

OPNET TECHNOLOGIES INC
Form 10-Q
August 19, 2003
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2003

OR

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

(Commission file number: 000-30931)

OPNET TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

7372
(Primary Standard Industrial
Classification Code Number)

52-1483235
(I.R.S. Employer
Identification No.)

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7255 Woodmont Avenue

Bethesda, MD 20814

(Address of principal executive office)

(240) 497-3000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrants were 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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.). Yes No

At June 30, 2003, there were outstanding 19,547,601 shares of common stock of the registrant.

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* The Condensed Consolidated Statement of Operations and Statement of Cash Flows for the Three Months ended June 30, 2002 have been restated as discussed in our Annual Report on Form 10-K/A for the year ended March 31, 2003 as filed on August 19, 2003 and in Note 2 of the Notes to Condensed Consolidated Financial Statements contained herein.	
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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Condensed Consolidated Financial Statements****OPNET TECHNOLOGIES, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share data)

(unaudited)

	June 30,	March 31,
	2003	2003
	<u> </u>	<u> </u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 64,589	\$ 70,251
Marketable securities	8,320	
Accounts receivable, net of \$394 and \$333 in allowance for doubtful accounts at June 30 and March 31, 2003, respectively	6,615	6,420
Unbilled accounts receivable	1,614	933
Prepaid expenses and other current assets	1,047	1,412
	<u> </u>	<u> </u>
Total current assets	82,185	79,016
Property and equipment, net	6,807	7,008
Intangible assets, net	1,442	1,566
Goodwill	12,212	12,212
Deferred income taxes and other assets	958	839
	<u> </u>	<u> </u>
Total assets	<u>\$ 103,604</u>	<u>\$ 100,641</u>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 599	\$ 215
Accrued liabilities	3,163	2,756
Deferred and accrued income taxes	287	172
Deferred revenue	10,397	9,694
	<u> </u>	<u> </u>
Total current liabilities	14,446	12,837
Notes payable	300	300
Deferred rent	726	632
Deferred revenue	560	484
	<u> </u>	<u> </u>
Total liabilities	<u>16,032</u>	<u>14,253</u>
Commitments and contingencies		

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Stockholders' equity:

Preferred stock - par value \$0.001; 5,000 shares authorized, no shares issued and outstanding at June 30 and March 31, 2003		
Common stock-par value \$0.001; 100,000 authorized; 25,682 and 25,522 shares issued at June 30 and March 31, 2003, respectively; 19,548 and 19,388 shares outstanding at June 30 and March 31, 2003, respectively	26	26
Additional paid-in capital	74,058	73,600
Deferred compensation	(55)	(59)
Retained earnings	17,667	16,903
Accumulated other comprehensive (loss) income	(24)	18
Treasury stock, at cost 6,134 shares at June 30 and March 31, 2003	(4,100)	(4,100)
	<hr/>	<hr/>
Total stockholders' equity	87,572	86,388
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 103,604	\$ 100,641
	<hr/>	<hr/>

See accompanying notes to condensed consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months	
	Ended June 30,	
	2003	2002
		(As restated, see Note 2)
Revenues:		
New software licenses	\$ 6,166	\$ 5,355
Software license updates and technical support	3,341	2,996
Professional services	2,798	2,802
Total revenues	12,305	11,153
Cost of revenues:		
New software licenses	257	190
Software license updates and technical support	376	476
Professional services	1,537	1,204
Amortization of acquired technology	125	125
Total cost of revenues	2,295	1,995
Gross Profit	10,010	9,158
Operating expenses:		
Research and development	3,197	3,141
Sales and marketing	4,527	4,518
General and administrative	1,382	1,185
Total operating expenses	9,106	8,844
Income from operations	904	314
Interest and other income, net	151	283
Income before provision for income taxes	1,055	597
Provision for income taxes	291	165
Net income	\$ 764	\$ 432
Basic net income per common share	\$ 0.04	\$ 0.02

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Diluted net income per common share	\$ 0.04	\$ 0.02
Weighted average common shares outstanding (basic)	19,452	19,163
Weighted average common shares outstanding (diluted)	20,150	19,910

See accompanying notes to condensed consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, except per share data)

(unaudited)

	Three Months	
	Ended June 30,	
	2003	2002
		(As restated, see Note 2)
Cash flows from operating activities:		
Net income	\$ 764	\$ 432
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	527	531
Provision for losses on accounts receivable	61	90
Deferred income taxes	132	(279)
Expense related to employee and other stock options	79	18
Changes in assets and liabilities:		
Accounts receivable	(937)	(887)
Prepaid expenses and other current assets	252	(61)
Refundable income taxes		940
Other assets	(138)	62
Accounts payable	384	26
Accrued liabilities	407	(129)
Accrued income taxes	115	(53)
Deferred revenue	779	154
Deferred rent	94	66
	<u>2,519</u>	<u>910</u>
Cash flows from investing activities:		
Purchase of property and equipment	(201)	(204)
Purchase of investments	(8,320)	
	<u>(8,521)</u>	<u>(204)</u>
Cash flows from financing activities:		
Proceeds from exercise of common stock options	231	156
Proceeds from issuance of common stock under employee stock purchase plan	147	165
	<u>378</u>	<u>321</u>
Effect of exchange rate changes on cash and cash equivalents	(38)	11
	<u>(5,662)</u>	<u>1,038</u>
Net (decrease) increase in cash and cash equivalents		
Cash and cash equivalents, beginning of period	70,251	62,240

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Cash and cash equivalents, end of period	<u>\$ 64,589</u>	<u>\$ 63,278</u>
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See accompanying notes to condensed consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation, Nature of Operations, and Significant Accounting Policies

OPNET Technologies, Inc. (OPNET , we or us) is a leading provider of management software for networks and applications. Our solutions address: application performance troubleshooting; network configuration auditing; network capacity and resiliency planning; application deployment planning; systems capacity planning; and network technology R&D. We sell our products to corporate enterprises, government and defense agencies, network service providers, and network equipment manufacturers. We market our product suite in North America primarily through a direct sales force and, to a lesser extent, several resellers and original equipment manufacturers. Internationally, we conduct research and development through our wholly-controlled subsidiary in Ghent, Belgium and market our products through our wholly-owned subsidiaries in Paris, France; Reading, United Kingdom; and Sydney, Australia; third-party distributors, and value-added resellers. OPNET is headquartered in Bethesda, MD and has offices in Cary, NC; Dallas, TX; and Santa Clara, CA.

The accompanying condensed consolidated financial statements include our results and the results of our wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The interim financial statements included herein are unaudited and have been prepared in accordance with generally accepted accounting principles (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (the SEC) regarding interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes thereto contained in the Company's Annual Report on Form 10-K/A, Amendment No. 1, for the year ended March 31, 2003, filed with the SEC. The March 31, 2003 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures including notes required by GAAP. In the opinion of management, these interim financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly our results for the interim periods. The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimates. In addition, our operating results for the three months ended June 30, 2003 may not be indicative of the operating results for the full fiscal year or any other future period.

Reclassifications. Fees and costs associated with the sale of periodic unspecified product updates (license updates) and technical support have been combined and presented as Software license updates and technical support in the accompanying consolidated statements of operations. License update revenues of \$1.65 million for the quarter ended June 30, 2002 were reclassified from license revenues to software license updates and technical support revenues. Cost of license update revenues of \$10,000 for the quarter ended June 30, 2002 were reclassified from cost of license revenues to cost of software license updates and technical support revenues. Technical support revenues of \$1.34 million for the quarter ended June 30, 2002 were reclassified from services revenue to software license updates and technical support. Cost of technical support revenues of \$466,000 for the quarter ended June 30, 2002 were reclassified from cost of service revenues to cost of software license updates and technical support.

