

OPNET TECHNOLOGIES INC
Form 10-K
June 14, 2004
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended March 31, 2004

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

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

Incorporation or organization)

7255 Woodmont Avenue, Bethesda, Maryland 20814-7900

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(Address of principal executive offices) (Zip Code)

Registrant's telephone number; including area code: (240) 497-3000

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$.001 par value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

YES NO

The aggregate market value of the voting stock held by non-affiliates of the registrant, computed using the closing sale price of the registrant's Common Stock on September 30, 2003, as reported on the NASDAQ National Market, was approximately \$93 million. Shares of Common Stock held by each officer and director and by each person who owns 5% or more of the outstanding Common Stock have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive for other purposes.

The number of shares of the registrant's Common Stock outstanding on June 11, 2004 was 20,093,712.

DOCUMENTS INCORPORATED BY REFERENCE

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Certain portions of the registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on September 14, 2004, are incorporated by reference into Part III of this Form 10-K.

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OPNET TECHNOLOGIES, INC.

ANNUAL REPORT ON FORM 10-K

FOR THE FISCAL YEAR ENDED MARCH 31, 2004

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This Annual 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 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 accurately or control. The factors listed in this Annual Report on Form 10-K under Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Factors That May Affect Future Results, as well as any cautionary language in this Annual Report on Form 10-K, 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 2005.

The forward-looking statements provided in this Annual Report on Form 10-K represent our expectations as of June 14, 2004. We anticipate that subsequent events and developments will cause our expectations to change. However, while we may elect to update this forward-looking information at some point in the future, we specifically disclaim any obligation to do so. This forward-looking information should not be relied upon as representing our expectations as of any date subsequent to June 14, 2004. IT Guru[®], Netbiz[®], NetDoctor[®], OPNET[®], OPNET Modeler[®], SP Guru[®], WDM Guru[®], OPNET Technologies, Inc.[®], OPNETWORK[®], and VNE Server are trademarks or service marks of OPNET. Other trademarks or service marks appearing in this Annual Report on Form 10-K are the property of their respective holders.

The years ended March 31, 2004, 2003, and 2002 are referred to as fiscal 2004, fiscal 2003, and fiscal 2002, respectively, in this Annual Report on Form 10-K.

We are a Delaware corporation, and our principal executive offices are located at 7255 Woodmont Avenue, Bethesda, Maryland 20814-2959 and our telephone number is (240) 497-3000. Our web site address is www.opnet.com. The information on our web site is not incorporated by reference into this Annual Report on Form 10-K and should not be considered to be a part of this Annual Report on Form 10-K. Our web site address is included in this Annual Report on Form 10-K as an inactive textual reference only.

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PART I

ITEM 1. BUSINESS

Overview

OPNET Technologies, Inc. (OPNET , we or us) is a provider of management software for networks and applications. Our solutions address: application performance troubleshooting; network configuration and security auditing; network capacity and resiliency planning; application deployment planning; and network technology research and development or R&D. Embedded in OPNET software is knowledge about how network devices, network protocols, applications and servers operate and interact. This intelligence enables users in application development, network operations, engineering, planning, and security functions to be more effective in optimizing performance and availability of their networks and applications. We believe our software solutions generate return on investment to a broad customer base, including corporate enterprises, government and defense agencies, network service providers, and network equipment manufacturers by empowering them to make better use of resources, reduce operational problems and improve competitiveness.

We market focused software solutions for each of our target markets. *OPNET IT Guru*, which was launched in August 1998 and *OPNET SP Guru*, which was launched in June 2001, are our platform intelligent application and network management products for enterprises and service providers, respectively. *OPNET WDM Guru*, which was launched in December 2001, is an optical network planning product for equipment manufacturers and service providers. *OPNET Modeler*, our first product which was launched in 1987, is a modeling and simulation product for network R&D, mainly sold to network equipment manufacturers and the U.S. Department of Defense. *OPNET Netbiz* applications are custom solutions developed with the OPNET Development Kit (ODK), which were launched in August 1998, and are sold primarily to network equipment manufacturers. *OPNET VNE Server*, which was launched in June 2002, is our software solution for unified network data management. *OPNET VNE Server* is sold primarily to enterprises and service providers. Government and defense agencies purchase most of our software solutions, as their needs are similar to enterprises, service providers, and network equipment manufacturers.

