the specific timing of customer renewals, and foreign currency fluctuations. The Company did not have any significant financing components, or variable consideration or performance obligations satisfied in a prior period recognized during the three and six months ended September 30, 2018.

Contract Balances

The Company receives payments from customers based on a billing schedule as established by the Company’s contracts. Contract assets relate to performance obligations in advance of scheduled billings. Upon adoption, the Company recorded unbilled accounts receivable representing the right to consideration in exchange for goods or services that have been transferred to a customer conditional on the passage of time. The Company did not record any contract assets upon adoption. Deferred revenue relates to payments received in advance of performance under the contract. The following table provides information about contract assets and liabilities (in thousands):

	April 1, 2018	September 30, 2018	Increase/ (Decrease)
ASSETS:			
Customer accounts receivable	$205,299	$190,903	$(14,396)
Unbilled receivables	4,338	4,402	64
Other receivables	4,996	3,287	(1,709)
Long-term unbilled receivables	2,254	3,754	1,500
	$216,887	$202,346	$(14,541)
LIABILITIES:			
Deferred revenue	$271,698	$230,098	$(41,600)
Deferred revenue, long-term	90,157	77,135	(13,022)
	$361,855	$307,233	$(54,622)

Changes in deferred revenue during the six months ended September 30, 2018 were as follows (in thousands):

Balance at April 1, 2018	$361,855
Revenue recognized in the period	(206,512)
Additions to customer deposits and contract liabilities	159,265
Reclassifications and other adjustments	594
Divestiture of the HNT tools business	(7,969)
Balance at September 30, 2018	$307,233

Costs to Obtain Contracts

The Company has determined that the only significant incremental costs incurred to obtain contracts with clients within the scope of Topic 606 are sales commissions paid to its associates. Sales commissions are recorded as an asset and amortized to expense ratably over the remaining performance periods of the related contracts with remaining performance obligations.

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The Company applies the practical expedient in Topic 606 and expenses costs as incurred for sales commissions when the amortization period would have been one year or less.

At September 30, 2018, the consolidated balance sheet included $5.6 million in assets related to sales commissions to be expensed in future periods. A balance of $3.6 million was included in prepaid expenses and other current assets, and a balance of $2.0 million was included as other assets in the Company's consolidated balance sheet at September 30, 2018.

During the three and six months ended September 30, 2018, the Company recognized $1.8 million and $3.3 million of amortization related to this sales commission asset, which is included in the sales and marketing expense line in the Company's consolidated statements of operations.

NOTE 3 – CONCENTRATION OF CREDIT RISK AND SIGNIFICANT CUSTOMERS

Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of investments, trade accounts receivable and accounts payable. The Company's cash, cash equivalents, and marketable securities are placed with financial institutions with high credit standings.

At September 30, 2018 the Company had one direct customer, Verizon, who accounted for more than 10% of the accounts receivable balance, while no indirect channel partner accounted for more than 10% of the accounts receivable balance. At March 31, 2018, the Company had no direct customers or indirect channel partners which accounted for more than 10% of the accounts receivable balance.

During the three and six months ended September 30, 2018 and September 30, 2017, no direct customers or indirect channel partners accounted for more than 10% of the Company's total revenue.

As disclosed parenthetically within the Company's consolidated balance sheet, the Company has receivables from related parties included within prepaid expenses and other current assets that represent a concentration of credit risk of $1.5 million and $3.2 million at September 30, 2018 and March 31, 2018, respectively.

Historically, the Company has not experienced any significant failure of its customers' ability to meet their payment obligations nor does the Company anticipate material non-performance by its customers in the future; accordingly, the Company does not require collateral from its customers. However, if the Company's assumptions are incorrect, there could be an adverse impact on its allowance for doubtful accounts.

NOTE 4 – SHARE-BASED COMPENSATION

The following is a summary of share-based compensation expense including restricted stock units granted pursuant to the Company's 2007 Equity Incentive Plan, as amended, and employee stock purchases made under the Company's 2011 Employee Stock Purchase Plan, as amended, (ESPP) based on estimated fair values within the applicable cost and expense lines identified below (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2018	2017	2018	2017
Cost of product revenue	$544	$293	$813	$506
Cost of service revenue	1,845	1,294	3,175	2,310
Research and development	5,414	3,915	9,565	7,090
Sales and marketing	6,043	4,147	10,402	7,591
General and administrative	3,572	2,949	6,428	5,332
	$17,418	$12,598	$30,383	$22,829

Employee Stock Purchase Plan – The Company maintains the ESPP for all eligible employees as described in the Company's Annual Report on Form 10-K for the year ended March 31, 2018. Under the ESPP, shares of the Company's common stock may be purchased on the last day of each bi-annual offering period at 85% of the fair value on the last day of such offering period. The offering periods run from March 1st through August 31st and from September 1st through the last day of February each year. During the six months ended September 30, 2018, employees purchased 302,994 shares under the ESPP and the value per share was $25.00.

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NOTE 5 – CASH, CASH EQUIVALENTS, RESTRICTED CASH AND MARKETABLE SECURITIES

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents and those investments with original maturities greater than three months to be marketable securities. Cash and cash equivalents consisted of money market instruments and cash maintained with various financial institutions at September 30, 2018 and March 31, 2018.