Investments. We consider all highly-liquid investments with maturities of three months or less when purchased to be cash equivalents. We have determined that all of our marketable securities are to be classified as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses reported in stockholders' equity in the accompanying Condensed Consolidated Balance Sheets under the caption Accumulated other comprehensive (loss) income. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity using the effective interest method. Such amortization is included in the Interest and other income, net line item on the accompanying Condensed Consolidated Statements of Operations. Realized gains and losses on available-for-sale securities are included in the Interest and other income, net line item on the Condensed Consolidated Statements of Operations. The cost of securities sold is

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based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in the Interest and other income, net line item on the Consolidated Statements of Operations.

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Indemnifications. Under the terms of substantially all of our license agreements, we have agreed to indemnify customers for costs and damages arising from claims against such customers based on allegations that our software product infringes the intellectual property rights of a third party. The indemnification is limited to the amount paid by the customer. To date, we have not had to reimburse any of our customers for any losses related to these indemnification provisions and no material claims are outstanding as of June 30, 2003. For several reasons, including the lack of prior indemnification claims, we cannot determine the maximum amount of potential future payments, if any, related to such indemnification provisions. There can be no assurance that potential future payments will not have a material adverse effect on the Company's operating performance or financial condition.

Our standard license agreement includes a warranty provision for software products. We generally warrant for the first ninety days after delivery that the software shall operate substantially as stated in the then current documentation provided that the software is used in a supported computer. We provide for the estimated cost of product warranties based on specific warranty claims, provided that it is probable that a liability exists and provided the amount can be reasonably estimated. To date, we have not had any material costs associated with these warranties.

Stock-Based Compensation. We account for stock-based compensation given to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and accordingly, recognize compensation expense for fixed stock option grants only when the exercise price is less than the quoted market price of the shares on the date of the grant. Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation , permits the use of either a fair-value based method or the intrinsic value method provided in APB No. 25 to account for employee stock-based compensation arrangements. Companies that elect to use the intrinsic value method provided in APB No. 25 are required to disclose the pro forma net income (loss) and earnings (loss) per share that would have resulted from the use of the fair value method. We have provided below the pro forma disclosures of the effect on net income and earnings per share as if SFAS No. 123 had been applied in measuring compensation expense for all periods.

The following table illustrates the effect on net income and related net income per share for the three months ended June 30, 2003 and 2002, had compensation cost for employee stock-based compensation plans been determined based upon the fair value method prescribed under SFAS No. 123:

	Three Months	
	Ended June 30,	
	2003	2002
	(in thousands,	
	except per share data)	
Net income	\$ 764	\$ 432
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	9	18
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(991)	(867)
Pro forma net income (loss)	\$ (218)	\$ (417)
Basic net income (loss) per common share:		
As reported	\$.04	\$.02
Pro forma	\$ (.01)	\$ (.02)
Diluted net income (loss) per common share:		

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As reported	\$.04	\$.02
Pro forma	\$ (.01)	\$ (.02)

2. Restatement

Subsequent to the issuance of our consolidated financial statements as of March 31, 2003, we concluded that a portion of the revenue from certain software arrangements should have been deferred to account for the value of certain free training offered to our customers. We also determined that amortization of acquired technology should be included as a cost of revenue rather than as an operating expense. As a consequence, our consolidated financial statements for the three months ended June 30, 2002 have been restated. For the quarter ended June

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30, 2002, this restatement reduced our previously reported revenue from \$11,177,000 to \$11,153,000 and reduced our previously reported net income from \$449,000 to \$432,000, but had no effect on our previously reported diluted earnings per common share of \$0.02. The restatement resulted in a decrease in new software license revenues of \$175,000 for the quarter ended June 30, 2002 and an increase in professional service revenues of \$151,000 for the quarter ended June 30, 2002.

The effect of the reclassification of amortization of acquired technology was to increase previously reported cost of revenues and reduce previously reported gross profit by \$125,000 for the quarter ended June 30, 2002. This reclassification of amortization of acquired technology had no impact on previously reported net income.

A summary of the significant effects of the restatement is as follows:

<i>Condensed Consolidated Balance Sheet Data:</i>	<u>At June 30, 2002</u>	
	As Previously	
	<u>Reported</u>	<u>As Restated</u>
	(in thousands)	
Other assets	\$ 405	\$ 616
Total assets	95,990	96,201
Deferred revenue	8,655	9,222
Retained earnings	14,948	14,592
Total stockholders equity	83,789	83,433
	 Three Months Ended <u>June 30, 2002</u>	
<i>Condensed Consolidated Statement of Operations Data:</i>	As Previously	
	<u>Reported</u>	<u>As Restated</u>
	(in thousands,	
	except per share data)	
Revenues	\$ 11,177	\$ 11,153
Gross profit	9,307	9,158
Income before provision for income taxes	621	597
Net income	449	432
Basic net income per common share	\$.02	\$.02
Diluted net income per common share	\$.02	\$.02

3. Intangible Assets

Intangible assets consisted of the following:

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	At June 30, At March 31,	
	2003	2003
	(in thousands)	
Acquired technology	\$ 2,501	\$ 2,501
Accumulated amortization	(1,059)	(935)
Intangible assets, net	\$ 1,442	\$ 1,566

Acquired technology relating to the NetMaker and WDM NetDesign acquisitions resulted in amortization expense for the three months ended June 30, 2003 and 2002 of \$125,000 in each period. Amortization expense from acquired technology is included in cost of revenues in the Condensed Consolidated Statements of Operations. We expect amortization expense of \$500 in each of the fiscal years ending March 31, 2004, 2005 and 2006, and \$66 for the year ending March 31, 2007.

4. Credit Agreements

Effective June 10, 2002, we entered into a \$10.0 million credit facility with a commercial bank. The credit facility permits the use of funds for general corporate purposes and the issuance of letters of credit up to a maximum of \$10.0 million in the aggregate. Borrowings under the credit facility are limited to 80% of eligible accounts receivable. We used the facility to issue a

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letter of credit for approximately \$2.8 million to satisfy the security deposit requirements for our corporate office lease. Interest is payable monthly, based on LIBOR plus the applicable margin ranging from 2% to 2.5% as stated in the loan agreement. The credit facility includes a fee in the amount of 0.25% per annum on the unused portion of the credit facility. The credit facility is collateralized by our accounts receivable. The loan agreement contains customary affirmative and negative covenants including a restriction on the payment of dividends and a financial covenant requiring that we not exceed a ratio of Funded Debt to EBITDA of 2.5:1.0 as such terms are defined in the loan agreement. The credit facility expires June 10, 2004. As of June 30, 2003, we had no borrowings under the available credit facility.

5. Stockholders Equity

During the three months ended June 30, 2003, we received proceeds of approximately \$231,000 and issued 138,464 shares of common stock, respectively, pursuant to employee exercises of stock options. During the three months ended June 30, 2003 employees purchased 20,939 shares of common stock under the 2000 Employee Stock Purchase Plan, resulting in proceeds to us of approximately \$147,000.