Since inception, we have sold our products to enterprises such as Abbott Laboratories, Enterprise Rent-a-Car, FleetBoston Financial, Staples, RR Donnelley and Texas Utilities; service providers such as AT&T, British Telecom, France Telecom, NTT, SBC Communications and Sprint; network equipment manufacturers such as Cisco Systems, Ericsson, Motorola, Nokia, and Nortel Networks; and government agencies such as the Department of Homeland Security, FBI, NASA, U.S. Department of State, and U.S. Department of Defense.

Industry Background

Growth and Increased Complexity of Networks and Dependence on Applications

Organizations are increasingly reliant upon their communications networks and data applications to successfully execute their business strategies. The increasing use of business applications, such as enterprise resource planning, corporate intranets, online transaction processing, e-mail, voice over IP, and streaming multimedia, has expanded the amount of network traffic within organizations, and has resulted in significant growth in underlying network infrastructures. In addition, the proliferation and widespread adoption of the Internet has expanded the role of networks beyond organizational boundaries, and these networks now represent the fundamental infrastructure of business. As a result, organizations are recognizing that managing the growth and operation of their communications networks is critical to business success.

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To support the rapidly expanding size and scope of communications requirements, network infrastructures have been developed based on a wide range of equipment, technologies, protocols, and network services. As a result, the operation of these networks is becoming increasingly complex. Enterprises and service providers must now manage the convergence of voice, data, and video traffic over traditional, wireless, and optical architectures by integrating numerous existing and emerging technologies. The growth of networks, network complexity, and network data traffic has forced organizations to confront significant challenges in the cost-effective management of networks and applications.

Communications networks are sophisticated, dynamic systems that evolve on a daily basis. Applications are typically distributed across many clients, servers, and network segments. New and enhanced business applications are regularly being deployed and re-deployed. Because traffic levels rise steadily, constant evaluation of and improvements

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to the network are essential to maintaining business and application performance. However, due to the dependencies among network, server, and application configurations, it is very difficult for information technology (IT) professionals to identify the true root cause of end-to-end performance problems when they occur. The data required to diagnose end-to-end problems is often not available, and when it is, specialists are required to perform manual analysis that is time consuming, and sometimes impractical. Consider the challenge facing a typical IT manager when an end-user experiences performance problems with an important business application: Is there enough bandwidth available? Does the database server have enough capacity? What about the application server? Are network routing protocols tuned properly? What about protocols on the client and server? Was the application designed and configured properly?

Without a clear understanding of where problems are and what specific changes are required to solve them, IT managers resort to uninformed decision-making that translates into wasteful spending on unnecessary server and network upgrades. Due to the distributed nature of enterprise applications, IT professionals need solutions that enable them to focus their time and resources in the right places when problems occur to maximize the use of existing infrastructure. Since modifications to infrastructure are costly and have the potential to result in network failures or service level degradation, there is a growing need to plan and implement network changes in a controlled manner, taking into account the potential consequences of each action.

Inadequacy of Traditional Application and Network Management Solutions

Traditional application and network management systems have primarily played an important role in reporting on present and historical performance and availability. These systems typically collect, store and analyze data about the traffic on the network, the status and performance of network devices and links, and the availability of network services and applications. Traditional application and network management products are limited by their lack of understanding of the underlying technologies that support applications, and the relationships among these technologies. While they provide useful information, they do not automate the next step, which is performing intelligent analysis to digest gathered data into actionable information.

Traditional application and network management solutions do not adequately support key network management functions, including network design and deployment, applications troubleshooting and deployment, capacity planning, contingency planning, traffic engineering, configuration and security auditing, budgeting, and deployment of network policies. Each of these functions depends on a significant amount of expertise, manual effort and multiple sources of data to be done properly without the support of intelligent application and network management. Traditional application and network management products lack an operational knowledge of how network devices, applications, and traffic behave together, and are thus limited both in their ability to diagnose complex problems and also their ability to provide quantitative insight into how changes will affect performance.

In general, the troubleshooting support available from traditional products is focused on monitoring an individual data source, such as traffic volume, or application response time. The support available from traditional tools for future planning is limited to trend analysis and simple projections based on historical information, again, often from a single data source. These solutions do not generally take into account the network as a whole, the interaction among network components, and the complex behaviors that are inherent to modern networks and distributed applications.