Cash, Cash Equivalents and Restricted Cash

The following table provides a reconciliation of cash, cash equivalents and restricted cash reported within the consolidated balance sheets that sum to the total of the same such amounts shown in the consolidated statements of cash flows (in thousands):

	September 30, 2018	March 31, 2018	September 30, 2017	March 31, 2017
Cash and cash equivalents	$ 332,183	$ 369,821	$ 251,505	$ 304,880
Restricted cash	187	910	909	846
Total cash, cash equivalents and restricted cash	$ 332,370	$ 370,731	$ 252,414	$ 305,726

The Company's restricted cash includes cash balances which are legally or contractually restricted. The Company's restricted cash is included within prepaid and other current assets and consists of amounts related to holdbacks associated with prior acquisitions.

Marketable Securities

The following is a summary of marketable securities held by NetScout at September 30, 2018, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Losses	Fair Value
Type of security:			
U.S. government and municipal obligations	$ 62,502	$ (29)	$ 62,473
Commercial paper	54,701	—	54,701
Corporate bonds	2,762	(1)	2,761
Total short-term marketable securities	119,965	(30)	119,935
Total long-term marketable securities	—	—	—
Total marketable securities	$ 119,965	$ (30)	$ 119,935

The following is a summary of marketable securities held by NetScout at March 31, 2018, classified as short-term and long-term (in thousands):

	Amortized Cost	Unrealized Losses	Fair Value
Type of security:			
U.S. government and municipal obligations	$ 42,246	$ (60)	$ 42,186
Commercial paper	33,003	—	33,003
Corporate bonds	2,754	(2)	2,752
Total short-term marketable securities	78,003	(62)	77,941
Total long-term marketable securities	—	—	—
Total marketable securities	$ 78,003	$ (62)	$ 77,941

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Contractual maturities of the Company's marketable securities held at September 30, 2018 and March 31, 2018 were as follows (in thousands):

	September 30, 2018	March 31, 2018
Available-for-sale securities:		
Due in 1 year or less	$ 119,935	$ 77,941
	$ 119,935	$ 77,941

NOTE 6 – FAIR VALUE MEASUREMENTS

The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value. Level 1 refers to fair values determined based on quoted prices in active markets for identical assets. Level 2 refers to fair values estimated using significant other observable inputs, and Level 3 includes fair values estimated using significant non-observable inputs. The following tables present the Company's financial assets and liabilities measured on a recurring basis using the fair value hierarchy at September 30, 2018 and March 31, 2018 (in thousands):

	Fair Value Measurements at September 30, 2018			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$332,183	$—	$—	$332,183
U.S. government and municipal obligations	43,406	19,067	—	62,473
Commercial paper	—	54,701	—	54,701
Corporate bonds	2,761	—	—	2,761
Derivative financial instruments	—	16	—	16
Contingent consideration	—	—	2,267	2,267
	$378,350	$73,784	$2,267	$454,401
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(5,017)	$(5,017)
Derivative financial instruments	—	(220)	—	(220)
	$—	$(220)	$(5,017)	$(5,237)

	Fair Value Measurements at March 31, 2018			
	Level 1	Level 2	Level 3	Total
ASSETS:				
Cash and cash equivalents	$369,821	$—	$—	$369,821
U.S. government and municipal obligations	14,513	27,673	—	42,186
Commercial paper	—	33,003	—	33,003
Corporate bonds	2,752	—	—	2,752
Derivative financial instruments	—	122	—	122
	$387,086	$60,798	$—	$447,884
LIABILITIES:				
Contingent purchase consideration	$—	$—	$(5,464)	$(5,464)
Derivative financial instruments	—	(40)	—	(40)
	$—	$(40)	$(5,464)	$(5,504)

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

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The Company's Level 1 investments are classified as such because they are valued using quoted market prices or alternative pricing sources with reasonable levels of price transparency.

The Company's Level 2 investments are classified as such because fair value is calculated using market observable data for similar but not identical instruments, or a discounted cash flow model using the contractual interest rate as compared with the underlying interest yield curve. The Company classifies municipal obligations as level 2 because the fair values are determined using quoted prices from markets the Company considers to be inactive. Commercial paper is classified as Level 2 because the Company uses market information from similar but not identical instruments and discounted cash flow models based on interest rate yield curves to determine fair value. The Company's derivative financial instruments consist of forward foreign exchange contracts and are classified as Level 2 because the fair values of these derivatives are determined using models based on market observable inputs, including spot prices for foreign currencies and credit derivatives, as well as an interest rate factor.

The Company's Level 3 assets consist of contingent consideration related to the divestiture of the Company's handheld network test (HNT) tools business in September 2018. The contingent consideration of $2.3 million represents potential future earnout payments to the Company of up to $4.0 million over two years that are contingent on the HNT tools business achieving certain milestones. The fair value of the contingent consideration was recognized on the acquisition date and was measured using unobservable (Level 3) inputs. The $2.3 million of contingent consideration is included in other assets within the Company’s consolidated balance sheet at September 30, 2018.

The Company's Level 3 liabilities consist of contingent purchase consideration.

The fair value of contingent purchase consideration related to the acquisition of Simena LLC (Simena) in November 2011 for future consideration to be paid to the seller is $5.0 million and $4.9 million at September 30, 2018 and March 31, 2018 respectively. The contingent purchase consideration is included as a contingent liability within accrued other in the Company's consolidated balance sheet at September 30, 2018 and March 31, 2018.

The Company's contingent purchase consideration at March 31, 2018 included $523 thousand related to the acquisition of certain assets and liabilities of Efflux Systems, Inc. (Efflux) in the second quarter of fiscal year 2018. The contingent purchase consideration was released from escrow to the sellers in July 2018.

The following table sets forth a reconciliation of changes in the fair value of the Company's Level 3 financial assets and liabilities for the six months ended September 30, 2018 (in thousands):