6. Net Income per Common Share

The following is a reconciliation of the amounts used in calculating basic and diluted net income per common share for the three months ended June 30, 2003 and 2002:

	Three Months	
	Ended June 30,	
	2003	2002
	(in thousands,	
	except per share data)	
Income (Numerator):		
Net income (basic and diluted)	\$ 764	\$ 432
Shares (Denominator):		
Weighted average shares outstanding (basic)	19,452	19,163
Plus:		
Effect of other dilutive securities options	698	747
Weighted average shares outstanding (diluted)	20,150	19,910
Net income per common share:		
Basic net income per common share	\$ 0.04	\$ 0.02
Diluted net income per common share	\$ 0.04	\$ 0.02

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We operate in one industry segment, the development and sale of computer software programs and related services. Revenues from transactions with U.S. government agencies were approximately 44% and 39% of total revenues for the three months ended June 30, 2003 and 2002, respectively. Substantially all assets were held in the United States at June 30 and March 31, 2003. Revenues by geographic destination and as a percentage of total revenues is as follows:

	Three Months	
	Ended June 30,	
	2003	2002
	(in thousands)	
Geographic Area by Destination:		
United States	\$ 9,796	\$ 9,068
International	2,509	2,085
Total revenue	\$ 12,305	\$ 11,153
Geographic Area by Destination:		
United States	79.6%	81.3%
International	20.4	18.7
Total revenue	100.0%	100.0%

8. Supplemental Cash Flow Information

	Three Months	
	Ended June 30,	
	2003	2002
	(in thousands)	
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 182	\$
Cash paid for interest	4	

9. Comprehensive Income

Comprehensive income includes net income, foreign currency translation adjustments, and unrealized loss on marketable securities. Total comprehensive income is summarized as follows:

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	Three Months	
	Ended June 30,	
	2003	2002
	(in thousands)	
Net income	\$ 764	\$ 432
Foreign currency translation adjustments	(38)	11
Unrealized loss on marketable securities	(4)	
Total comprehensive income	\$ 722	\$ 443

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10. Commitments and Contingencies

We are involved in various claims and legal proceedings arising from our normal operations. We do not expect those matters, individually or in the aggregate, to have a material effect on our financial condition or results of operations.

11. New Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Interpretation No. 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement was effective for guarantees issued or modified after December 31, 2002. We adopted Interpretation No. 45 effective December 2002 and the applicable disclosures have been made.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging*. The statement requires that contracts with comparable characteristics be accounted for similarly and clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except in certain circumstances, and for hedging relationships designated after June 30, 2003. We currently do not hedge foreign exchange rate risk. Accordingly, we do not expect that the adoption of this standard will have a material effect on our consolidated results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not expect that the adoption of this standard will have a material effect on our consolidated results of operations or financial position because we have not issued any of these types of financial instruments.

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

The following discussion and analysis relates to our financial condition and results of operations for the three months ended June 30, 2003 (Quarter 2004) and 2002 (Quarter 2003), and should be read in conjunction with our condensed consolidated financial statements and the related notes included elsewhere in this report. You should also read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K/A, Amendment No. 1, for the year ended March 31, 2003, filed with the SEC.

This report contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and would or similar words. You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to predict or control accurately. The factors listed in this section, as well as any cautionary language contained herein, provide examples of risks, uncertainties, and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should also carefully review the risks outlined in other documents that we file from time to time with the Securities and Exchange Commission, including our Quarterly Reports on Form 10-Q that we will file in fiscal 2004.

Overview

Revenues. We derive revenues from three primary sources: (1) new software licenses, (2) software license updates and technical support, and (3) professional services, which include consulting and training services. New software license revenues represent all fees earned from granting customers licenses to use our software, and excludes revenues derived from software license updates, which are included in software license updates and technical support revenues. The majority of our new software license revenues consist of perpetual license sales of our software products. Software license updates and technical support revenues represent fees associated with the sale of periodic unspecified product updates (license updates) and technical support under our maintenance agreements. We offer professional services, generally under fixed-price agreements, primarily to provide product customization and enhancements and to facilitate the adoption of our technology.

Revenues from sales outside of the United States represented 20.4%, and 18.7% of our total revenues in Quarter 2004 and Quarter 2003, respectively. Sales outside the United States were primarily made through our Paris, France and Reading, United Kingdom offices as well as third-party distributors and value-added resellers, who are generally responsible for providing technical support and service to customers within their territory. We expect revenues from sales outside the United States to continue to account for a significant portion of our total revenues in the future. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets.

Reclassifications

Revenue and costs associated with the sale of license updates and technical support have been combined and presented as Software license updates and technical support in the accompanying consolidated statements of operations. These reclassifications had no impact on total revenues, net income, or net income per common share for Quarter 2003. See Note 1 Significant Accounting Policies Reclassifications in the accompanying notes to our condensed consolidated financial statements for additional information regarding the reclassifications.

Restatement

As discussed in Note 2 to the condensed consolidated financial statements included under Item 1, we have restated our condensed consolidated financial statements for the three months ended June 30, 2002.

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The following table sets forth items from our statements of operations expressed as a percentage of total revenues for the periods indicated:

	Three Months	
	Ended June 30,	
	2003	2002
	<u> </u>	<u> </u>
Revenues:		
New software licenses	50.1%	48.0%
Software license updates and technical support	27.2	26.9
Professional services	22.7	25.1
	<u> </u>	<u> </u>
Total revenues	100.0	100.0
	<u> </u>	<u> </u>
Cost of revenues:		
New software licenses	2.1	1.7
Software license updates and technical support	3.1	4.3
Professional services	12.5	10.8
Amortization of acquired technology	1.0	1.1
	<u> </u>	<u> </u>
Total cost of revenues	18.7	17.9
	<u> </u>	<u> </u>
Gross Profit	81.3	82.1
	<u> </u>	<u> </u>
Operating expenses:		
Research and development	26.0	28.2
Sales and marketing	36.8	40.5
General and administrative	11.2	10.6
	<u> </u>	<u> </u>
Total operating expenses	74.0	79.3
	<u> </u>	<u> </u>
Income from operations	7.3	2.8
Interest and other income, net	1.3	2.6
	<u> </u>	<u> </u>
Income before provision for income taxes	8.6	5.4
Provision for income taxes	2.4	1.5
	<u> </u>	<u> </u>
Net income	6.2%	3.9%
	<u> </u>	<u> </u>

The following table sets forth, for each component of revenues, the cost of these revenues as a percentage of the related revenues for the periods indicated:

	Three Months	
	Ended June 30,	
	2003	2002
	<u> </u>	<u> </u>
Cost of new software licenses revenues	4.2%	3.6%
Cost of software license updates and technical support revenues	11.3	15.9
Cost of professional services revenues	54.9	43.0

Revenues

New Software License Revenues. New software license revenues were \$6.2 million and \$5.4 million in Quarter 2004 and

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Quarter 2003, respectively, representing an increase of 15.1%. The growth in sales was primarily due to higher sales volumes to enterprise and U.S. government customers of *OPNET IT Guru*, *ACE*, *ACE Decode Module*, *OPNET SP Guru*, and *OPNET VNE Server*, which was launched in Quarter 2003. However, revenue contributions from the latter were partially offset by discounts associated with pricing strategies and product bundling in Quarter 2004.

We may experience a slower rate of growth, or even a decline, in overall new software license revenues in the near-term due to potentially lower spending levels by enterprise IT organizations, service providers and network equipment manufacturers as a result of a challenging economy.

Software License Updates and Technical Support Revenues. Software license updates and technical support revenues were \$3.3 million and \$3.0 million in Quarter 2004 and Quarter 2003, respectively, representing an increase of 11.5%. Software license updates and product support revenue growth rates are affected by the overall new software license revenue growth rates, as well as the renewal rate of annual maintenance contracts by existing customers. The increase reflects the increases in the overall customer installed base as compared to the prior year.

We may experience a slower rate of growth, or even a decline, in overall software license updates and technical support revenues in the near-term due to potentially lower spending levels by enterprise IT organizations, service providers and network equipment manufacturers as a result of a challenging economy.

Professional Service Revenues. Professional service revenues were \$2.8 million in both Quarter 2004 and Quarter 2003. For Quarter 2004, a slight decrease in consulting revenue due to a decline in billable hours was offset by higher training revenue. Consulting services revenues comprise 84.6% and 88.3% of professional services revenue for Quarter 2004 and Quarter 2003, respectively. A consulting contract with the U.S. Department of Defense that contributed 31.7% of professional service revenues for the three months ended June 30, 2002 expired on December 31, 2002. The U.S. Department of Defense issued a request for proposal for this program and we were awarded a new contract in January 2003. The initial funding under this contract for calendar year 2003 is \$2.2 million, compared to \$3.2 million in calendar year 2002. There are four successive option years under this contract which may be exercised by the U.S. Department of Defense at its discretion. In the event that we are not awarded additional funding under this contract, our results of operations could be adversely impacted. Engagements with U.S. government agencies contributed significantly to the demand for our consulting services in Quarter 2004 and Quarter 2003, respectively.