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Market Opportunity for Intelligent Application and Network Management

Organizations need intelligent application and network management solutions that possess an operational understanding of network devices, protocols and applications to enable them to rapidly diagnose complex problems from live operational data sources, and to predict the impact of changes. A predictive capability allows IT professionals not only to test network and application performance under a wide range of operating conditions, but also to determine which network technologies are best suited to ultimately solve business problems. We believe business executives and IT professionals need a comprehensive application and network management solution that enhances their ability to:

generate revenue;

reduce operating and capital costs;

increase business productivity;

improve operational efficiency;

reduce time-to-market; and

manage risk.

Enterprises require intelligent application and network management solutions for more effectively identifying the root causes of end-to-end application performance problems, troubleshooting and auditing device configurations, validating changes, and performing critical operational and strategic planning functions.

Government and defense agencies have needs similar to those of enterprises, service providers, and network equipment manufacturers. These agencies also sometimes require specialized services to support large projects that incorporate intelligent application and network management technology.

Service providers require intelligent application and network management solutions for optimizing their investments in network infrastructure, more effectively troubleshooting network and auditing configurations, planning for services based on new technologies including wireless and optical, and making better use of network resources to increase competitiveness.

Network equipment manufacturers require advanced modeling and simulation solutions for accelerating network R&D, reducing time-to-market for new technologies, developing custom network design and analysis software, and for reducing sales cycles for sophisticated technology products.

The OPNET Solution and Products

OPNET software solutions directly address the intelligent application and network management needs of enterprises, government and defense agencies, service providers, and network equipment manufacturers. Our intelligent application and network management solutions use a variety of advanced technologies to support the assessment of network, application, and server performance under a wide range of current and future operating conditions. Our products include model libraries that permit the simulation and analysis of major network technologies and communication protocols, such as Transmission Control Protocol/Internet Protocol, or TCP/IP, IP-QoS, Voice over IP, SONET, CDMA, Virtual Local Area Networks, or VLANs, Frame Relay, data over cable, and ATM. We sell both off-the-shelf and customized products that offer interfaces to third party network management solutions, including those from Concord, Infovista, Network Associates, and Netscout. All of the OPNET products share a significant amount of core software based on an open architecture. Our product architecture enables us to create new products more efficiently, to foster interoperability of our products, and to provide interfaces to a wide range of external data sources including third party management tools and network topology, traffic, and configuration information.

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The following chart summarizes our OPNET product suite:

| <u>Product</u> | <u>Description</u> | <u>Target Customers</u> |
|---|--|---|
| <i>OPNET IT Guru</i> | An intelligent application and network management platform product for enterprises. Enables users to troubleshoot and predict the performance of networks, applications, and servers. | Large and medium enterprises, and government and defense agencies. |
| <i>OPNET SP Guru</i> | An intelligent application and network management platform product for service providers. Enables network service providers to troubleshoot, validate, plan and design networks. | Network service providers and very large enterprises. Networking professionals who focus on planning, operations, design, and architecture. |
| <i>OPNET Modeler</i> | A modeling and simulation product for network R&D. Enables designers to evaluate how networking equipment, technologies and protocols will perform under simulated network conditions. | Network equipment manufacturers and R&D organizations. |
| <i>OPNET Netbiz and OPNET Development Kit (ODK)</i> | Custom applications for automating network design, planning, provisioning, proposals, and analyses. | Network equipment manufacturers and the U.S. Department of Defense. |
| <i>OPNET WDM Guru</i> | Optical network planning product for designing resilient, cost-efficient optical networks. | Network equipment manufacturers and service providers. Optical transport layer design and planning engineers. |
| <i>OPNET Modules</i> | Provides enhanced functionality to our primary software products. | Entire customer base. |
| <i>OPNET Model Libraries</i> | Libraries of models that simulate the behavior of networking technologies and communication protocols. | Entire customer base. |
| <i>OPNET VNE Server</i> | Maintains a comprehensive view of a customer's network. Used as a front end for <i>OPNET IT Guru and SP Guru</i> . | Entire customer base. |
| <i>OPNET IT Guru</i> | | |

We began commercial distribution of *OPNET IT Guru* in August 1998. *OPNET IT Guru* uses a variety of advanced technologies, including troubleshooting and predictive simulation, to analyze many aspects of network behavior. IT Guru enables our customers to identify current problems related to application performance and network configurations, and also to predict the impact of changes to their networks, applications, and servers under a wide range of scenarios. *OPNET IT Guru* allows users to identify the root-cause of end-to-end performance problems and to make comparisons among alternative approaches to solving them. IT Guru's predictive component supports managing change within customers' networks, such as adopting new technologies, increasing capacity, and reorganizing assets. *OPNET IT Guru* also provides detailed views of an application's performance within a network. This enables network managers and application deployment teams to understand the impact of implementing a new application on existing applications, as

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well as the ability of a network to support the resulting traffic. *OPNET IT Guru* supports many popular communication protocols and networking technologies that operate within wireline and wireless networks.