We do not expect significant growth in our professional service revenues in the near-term due to the mix of consulting contracts. Our ability to grow professional service revenues will be dependent on our ability to expand our installed base of customers and our ability to maintain several large consulting contracts with U.S. government agencies.

International Revenues. Our international revenues increased 20.3% to \$2.5 million, or 20.4% of total revenues, for Quarter 2004 from \$2.1 million, or 18.7% of total revenues, for Quarter 2003. Our international revenues are primarily generated in Europe and Japan. During Quarter 2003, we expanded our operations outside the United States. International revenues in Quarter 2004 benefited from our expansion. The challenging global economy can lengthen our sales cycle for international customers and therefore impact the timing of sales orders. We believe that we will need to further expand our international sales, marketing and customer service functions to increase international revenue and we expect to continue experiencing fluctuations of international revenues in the future.

Cost of Revenues

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Cost of new software license revenues consists primarily of royalties, media, manuals, and distribution costs. Cost of software license updates and technical support revenues consists of royalties, media, distribution costs, and personnel-related costs in providing technical support to our customers. Cost of professional service revenues consists primarily of personnel-related costs in providing consulting and training to customers. Gross margin on new software license revenues is substantially higher than gross margin on professional service revenues, due to the low materials, packaging and other costs of software products compared with the relatively high personnel costs associated with providing professional services.

In connection with our acquisitions of NetMaker in March 2001 and WDM NetDesign in January 2002, we recorded acquired technology of \$2.5 million. Beginning in fiscal 2002, these acquired technologies are being amortized on a straight-line basis over five years. Amortization expense from acquired technology for Quarter 2004 and Quarter 2003 was \$125,000 in both periods and was included in the cost of revenues in the condensed consolidated statements of operations.

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Cost of New Software License Revenues. Cost of new software license revenues were \$257,000 and \$190,000 in Quarter 2004 and Quarter 2003, respectively. Gross margin on new software license revenues decreased to 95.8% for Quarter 2004 from 96.5% for Quarter 2003. The increase in cost of software license revenues and the resulting lower gross margins in Quarter 2004 were primarily due to an increase in sales requiring royalty payments under licensing agreements.

Cost of Software License Updates and Technical Support Revenues. Cost of software license updates and technical support revenues were \$376,000 and \$476,000 in Quarter 2004 and Quarter 2003, respectively. Gross margin on software license updates and technical support revenues increased to 88.7% for Quarter 2004 from 84.1% for Quarter 2003. This decline in costs and the improvement in gross margins were due to a reduction in overhead costs applicable to technical support.

Cost of Professional Service Revenues. Cost of professional service revenues were \$1.5 million and \$1.2 million in Quarter 2004 and Quarter 2003, respectively. Cost of professional service revenues increased 27.7% in Quarter 2004 from Quarter 2003. Gross margin on professional service revenues decreased to 45.1% for Quarter 2004 from 57.0% for Quarter 2003. The increase in cost of professional service revenues and the resulting lower gross margins were primarily due to an increase in overhead costs and certain costs associated with specific consulting engagements such as travel costs. We expect cost of professional services revenues as a percentage of professional services revenue to vary based primarily on the profitability of individual consulting engagements.

Operating Expenses

Research and Development. Research and development expenses were \$3.2 million and \$3.1 million in Quarter 2004 and Quarter 2003, respectively, representing an increase of 1.8%. In Quarter 2004, costs were increased due to higher personnel costs, but these costs were offset by lower overhead costs. We believe that a significant level of research and development investment will be required to maintain our competitive position and broaden our product lines, as well as enhance the features and functionality of our current products. We expect that the absolute dollar amount of these expenditures will continue to grow but generally decrease as a percentage of total revenues in future periods. Our ability to decrease these expenses as a percentage of revenues will depend upon our revenue growth, among other factors.

Sales and Marketing. Sales and marketing expenses were \$4.5 million in both Quarter 2004 and Quarter 2003. In Quarter 2004, sales and marketing expenses were increased over Quarter 2003 due to increased commission costs associated with growth in revenues. These increases were offset by decreases in lower travel and entertainment expenses, conference costs and advertising expenses. We anticipate that we will continue to commit substantial resources to sales and marketing in the future and that sales and marketing expenses may increase both in absolute dollars and as a percentage of total revenues in future periods.

General and Administrative. General and administrative expenses were \$1.4 million and \$1.2 million in Quarter 2004 and Quarter 2003, respectively. The 16.6% increase was primarily due to higher personnel costs, insurance expense, and software maintenance costs associated with new financial systems that were deployed in April 2003. We expect the dollar amount of general and administrative expenses to increase as we continue to expand our operations but generally decrease as a percentage of total revenues in future periods. Our ability to decrease these expenses as a percentage of revenues will depend upon our revenue growth, among other factors.

Interest and Other Income, Net

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Interest and other income, net were \$151,000 and \$283,000 in Quarter 2004 and Quarter 2003, respectively. The decrease in each period was primarily due to a reduction in interest income earned on our cash and cash equivalents due to the decline in interest rates throughout the periods.

Provision for Income Taxes

Our effective tax rates were 28% for both Quarter 2004 and Quarter 2003. The effective tax rate differs from the statutory tax rate and varies from period to period due principally to the amount of income before taxes from various tax jurisdictions and the amount of tax credits available to us in each period from incremental research expenditures.

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We expect our effective tax rate in the near-term to range from 28% to 32%; however, future provisions for taxes will depend, among other things, on the mix and amount of worldwide income, the tax rates in effect for various tax jurisdictions and the amount of increased research tax credits.

Liquidity and Capital Resources

Since inception, we have funded our operations primarily through cash provided by operating activities and through the sale of equity securities. In August 2000, we completed our initial public offering in which we raised approximately \$54.1 million, net of underwriting discounts and offering expenses payable by us. As of June 30, 2003, we had cash and cash equivalents totaling \$64.6 million.

Cash provided by operating activities was \$2.5 million and \$910,000 for Quarter 2004 and Quarter 2003, respectively. Cash provided by operating activities is primarily derived from net income, as adjusted for non-cash items such as depreciation and amortization expense and changes in operating assets and liabilities. The increase in cash provided by operations in Quarter 2004 from Quarter 2003 was attributable to an increase in accrued liabilities associated with expanded operations, including deferred revenue, and increased income taxes payable. Cash flow from operating activities for Quarter 2003 benefited from a reduction in refundable income taxes of \$940,000 primarily due to the collection of refundable income taxes in Quarter 2003 from tax credits for incremental research expenditures and no requirement for a federal income tax installment payment in Quarter 2003 as payments made prior to Quarter 2003 were applied to the current income tax provision.

Cash used in investing activities was \$8.5 million and \$204,000 for Quarter 2004 and Quarter 2003, respectively. For Quarter 2004, funds were used to purchase marketable securities of \$8.3 million and to purchase property and equipment of \$201,000. For Quarter 2003, funds were used to purchase property and equipment of \$204,000.

Cash provided by financing activities was \$378,000 and \$321,000 for Quarter 2004 and Quarter 2003, respectively. Cash provided by financing activities reflects the proceeds received from the exercise of stock options and the sale of common stock under our 2000 Employee Stock Purchase Plan.

As discussed in Note 3 to our condensed consolidated financial statements, we have a \$10.0 million credit facility with a commercial bank, which expires in June 2004. Borrowings under this line of credit bear interest at an annual rate equal to LIBOR plus 2% to 2.5%. We have currently used \$2.8 million of this facility for a letter of credit that secures the lease for our headquarters in Bethesda, Maryland. We had no outstanding borrowings under this line of credit facility as of June 30, 2003.

As of June 30, 2003, our contractual commitments include operating leases for office facilities, notes payable in the amount of \$300,000, and a letter of credit in the amount of \$2.8 million.

We expect working capital needs to increase in the foreseeable future in order for us to execute our business plan. We anticipate that operating activities, as well as planned capital expenditures, will constitute a material use of our cash resources. In addition, we may utilize cash resources to fund acquisitions or investments in complementary businesses, technologies or products.

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We believe that our current cash and cash equivalents and cash generated from operations, along with available borrowings under our line of credit facility, will be sufficient to meet our anticipated cash requirements for working capital and capital expenditures for at least the next 12 months.

New Accounting Pronouncements

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Interpretation No. 45 requires a guarantor to include disclosure of certain obligations, and if applicable, at the inception of the guarantee, recognize a liability for the fair value of other certain obligations undertaken in issuing a guarantee. The recognition requirement was effective for guarantees issued or modified after December 31, 2002. We adopted Interpretation No. 45 effective December 2002 and the applicable disclosures have been made.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging*

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Activities. SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging*. The statement requires that contracts with comparable characteristics be accounted for similarly and clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except in certain circumstances, and for hedging relationships designated after June 30, 2003. We currently do not hedge foreign exchange rate risk. Accordingly, we do not expect that the adoption of this standard will have a material effect on our consolidated results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not expect that the adoption of this standard will have a material effect on our consolidated results of operations or financial position because we have not issued any of these types of financial instruments.

Critical Accounting Policies

The preparation of our financial statements in conformity with generally accepted accounting principles requires us to utilize accounting policies and make estimates and assumptions that affect our reported amounts. Future results may differ from these estimates under different assumptions or conditions. We consider the following accounting policies to be both important to the portrayal of our financial position and results of operations and require the exercise of significant, subjective, or complex judgment and/or estimates.

Revenue Recognition. We recognize revenue in accordance with Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and the Securities and Exchange Commission Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*.

For our software arrangements, a determination needs to be made for each arrangement regarding whether the percentage-of-completion contract accounting method should be used to recognize revenue or whether revenue can be recognized when the software is delivered and all of the conditions of SOP 97-2, as amended, are met. Contract accounting is required if our services are essential to the arrangement. In many cases, our services are essential to the arrangement because they involve customization and enhancements, and our fees are paid in stages based upon the completion of defined service deliverables. As a result, we typically recognize revenue from these arrangements using contract accounting, which generally results in recording revenue over a longer period of time. In other cases, our services are not essential to the arrangement and the realization of our license fee is not dependent on the completion of such services. In these situations, we recognize software license revenue when (1) persuasive evidence of an arrangement exists, (2) the product has been delivered, (3) the fee is fixed or determinable, and (4) collectibility is probable, which generally results in recording revenue earlier than when contract accounting is used. The determination of whether our services are essential involves significant judgment and could have a material impact on our results of operations from period to period to the extent that significant new arrangements are not accounted for using contract accounting.

Under the percentage-of-completion contract accounting method, we recognize revenue from the entire arrangement based on the percentage of hours actually incurred related to our services at any given time, compared to the total hours we estimate will be required to perform such services. Using the percentage-of-completion method requires us to make estimates about the future cost of services and estimated hours to complete, which are subject to change for a variety of internal and external factors. A change in these estimates could result in a material

adjustment to the amount of revenue recorded in any period under the arrangement.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts receivable for estimated losses resulting from the inability of our customers to make required payments and for the limited circumstances when the customer disputes the amounts due us. Our methodology for determining this allowance requires significant estimates. In estimating the

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allowance, we consider the age of the receivable, the creditworthiness of the customer, the economic conditions of the customer's industry and general economic conditions. While we believe that the estimates we use are reasonable, should any of these factors change, our estimates will also change, which could affect the amount of our future allowance for doubtful accounts as well as future operating income. Specifically, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments to us, additional allowances could be required. As of June 30, 2003, accounts receivable totaled \$6.6 million, net of an allowance for doubtful accounts of \$394,000.

Valuation of Intangible Assets and Goodwill. We account for our goodwill and intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. Our intangible assets consist of acquired technology related to our acquisition of NetMaker in March 2001 and WDM NetDesign in January 2002. They are recorded at cost and amortized on a straight-line basis over their expected useful lives of five years. We use the projected discounted cash flow method in valuing our acquired technology, using certain assumptions including revenue growth, cost levels, present value discount rate and working capital requirements. While we believe the assumptions used are reasonable, actual results will likely differ from those assumptions. Future cash flows are subject to change for a variety of internal and external factors. We will periodically review the value of acquired technology for recoverability. Changes in our assumptions at the time of future periodic reviews could result in impairment losses. As of June 30, 2003, intangible assets totaled \$1.4 million, net of accumulated amortization of \$1.1 million. No impairment losses have been recorded to date.

Goodwill is recorded when the consideration paid for acquisitions exceeds the fair value of net tangible and intangible assets acquired. Goodwill is not amortized. We perform an annual review during our fourth quarter to identify any facts or circumstances that indicate the carrying value of goodwill is impaired. The review is based on various analyses including cash flow and profitability projections and the market capitalization of our common stock. Impairment, if any, is based on the excess of the carrying amount of goodwill over its fair value. As of June 30, 2003, we had goodwill of \$12.2 million. No impairment has been indicated to date.

Accounting for Software Development Costs. Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Development costs are capitalized beginning when a product's technological feasibility has been established and ending when the product is available for general release to our customers. Technological feasibility is reached when the product reaches the working model stage. To date, products and enhancements have generally reached technological feasibility and have been released for sale at substantially the same time and all research and development costs have been expensed. Consequently, no research and development costs were capitalized in Quarter 2004 and Quarter 2003.

Certain Factors That May Affect Future Results

The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Annual Report and presented elsewhere by management from time to time.

Our operating results may fluctuate significantly as a result of factors outside of our control, which could cause the market price of our stock to decline.

Our operating results have fluctuated in the past, and are likely to fluctuate significantly in the future. Our financial results may as a consequence fall short of the expectations of public market analysts or investors, which could cause the price of our common stock to decline. Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, many of which are beyond our control. Factors that could affect our operating results include:

the timing of large orders;

changes in the proportion of software arrangements requiring contract accounting;

changes in the mix of our sales, including the mix between higher margin software products and lower margin services and maintenance, and the proportion of our license sales requiring us to make royalty payments;

the timing and amount of our marketing, sales, and product development expenses;

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the cost and time required to develop new software products;

the introduction, timing, and market acceptance of new products introduced by us or our competitors;

changes in network technology or in applications, which could require us to modify our products or develop new products;

general economic conditions, which can affect our customers' purchasing decisions, the length of our sales cycle, and our customers' ability to pay us on time, if at all;

changes in our pricing policies or those of our competitors; and

the timing and size of potential acquisitions by us.

We expect to make significant expenditures in all areas of our business, particularly sales and marketing operations, in order to promote future growth. Because the expenses associated with these activities are relatively fixed in the short term, we may be unable to adjust spending quickly enough to offset any unexpected shortfall in revenue growth or any decrease in revenue levels. In addition, our revenues in any quarter depend substantially on orders we receive and ship in that quarter. We typically receive a significant portion of orders in any quarter during the last month of the quarter, and we cannot predict whether those orders will be placed and shipped in that period. If we have lower revenues than we expect, we probably will not be able to reduce our operating expenses quickly in response. Therefore, any significant shortfall in revenues or delay of customer orders could have an immediate adverse effect on our operating results in that quarter.

For all of these reasons, quarterly comparisons of our financial results are not necessarily meaningful and you should not rely on them as an indication of our future performance.

The market for intelligent network management software is new and evolving, and if this market does not develop as anticipated, our revenues could decline.

We derive all of our revenues from the sale of products and services that are designed to allow our customers to manage the performance of networks and applications. Accordingly, if the market for intelligent network management software does not continue to grow, we could face declining revenues, which could ultimately lead to our becoming unprofitable. The market for intelligent network management software solutions is in an early stage of development. Therefore, we cannot accurately assess the size of the market and may be unable to identify an effective distribution strategy, the competitive environment that will develop, and the appropriate features and prices for products to address the market. If we are to be successful, our current and potential customers must recognize the value of intelligent network management software solutions, decide to invest in the management of their networks, and, in particular, adopt and continue to use our software solutions.