OPNET SP Guru

We began general commercial distribution of *OPNET SP Guru* in June 2001. *OPNET SP Guru* enables service providers and very large enterprises to manage networks cost-effectively and improve network efficiency. Its advanced configuration troubleshooting and operational validation capabilities enable network operators to identify problems sooner and reduce costly mistakes. *OPNET SP Guru* uses our predictive modeling and diagnostic technology to characterize and forecast many aspects of network behavior. In addition, *OPNET SP Guru* provides sophisticated design and optimization capabilities that enable service providers to automatically produce more efficient, less costly network designs. Using *OPNET SP Guru*, network operators are able to maintain a reliable infrastructure with high availability and superior service quality, accelerate deployment of new services, differentiate their services from those of competitors, reduce capital and operating costs, and manage risk.

OPNET Modeler

OPNET Modeler was our first product and was introduced in 1987. *OPNET Modeler* uses our device and protocol design environment, as well as our predictive simulation technology, to enable our customers to build software models of a broad range of network devices, communication protocols, and applications, and to combine these models to run simulations in order to predict network behavior and performance. These capabilities support the design, modeling, and development of network equipment and protocols. *OPNET Modeler* enables network equipment manufacturers to test product designs in a wide variety of scenarios prior to manufacturing. Using *OPNET Modeler*, network technology and equipment designers gain a better understanding of design tradeoffs earlier in the product development process, reducing the need for time-intensive and expensive hardware prototyping.

OPNET Netbiz and ODK

We began commercial distribution of *OPNET Netbiz* and *ODK* in August 1998. *OPNET Netbiz* and *ODK* provide network equipment manufacturers, the U.S. Department of Defense, and service providers with a platform for automating network design, provisioning, proposals, and analyses. *OPNET Netbiz* and *ODK* can incorporate customers' proprietary algorithms and business policies to automatically produce and optimize network configurations and designs. *OPNET Netbiz* and *ODK* enable network equipment manufacturers to provide vendor-specific planning solutions to their service provider customers, and enable service providers to differentiate service offerings from competitors, improve proposal quality, and accelerate business cycles.

OPNET WDM Guru

We began commercial distribution of *OPNET WDM Guru* in December 2001. This product is an advanced network planning solution that enables service providers and network equipment manufacturers to create cost-effective optical networks. Its extensive, built-in network expertise provides powerful capabilities for routing, grooming and dimensioning networks to meet current and future traffic demands. Users can create and test different what-if scenarios with varying topologies, traffic loads, and configurations. *OPNET WDM Guru*'s reporting features allows users to compare the results of different scenarios, and thereby determine the most cost-effective designs to meet future demands.

OPNET VNE Server

We began commercial distribution of *OPNET VNE Server* in June 2002. This is an on-line continuously operating software product that maintains a valid comprehensive view of the network, including infrastructure, configuration and performance data. It merges and validates multiple sources of information into a cohesive model for problem resolution, problem prevention, and network planning. *OPNET VNE Server* is also used as a front end for *OPNET IT Guru*, *OPNET SP Guru*, and *OPNET Modeler*.

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OPNET Modules

We develop and sell a variety of software modules that provide enhanced functionality to our intelligent application and network management software products. Currently available OPNET modules include:

Application Characterization Environment (ACE), for analyzing, diagnosing, and simulating the performance of applications;

ACE Decode Module, for enhancing *ACE*'s visualizations and diagnoses using a comprehensive application and protocol decode engine;

Expert Service Prediction, for the definition and compliance testing of service level agreements;

High-Level Architecture, to support building and running a federation of many simulators, each modeling some aspect of a composite system;

Flow Analysis, for determining the route taken by each circuit or traffic flow, as well as the resulting traffic loads on links, and investigating the impact of failure in selected devices or links - (This module has two versions: the Service Provider version and the Enterprise version);

Multi-Vendor Import, for importing network infrastructure and traffic information from other network management software applications;

NetDoctor, for automated auditing and validation of network, protocol and security configurations; and

Wireless, for modeling wireless networks and the effects of terrain on those networks.

OPNET Model Libraries

The model libraries are used by *OPNET IT Guru*, *OPNET SP Guru*, and *OPNET Modeler* to simulate and analyze major networking technologies and communication protocols. These libraries provide the building blocks used to generate models of networks. A network model consists of software objects that correspond to the devices, computers, and links that constitute the actual network of interest. The behavior of these objects is controlled by models of devices, computers, applications, communication protocols, and links. *OPNET IT Guru*, *OPNET SP Guru*, and *OPNET Modeler* include extensive libraries of popular and emerging networking technologies and communication protocols, such as TCP/IP, hypertext transfer protocol, or HTTP, Open Shortest Path First routing, or OSPF, Asynchronous Transfer Mode, or ATM, frame relay, IP-QoS, and 802.11, or Wi-Fi. Some of our model libraries are included in our base products and others are available for an additional fee.

Customers

Our customers include:

large and medium-sized enterprises that rely on networks to conduct business;

service providers, including telecommunications carriers and Internet Service Providers, or ISPs;

network equipment manufacturers; and

government agencies.

Our software license agreements provide our customers with perpetual and annual licenses for use by a specified number of concurrent users.

For fiscal 2004, fiscal 2003, and fiscal 2002 we generated 20.5%, 19.2% and 20.6%, respectively, of our total revenues from customers located outside the United States. For fiscal 2004, fiscal 2003 and fiscal 2002, revenues from transactions with U.S. government agencies were approximately 44%, 39%, and 23% of our total revenues, respectively.

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Note 16 to our consolidated financial statements presents information regarding revenues generated in the United States and internationally.

Sales and Marketing

We sell our software through our direct sales force, our international subsidiaries, third-party distributors, and a number of original equipment manufacturers and value-added resellers. To date, original equipment manufacturers have not accounted for a material portion of our revenues. In North America, our direct sales force makes almost all of our sales. As of March 31, 2004, our sales and marketing organization consisted of 95 employees, including 44 quota-carrying salespersons located in our headquarters in Bethesda, Maryland and our domestic offices in Cary, North Carolina; Dallas, Texas; Santa Clara, California; and our overseas subsidiaries in France, and the United Kingdom. We intend to expand our sales and marketing organization by recruiting additional qualified individuals.

Our direct sales force concentrates on sales opportunities in the United States. Our international sales activities are primarily conducted through our subsidiaries in Paris, France; Slough, United Kingdom; and Sydney, Australia; and our 26 distributors that resell our products in Australia, Brazil, China, France, Germany, Greece, Italy, Israel, Japan, Latin America, the Middle East, Poland, Scandinavia, Singapore, South Africa, South Korea, and Switzerland. Our vice president of international sales manages international sales activities. Our marketing division works internally with our engineering and sales teams to develop customer value propositions, and externally to raise awareness of our company and products in order to generate leads for sales. Our external marketing activities are aimed at existing customers, new customer and partner prospects, the media, and industry analysts. These include:

participation in industry tradeshows;

product seminars;

advertisements in trade journals and websites;

direct mailings;

product collateral development;

strategic support for sales teams;

briefings with industry analysts; and

a variety of public relations activities, including our annual international technology conference, OPNETWORK.

For each of the last six years, we have sponsored OPNETWORK, an annual international technology conference convened in Washington, D.C. that focuses on intelligent application and network management for professionals in all areas of networking and information technology. OPNETWORK 2003, held in August 2003, included more than 500 hours of classes, labs and panels led by OPNET employees and outside experts. Approximately 1,200 people attended OPNETWORK 2003.

Service and Support

Our service and support offerings include:

consulting services;

software maintenance, which includes providing software updates for major and minor revisions;

technical support by telephone, e-mail, or fax; and

training, which includes courses that enable our customers to more effectively use our products.

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We offer consulting services to assist our clients to facilitate the adoption of our software solutions and to provide customization and enhancements to OPNET products. In particular, our customers typically include customization services with their purchase of *OPNET Netbiz*. Customization services are performed by our consulting staff, which consists of software development engineers, quality assurance engineers, technical documentation specialists, and product managers. Some customers also choose to engage our consulting services for troubleshooting application performance problems, network planning, network design, and communication protocol design. As of March 31, 2004, our consulting staff consisted of 60 employees.