Our customers are primarily in four target groups and our operating results may be adversely affected by changes in one or more of these groups.

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Our software solutions and services are designed to meet the needs of enterprises, U.S. government agencies, service providers, and network equipment manufacturers, and we market our solutions and services to those four customer groups. Consequently, our financial results depend, in significant part, upon the economic conditions of enterprises, U.S. government agencies, service providers, and network equipment manufacturers. An economic downturn or adverse change in the regulatory environment or business prospects for one or more of these customer groups may decrease our revenues or lower our growth rate.

The U.S. Department of Defense may not extend one consulting contract with us, which could harm our business.

In January 2003, we were awarded a consulting contract with the U.S. Department of Defense. The initial funding under this contract for calendar year 2003 is \$2.2 million, and there are four successive option years under the contract that may be exercised by the U.S. Department of Defense in its discretion. Our results of operations could be adversely affected if we do not receive additional funding under this contract.

A decline in information technology spending may result in a decrease in our revenues or lower our growth rate.

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A decline in the demand for information technology among our current and prospective customers may result in decreased revenues or a lower growth rate for us because our sales depend, in part, on our customers' budgets for new or additional information technology systems and services. A continued economic downturn may cause our customers to reduce or eliminate information technology spending and force us to lower prices of our solutions, which would substantially reduce the number of new software licenses we sell and the average sales price for these licenses. Accordingly, we cannot assure you that we will be able to increase or maintain our revenues.

Our sales to U.S. government agencies subject us to special risks that could adversely affect our business.

We derive a substantial portion of our revenues from sales directly or indirectly to U.S. government agencies. Transactions with U.S. government agencies accounted for approximately 44% and 39% of our total revenues for Quarter 2004 and 2003, respectively. Government sales entail a variety of risks including:

Government contracts are subject to the approval of appropriations by the U.S. Congress to fund the expenditures by the agencies under these contracts. Congress often appropriates funds for government agencies on a yearly basis, even though their contracts may call for performance over a number of years.

A significant decline in government expenditures generally, or a shift in budget priorities away from agencies or programs that we support, could cause a material decline in our government business. In particular, a decline in government spending on information technology or related services could hurt our government business.

Our products and services are included on a General Services Administration (GSA) schedule. We believe that the GSA schedule facilitates our sales to U.S. government agencies. The loss of the GSA schedule covering our products and services could adversely affect our results of operations.

We must comply with complex federal procurement laws and regulations in connection with government contracts, which may impose added costs on our business.

Some of our government business requires that we maintain facility security clearances, and requires some of our employees to maintain individual security clearances. If we were to lose these clearances, our government business might decline.

The federal government audits and reviews the performance of federal contractors on contracts, pricing practices, cost structure, and compliance with applicable laws, regulations, and standards. An audit of our work could result in a finding that we overcharged the government, which could result in an adjustment to our previously reported operating results. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies.

Many of our government contracts are firm fixed-price contracts. To the extent that the assumptions we have used in pricing these contracts prove inaccurate, we could incur losses on contracts, which would adversely affect our operating results.

A portion of our sales to the U.S. government are made indirectly as a subcontractor to another government contractor, referred to as the prime contractor, who has the direct relationship with the government. We also team with prime contractors to bid on competitive government opportunities for which we hope to serve as a subcontractor. If prime contractors lose existing business on which we serve as a subcontractor, or fail to win the competitive bids on which we team with them, our government business would be hurt.

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We could face expense and delay if any of our competitors, or competitors of the prime contractors to which we serve as a subcontractor, protest or challenge contract awards made to us or our prime contractors pursuant to competitive bidding.

Federal government contracts contain provisions and are subject to laws and regulations that provide government clients with rights and remedies not typically found in commercial contracts. These rights and remedies allow government clients, among other things, to terminate existing contracts, with short notice, for convenience without cause; reduce or modify contracts or subcontracts; and claim rights in products, systems, and technology produced by us.

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If our newest products, particularly those targeted primarily for enterprises and U.S. government agencies, do not gain widespread market acceptance, our revenues might not increase and could even decline.

We expect to derive a substantial portion of our revenues in the future from sales to enterprises and U.S. government agencies of version 9.1 of *OPNET IT Guru*, which was released in December 2002, and its associated modules including *Application Characterization Environment*, *ACE Decode Module*, *NetDoctor* and *Flow Analysis*, and *OPNET VNE Server*, which was released in June 2002. Our business depends on customer acceptance of these products and our revenues may not increase, or may decline, if our target customers do not adopt and expand their use of our products. In addition, if our *OPNET Modeler* product, which we have been selling since 1987, continues to encounter declining sales, which could occur for a variety of reasons, including market saturation and the financial condition of network equipment manufacturers, and sales of our newer products do not grow at a rate sufficient to offset the shortfall, our revenues would decline.

We may not be able to grow our business if service providers do not buy our products.

An element of our strategy is to increase sales to service providers of *OPNET SP Guru* and *OPNET WDM Guru*, both launched in fiscal 2002, and *OPNET VNE Server*, which was launched in fiscal 2003. Accordingly, if our products fail to perform favorably in the service provider environment, or fail to gain wider adoption by service providers, our business and future operating results could suffer.

Our lengthy and variable sales cycle makes it difficult to predict operating results.

It is difficult for us to forecast the timing and recognition of revenues from sales of our products because prospective customers often take significant time evaluating our products before licensing them. The period between initial customer contact and a purchase by a customer may vary from three months to more than a year. During the sales process, the customer may decide not to purchase or may reduce proposed orders of our products for various reasons, including changes in budgets and purchasing priorities. Our prospective customers routinely require education regarding the use and benefit of our products. This may also lead to delays in receiving customers' orders.

If we do not successfully expand our sales force, we may be unable to increase our sales.

We sell our products primarily through our direct sales force, and we must expand the size of our sales force to increase revenues. If we are unable to hire or retain qualified sales personnel, if newly hired personnel fail to develop the necessary skills to be productive, or if they reach productivity more slowly than anticipated, our ability to increase our revenues and grow our business could be compromised. Our sales people require a long period of time to become productive, typically three to nine months. The time required to reach productivity, as well as the challenge of attracting, training, and retaining qualified candidates, may make it difficult to meet our sales force growth targets. Further, we may not generate sufficient sales to offset the increased expense resulting from growing our sales force or we may be unable to manage a larger sales force.

Our ability to increase our sales will be impaired if we do not expand and manage our indirect distribution channels.

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To increase our sales, we must, among other things, further expand and manage our indirect distribution channels, which consist primarily of international distributors and original equipment manufacturers and resellers. If we are unable to expand and manage our relationships with our distributors, our distributors are unable or unwilling to effectively market and sell our products, or we lose existing distributor relationships, we might not be able to increase our revenues. Our international distributors and original equipment manufacturers and resellers have no obligation to market or purchase our products. In addition, they could partner with our competitors, bundle or resell competitors' products, or internally develop products that compete with our products.

We may not be able to successfully manage our expanding operations, which could impair our ability to operate profitably.

We may be unable to operate our business profitably if we fail to manage our growth. Our rapid growth has sometimes strained, and may in the future continue to strain, our managerial, administrative, operational, and financial resources and controls. We plan to continue to expand our operations and increase the number of our full-time employees. Our ability to manage growth will depend in part on our ability to continue to enhance our operating, financial, and management information systems. Our personnel, systems, and controls may not be adequate to support our growth. In addition, our revenues may not continue to grow at a sufficient rate to absorb the costs associated with a larger overall employee base.

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If we are unable to introduce new and enhanced products on a timely basis that respond effectively to changing technology, our revenues may decline.

Our market is characterized by rapid technological change, changes in customer requirements, frequent new product and service introductions and enhancements, and evolving industry standards. If we fail to develop and introduce new and enhanced products on a timely basis that respond to these changes, our products could become obsolete, demand for our products could decline and our revenues could fall. Advances in network management technology, software engineering, and simulation technology, or the emergence of new industry standards, could lead to new competitive products that have better performance, more features, or lower prices than our products and could render our products unmarketable.

Our future revenue is substantially dependent upon our existing customers continuing to license additional products, renew maintenance agreements and purchase additional services.

Our existing customers have traditionally generated additional revenue from consulting services, renewed maintenance agreements and purchase of additional software licenses, which represents a majority of our annual revenue. The maintenance agreements are generally renewable at the option of the customers and there are no mandatory payment obligations or obligations to license additional software. In addition, customers may decide not to purchase additional products or services. If our existing customers fail to renew their maintenance agreements or purchase additional products or services, our revenues could decrease.

Increases in professional service revenues as a percentage of total revenues could decrease overall margins and adversely affect our operating results.

We realize lower margins on professional service revenues than we do on other types of revenues. As a result, if professional service revenues increase as a proportion of total revenues, our gross margins will be lower and our operating results may be adversely affected.

If we fail to retain our key personnel and attract and retain additional qualified personnel, we might not be able to maintain our current level of revenue.

Our future success and our ability to maintain our current level of revenue depend upon the continued service of our executive officers and other key sales and research and development personnel. The loss of any of our key employees, in particular Marc A. Cohen, our chairman of the board and chief executive officer, and Alain J. Cohen, our president and chief technology officer, could also adversely affect our ability to pursue our growth strategy. We do not have employment agreements or any other agreements that obligate any of our officers or key employees to remain with us.

We must also continue to hire highly qualified individuals, particularly software engineers and sales and marketing personnel. Our failure to attract and retain technical personnel for our product development, consulting services, and technical support teams may limit our ability to develop new products or product enhancements. Competition for these individuals is intense, and we may not be able to attract and retain additional highly qualified personnel in the future. In addition, limitations imposed by federal immigration laws and the availability of visas could impair our ability to recruit and employ skilled technical professionals from other countries to work in the United States.

Our international operations subject our business to additional risks, which could cause our sales or profitability to decline.

We plan to increase our international sales activities, but these plans are subject to a number of risks that could cause our sales to decline or could otherwise cause a decline in profitability. These risks include:

difficulty in attracting distributors that will market and support our products effectively;

greater difficulty in accounts receivable collection and longer collection periods;

the need to comply with varying employment policies and regulations that could make it more difficult and expensive to manage our employees if we need to establish more direct sales or support staff outside the United States;

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potentially adverse tax consequences;

the effects of currency fluctuations; and

political and economic instability.

We expect to face intense competition, which could cause us to lose sales, resulting in lower profitability.

Increasing competition in our market could cause us to lose sales and become unprofitable. We believe that the market for intelligent network management software is likely to become more competitive as it evolves and the demand for intelligent network management solutions continues to increase. At least one of our current competitors and many of our potential competitors are larger and have substantially greater financial and technical resources than we do. In addition, it is possible that other vendors as well as some of our customers or distributors will develop and market solutions that compete with our products in the future.

If our products contain errors and we are unable to correct those errors, our reputation could be harmed and our customers could demand refunds from us or assert claims for damages against us.

Our software products could contain significant errors or bugs that may result in:

the loss of or delay in market acceptance and sales of our products;

the delay in introduction of new products or updates to existing products;

diversion of our resources;

injury to our reputation; and

increased support costs.

Bugs may be discovered at any point in a product's life cycle. We expect that errors in our products will be found in the future, particularly in new product offerings and new releases of our current products.

Because our customers use our products to manage networks that are critical to their business operations, any failure of our products could expose us to product liability claims. In addition, errors in our products could cause our customers' networks and systems to fail or compromise their data, which could also result in liability to us. Product liability claims brought against us could divert the attention of management and key personnel, could be expensive to defend, and may result in adverse settlements and judgments.

Our software products rely on our intellectual property, and any failure to protect our intellectual property could enable our competitors to market products with similar features that may reduce our revenues and could allow the use of our products by users who have not paid the required license fee.

If we are unable to protect our intellectual property, our competitors could use our intellectual property to market products similar to our products, which could reduce our revenues. In addition, we may be unable to prevent the use of our products by persons who have not paid the required license fee, which could reduce our revenues. Our success and ability to compete depend substantially upon the internally developed technology that is incorporated in our products. Policing unauthorized use of our products is difficult, and we may not be able to prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as those in the United States. Others may circumvent the patents, copyrights, and trade secrets we own. In the ordinary course of business, we enter into a combination of confidentiality, non-competition and non-disclosure agreements with our employees.

These measures afford only limited protection and may be inadequate, especially because our employees are highly sought after and may leave our employ with significant knowledge of our proprietary information. In addition, any confidentiality, non-competition and non-disclosure agreements we enter into may be found to be unenforceable, or our copy protection mechanisms

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embedded in our software products could fail or could be circumvented.

Our products employ technology that may infringe on the proprietary rights of others, and, as a result, we could become liable for significant damages.

We expect that our software products may be increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionalities of products in different industry segments overlap.

Regardless of whether these claims have any merit, they could:

be time-consuming to defend;

result in costly litigation;

divert our management's attention and resources;

cause us to cease or delay product shipments; or

require us to enter into royalty or licensing agreements.

These royalty or licensing agreements may not be available on terms acceptable to us, if at all. A successful claim of product infringement against us or our failure or inability to license the infringed or similar technology could adversely affect our business because we would not be able to sell the affected product without redeveloping it or incurring significant additional expense.

Future interpretations of existing accounting standards could adversely affect our operating results.

The American Institute of Certified Public Accountants and its Software Revenue Recognition Task Force continue to issue interpretations and guidance for applying the relevant standards to a wide range of sales contract terms and business arrangements that are prevalent in the software industry. Future interpretations of existing accounting standards or changes in our business practices could result in future changes in our revenue recognition accounting policies that could have a material adverse effect on our results of operations.

As with other software vendors, we may be required to delay revenue recognition into future periods, which could adversely affect our operating results.

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We have in the past had to, and in the future may have to, defer recognition for license fees due to several factors, including whether:

software arrangements include undelivered elements for which we do not have vendor specific evidence of fair value;

we must deliver services for significant customization, enhancements and modifications of our software;

the transaction involves material acceptance criteria or there are other identified product-related issues;

the transaction involves contingent payment terms or fees;

we are required to accept a fixed-fee services contract; or

we are required to accept extended payment terms.

Because of the factors listed above and other specific requirements under accounting principles generally accepted in the United States for software revenue recognition, we must have very precise terms in our software arrangements in order to recognize revenue when we initially deliver software or perform services. Negotiation of mutually acceptable terms and

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conditions can extend the sales cycle, and sometimes we do not obtain terms and conditions that permit revenue recognition at the time of delivery.

If we undertake acquisitions, they may be expensive and disruptive to our business and could cause the market price of our common stock to decline.

We completed the NetMaker and WDM NetDesign acquisition in March 2001 and January 2002, respectively. We may continue to acquire or make investments in companies, products or technologies if opportunities arise. Any acquisition could be expensive, disrupt our ongoing business, distract our management and employees, and adversely affect our financial results and the market price of our common stock. We may not be able to identify suitable acquisition or investment candidates, and if we do identify suitable candidates, we may not be able to make these acquisitions or investments on commercially acceptable terms or at all. If we make an acquisition, we could have difficulty integrating the acquired technology, employees, or operations. In addition, the key personnel of the acquired company may decide not to work for us.

We also expect that we would incur substantial expenses if we acquired other businesses or technologies. We might use cash on hand, incur debt, or issue equity securities to pay for any future acquisitions. If we issue additional equity securities, our stockholders could experience dilution and the market price of our stock may decline.