Our customers may purchase software maintenance and technical support, generally on an annual basis. Purchasers of maintenance are provided with unspecified updates to the software they license from us as the unspecified updates are released. The fee for this service is generally determined as a percentage of the current price of product licenses. Beginning in July 2001, our customers have been able to separately purchase periodic unspecified product updates without purchasing technical support. Customers purchasing technical support are still required to purchase periodic unspecified product updates.

We provide customer support from our support center at our headquarters in Bethesda, Maryland, as well as from support staff in France, the United Kingdom, and Australia. Our technical support services are supported by a comprehensive information system designed to ensure that customer inquiries are addressed promptly, tracked until fully resolved, and recorded for future reference. Reports on the overall responsiveness of the technical support infrastructure, and the status of pending customer inquiries, are provided regularly to our technical support staff, technical support management, and executive management.

We have a core team of 6 technical support staff supplemented by a number of product developers and consultants who perform technical support on a rotational basis. This staffing approach ensures that customers have access to the best available product expertise, while simultaneously providing product developers with direct customer feedback, which in turn helps us improve our products.

We regularly offer training courses to our customers to assist them in maximizing the benefit they receive from using our products. Our training classes cover a broad range of topics. Training classes are offered at our headquarters in Bethesda, Maryland, our facilities in Santa Clara, California; Cary, North Carolina; Paris, France; and Slough, United Kingdom; and at our customers' locations. As of March 31, 2004, our full time training staff consisted of 3 employees.

Research and Development

We believe that our ability to enhance our current products, and create new products in response to the needs of our customer base will be an important factor for our future success. Accordingly, we intend to continue to commit significant resources to product research and development. We expect to accomplish a large part of our product improvements and new product development through internal development efforts. New capabilities may also be integrated into our product lines through the acquisition of technologies or businesses, or the licensing of externally developed technologies.

Our total expenses for research and development for fiscal 2004, 2003, and 2002 were \$13.0 million, \$12.9 million, and \$12.3 million, respectively. Our research and development efforts to date have been conducted at our offices in Bethesda, Maryland; Cary, North Carolina; and Ghent, Belgium. All related costs have been expensed as incurred. As of March 31, 2004, our research and development staff consisted of 108 engineers and technical professionals.

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Our research and development efforts are directed at increasing our revenues by expanding the scope of our solutions to address additional customer requirements. Our existing customers provide a meaningful source of information, which we use in order to guide our future product development. In addition, we invest in research and analysis of trends in our industry and our product markets, and we expect that our future products will reflect the results of these analyses.

Competition

The market for our products is evolving rapidly and is highly competitive. We believe that this market is likely to become more competitive as the demand for intelligent application and network management solutions continues to increase. Although none of our competitors offers a solution that is identical to ours, we are subject to current and potential competition from:

software vendors with networked application troubleshooting and predictive analysis offerings, such as Compuware and its Vantage product line;

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consultants who offer advisory services related to intelligent application and network management; and

customers who develop their own intelligent network management capabilities, either internally or through outsourcing.

In addition, we have identified approximately 40 entities that have applications or technologies that compete or could potentially compete with one or more of our software products. Also, it is possible that other vendors as well as some of our customers or distributors will develop and market competitive solutions in the future. Many of our current and potential competitors are larger and have substantially greater financial and technical resources than we do.

We believe the principal competitive factors affecting the market for our software products are the following:

scope, quality, and cost-effectiveness of application and network management solutions;

industry knowledge and expertise embedded in the software;

the interoperability of solutions with existing network management solutions;

product performance, accuracy, technical features, ease of use, and price; and

customer service and support.

Intellectual Property

We rely on a combination of copyright, trademark, patent, and trade secret laws, confidentiality agreements, and contractual provisions to protect our intellectual property. However, we believe that these laws and agreements afford us only limited protection. Despite our efforts to protect our intellectual property, unauthorized parties may infringe upon our proprietary rights. In addition, the laws of some foreign countries do not provide as much protection of our proprietary rights as do the laws of the United States.

We currently hold registered trademarks in the United States for *OPNET*, *IT Guru*, *Netbiz*, *OPNET Modeler*, *SP Guru* and *WDM Guru*. We have pending applications in the United States for the trademark registrations of *VNE Server*. We also hold additional registered trademarks in the United States and have additional pending applications. If not renewed, our registered trademarks will expire at various times between February 2008 and May 2013. We have applied for trademark protection in a number of international jurisdictions, and hold a registered trademark in France for *OPNET* that will expire in 2010, if not renewed. In addition, we have one patent granted by the Patent and Trademark Office of the United States for technology related to the *OPNET* product suite that will expire in 2017, and four pending U.S. patent applications that if granted would expire in twenty years from the filing date of the applications. We believe that, because of the rapid pace of change in our industry, the intellectual property protection for our products will be a less significant factor for our future success than the knowledge, abilities, and experience of our employees.

Employees

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As of March 31, 2004, we had 307 full-time employees, 291 of whom were located in the United States. These included 95 in sales and marketing, 69 in professional services and support, 108 in engineering, research, and development, and 35 in general and administrative functions. Our employees are not represented by a collective bargaining agreement and we consider our relations with our employees to be good.

Web Site Access to SEC Reports

Our web site address is www.opnet.com. We make available free of charge on our web site our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. The information on our web site is not incorporated by reference into this Annual

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Report and should not be considered to be a part of this Annual Report. Our web site address is included in this Annual Report as an inactive textual reference only.

ITEM 2. PROPERTIES

Our corporate office and principal facility is located in Bethesda, Maryland and consists of approximately 60,000 square feet of office space held under a lease that expires on January 31, 2011, exclusive of renewal options. We also lease office space in the following locations: Cary, North Carolina; Dallas, Texas; Santa Clara, California; Ghent, Belgium; Paris, France; and Slough, United Kingdom.

ITEM 3. LEGAL PROCEEDINGS

We are involved in various claims and legal proceedings arising from our normal operations. We do not regard any of those matters to be material.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our stockholders during the fourth quarter of fiscal 2004.

Executive Officers and Directors of the Registrant

Our executive officers and directors, and their ages as of June 11, 2004, are as follows:

| <u>Name</u> | <u>Age</u> | <u>Position</u> |
|---------------------------------------|------------|---|
| Marc A. Cohen | 41 | Chairman of the Board and Chief Executive Officer |
| Alain J. Cohen | 37 | President, Chief Technology Officer and Director |
| Joseph W. Kuhn | 44 | Vice President and Chief Financial Officer |
| Steven G. Finn, PhD ⁽¹⁾⁽²⁾ | 58 | Director |
| Ronald W. Kaiser ⁽¹⁾ | 50 | Director |
| William F. Stasior ⁽¹⁾⁽²⁾ | 63 | Director |

⁽¹⁾ Member of the Audit Committee

⁽²⁾ Member of the Compensation Committee

Set forth below is information regarding the professional experience for each of our executive officers and directors. These executive officers and directors were elected to serve until their successors have been elected. Marc A. Cohen and Alain J. Cohen are brothers. There is no other

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family relationship between any of our other executive officers or between any of these officers and any of our directors.

Marc A. Cohen, one of our founders, has served as our chairman of the board since our inception in 1986 and as our chief executive officer since 1994. From 1986 to 1992, Mr. Cohen was also a consultant with Booz Allen Hamilton Inc. (Booz Allen), an international management and consulting company. Mr. Cohen received a bachelor's degree in engineering science from Harvard University and a master's degree in electrical engineering from Stanford University.

Alain J. Cohen, one of our founders, has served as our president and chief technology officer and as a member of our board of directors since our inception in 1986. Mr. Cohen received a bachelor's degree in electrical engineering from the Massachusetts Institute of Technology (M.I.T.).

Joseph W. Kuhn has served as vice president and our chief financial officer since January 2002. From March 2001 until joining OPNET, Mr. Kuhn served as executive vice president and chief financial officer of Wisor Telecom Corporation, a provider of communications software systems. From April 1997 to March 2001, Mr. Kuhn served as executive vice president, chief financial and operating officer and a member of the board of directors of Ciraden, Inc., a provider of business services and software systems to dental practices. Prior to April 1997, Mr. Kuhn served as an officer at Alaris Medical, Inc., a publicly traded corporation that develops, manufactures and provides integrated intravenous infusion therapy and patient monitoring instruments and related disposables. Mr. Kuhn is a graduate of Rutgers University and a certified public accountant.