Our products are subject to changing computing environments, including operating system software and hardware platforms, which could render our products obsolete.

The evolution of existing computing environments and the introduction of new popular computing environments may require us to redesign our products or develop new products. Computing environments, including operating system software and hardware platforms, are complex and change rapidly. Our products are designed to operate in currently popular computing environments. Due to the long development and testing periods required to adapt our products to new or modified computing environments, our research and development efforts could be distracted and we could experience significant delays in product releases or shipments, which could result in lost revenues and significant additional expense.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We consider all highly liquid investments 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 marketable securities consist primarily of investment grade securities with high credit ratings of relatively short duration that trade in highly liquid markets. Accordingly, we have no quantitative information concerning the market risks and believe that the risk is minimal. Our outstanding notes payable have fixed interest rates and their carrying values approximate fair value. We currently do not hedge interest rate exposure, but do not believe that an increase in interest rates would have a material effect on the value of our cash equivalents, marketable securities or notes payable.

A majority of our revenue transactions outside the United States are denominated in U.S. dollars. The operating expenses of our foreign subsidiaries are denominated in local currencies. We currently do not hedge foreign exchange rate risk. Due to the limited nature of our foreign operations, we do not believe that a 5% change in exchange rates would have a material effect on our business, financial condition, or results of operations.

ITEM 4. CONTROLS AND PROCEDURES

We maintain a system of internal controls and procedures that are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Chief Executive Officer and our Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2003, and have each concluded that, as of the evaluation date, such controls and procedures were effective, in all material respects, to ensure that required information will be disclosed on a timely basis in our reports filed under the Exchange Act.

Subsequent to the date of the evaluation, there have been no significant changes to our internal controls or in other factors that could significantly affect our internal controls.

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PART II. OTHER INFORMATION

ITEM 1. *Legal Proceedings*

OPNET is involved in various claims and legal proceedings arising from its normal operations. Management does not consider any of those matters to be material.

ITEM 2. *Changes in Securities and Use of Proceeds*

In August 2000, we closed an initial public offering of our common stock. The Registration Statement on Form S-1 (No. 333-32588) was declared effective by the Securities and Exchange Commission on August 1, 2000 and we commenced the offering on that date. After deducting the underwriting discounts and commissions and the offering expenses, the net proceeds from the offering were approximately \$54.1 million.

As of June 30, 2003, the proceeds from the offering were used to fund approximately (i) \$7.6 million of general corporate expenses, working capital and capital expenditures, including \$4.8 million for capital expenditures and leasehold improvements related to our headquarters facility in Bethesda, MD, (ii) \$6.2 million of acquisition and acquisition-related expenses for the NetMaker acquisition, and (iii) \$1.4 million of the purchase price for WDM NetDesign. None of these amounts were paid directly or indirectly to any director, officer, or general partner of us or their associates, persons owning 10% or more of any class of our equity securities, or any affiliate of us. We have not allocated any of the remaining net proceeds to any identifiable uses. We may also use a portion of the net proceeds to acquire businesses, products, or technologies that are complementary to our business. Pending their use, we have invested the net proceeds in investment grade, interest-bearing securities.

ITEM 6. *Exhibits and Reports on Form 8-K*

- A. Exhibits: See Exhibit Index

- B. Reports on Form 8-K

Current Report on Form 8-K furnished to the SEC on April 28, 2003, furnished information under Item 9. Regulation FD Disclosure of Form 8-K rather than Item 12. Disclosure of Operations and Financial Condition of Form 8-K pursuant SEC Release No. 33-8216.

Current Report on Form 8-K furnished to the SEC on July 29, 2003, furnished information under Item 9. Regulation FD Disclosure of Form 8-K rather than Item 12. Disclosure of Operations and Financial Condition of Form 8-K pursuant SEC Release No. 33-8216.

Current Report on Form 8-K furnished to the SEC on August 14, 2003, furnished information under Item 9. Regulation FD Disclosure of Form 8-K.

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Current Report on Form 8-K furnished to the SEC on August 19, 2003, furnished information under Item 9. Regulation FD Disclosure of Form 8-K rather than Item 12. Disclosure of Operations and Financial Condition of Form 8-K pursuant SEC Release No. 33-8216.

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Exhibit		
Number	Description	Source
3.1	Third Amended and Restated Certificate of Incorporation of the Registrant	Incorporated by reference from exhibit 3.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
3.2	Amended and Restated By-Laws of the Registrant	Incorporated by reference from exhibit 3.4 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
4.1	Specimen common stock certificate	Incorporated by reference from exhibit 4.1 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
4.2	See Exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and By-Laws of the Registrant defining the rights of holders of common stock of the Registrant	Incorporated by reference from exhibit 4.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.1	2000 Employee Stock Purchase Plan, as Amended	Incorporated by reference from exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the period ended December 31, 2002 as filed with the SEC January 29, 2003.
10.2	Amended and Restated Registration Rights Agreement, dated as of March 30, 2001, by and among the Registrant, Summit Ventures IV, L.P., Summit Investors III, L.P., Alain J. Cohen, Marc A. Cohen and Make Systems, Inc.	Incorporated by reference from exhibit 10.1 to the Registrant's Annual Report on Form 10-K for the period ended March 31, 2001 as filed with the SEC on June 29, 2001.
10.3	Asset Purchase Agreement, dated as of March 20, 2001, by and among the Registrant, Make Systems, Inc. and Metromedia Company	Incorporated by reference from exhibit 2.1 to the Registrant's Current Report on Form 8-K dated March 22, 2001 filed with the Securities and Exchange Commission (SEC) on March 23, 2001 (File No. 000-30931).
10.4	Stock Purchase and Option Agreement, dated as of November 1, 1999, between the Registrant and Steven G. Finn	Incorporated by reference from exhibit 10.6 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.5	Stock Purchase and Option Agreement, dated as of November 1, 1999, between the Registrant and William F. Stasior	Incorporated by reference from exhibit 10.7 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.6	Amended and Restated 1993 Incentive Stock Option Plan	Incorporated by reference from exhibit 10.10 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.7	2000 Director Stock Option Plan	Incorporated by reference from exhibit 10.13 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).

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10.8	Non-competition Agreement, dated as of December 31, 1997, between the Registrant and Marc A. Cohen	Incorporated by reference from exhibit 10.15 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.9	Non-competition Agreement, dated as of December 31, 1997, between the Registrant and Alain J. Cohen	Incorporated by reference from exhibit 10.16 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588).
10.10	Change-in Control Agreement, dated as of June 1, 2000, between the Registrant and Pradeep K. Singh	Incorporated by reference from exhibit 10.19 to the Registrant's Annual Report on Form 10-K for the period ended March 31, 2001 as filed with the SEC on June 29, 2001.
10.11	Office Lease Agreement, dated May 2000, between the Registrant and Street Retail, Inc.	Incorporated by reference from exhibit 10.21 to the Registrant's Annual Report on Form 10-K for the period ended March 31, 2001 as filed with the SEC on June 29, 2001.
10.12	Amended and Restated 2000 Stock Incentive Plan	Incorporated by reference from exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the period ended December 31, 2001 as filed with the SEC November 14, 2001.
10.13	Loan Agreement, dated June 10, 2002, between Registrant and Bank of America, N.A.	Incorporated by reference from exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2002 as filed with the SEC August 9, 2002.
10.14	Promissory Note, dated June 10, 2002, between Registrant and Bank of America, N.A.	Incorporated by reference from exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the period ended June 30, 2002 as filed with the SEC August 9, 2002.
*31.1	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended	Exhibit 31.1 to this Quarterly Report on Form 10-Q.
*31.2	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended	Exhibit 31.1 to this Quarterly Report on Form 10-Q.
*32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit 32.1 to this Quarterly Report on Form 10-Q.
*32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit 32.2 to this Quarterly Report on Form 10-Q.

* filed herewith