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Dr. Steven G. Finn has served as a member of our board of directors since March 1998. Dr. Finn has been a principal research scientist and lecturer at M.I.T. since 1991. Dr. Finn has also served as a consultant with Matrix Partners, a venture capital firm, since 1991.

Ronald W. Kaiser has served as a member of our board of directors since October 2003. Mr. Kaiser presently serves as chief financial officer of Air Cargo, Inc., a privately-held firm and provider of U.S. and European cargo transportation logistics. Mr. Kaiser served as chief financial officer and treasurer of OTG Software, Inc. (OTG) from June 1998 until the sale of OTG to Legato Systems, Inc. in May 2002. OTG was a publicly traded corporation that provided online data storage and data access software solutions for business applications, email management and related services. From April 1998 to June 1998, Mr. Kaiser was an employee of Network Associates, Inc., an Internet security company, following the acquisition of Trusted Information Systems, Inc. by Network Associates, Inc. From May 1996 to April 1998, Mr. Kaiser served as the chief financial officer of Trusted Information Systems, Inc., an information security company.

William F. Stasior has served as a member of our board of directors since March 1998. Since October 1999, he has served as senior chairman of Booz Allen. From 1991 to 1999, he served as chairman and chief executive officer of Booz Allen. Mr. Stasior currently serves on the boards of directors of Skyterra Communications, Inc., a telecommunications service provider, and Vanu Inc., a privately-held software company.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS****Market for Common Stock**

Our common stock began trading on the NASDAQ National Market on August 2, 2000, under the symbol OPNT. The following table sets forth, on a per share basis, for the indicated periods, the high and low sale prices of our common stock as reported by the NASDAQ National Market.

| Quarter ended | Quarterly Common Stock-Price for the Year Ended March 31, | | | |
|----------------------|--|------------|-------------|------------|
| | 2004 | | 2003 | |
| | High | Low | High | Low |
| June 30 | \$ 12.50 | \$ 5.24 | \$ 10.98 | \$ 7.55 |
| September 30 | 14.40 | 9.21 | 9.31 | 5.68 |
| December 31 | 18.00 | 11.75 | 10.01 | 4.74 |
| March 31 | 20.28 | 12.21 | 8.51 | 5.00 |

Number of Stockholders of Record

As of June 11, 2004, we had approximately 72 holders of record of common stock. Because many of these shares are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these holders of record.

Dividends

We have never paid or declared any cash dividends on our common stock or other securities. Our loan agreement with a commercial bank prohibits the payment of dividends. We currently intend to retain all future earnings, if any, for use in the operation of our business, and therefore, do not anticipate paying cash dividends in the foreseeable future.

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

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the underwriting discounts and commissions and the offering expenses, the net proceeds from the offering were approximately \$54.1 million.

As of March 31, 2004, the proceeds from the offering had been 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, Maryland, (ii) \$6.2 million of acquisition costs and expenses related to our acquisition of the NetMaker division of Make Systems, Inc. in March 2001 and (iii) \$1.4 million of the purchase price related to our acquisition of WDM NetDesign BVBA in January 2002. None of these amounts were paid to any of our directors, officers, or their associates, persons owning 10% or more of any class of our equity securities, or any of our affiliates. 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.

Table of Contents**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report. The statement of operations data for the years ended March 31, 2004, 2003, and 2002, and the balance sheet data as of March 31, 2004 and 2003, are derived from, and are qualified by reference to, our audited consolidated financial statements included in this Annual Report. The balance sheet data as of March 31, 2002, 2001 and 2000 and the statement of operations data for the years ended March 31, 2001 and 2000 are derived from our consolidated financial statements that are not included in this annual report. Historical results are not necessarily indicative of results that may be expected for any future period.

| | Year Ended March 31, | | | | |
|--|---------------------------------------|-----------------|-----------------|-----------------|---------------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | (in thousands, except per share data) | | | | |
| Statement of Operations Data: | | | | | |
| Revenues: | | | | | |
| New software license revenue | \$ 28,164 | \$ 22,187 | \$ 24,435 | \$ 18,476 | \$ 10,372 |
| Software license updates and technical support | 15,152 | 12,667 | 10,384 | 7,697 | 4,848 |
| Professional services | 13,137 | 11,573 | 9,743 | 6,592 | 3,934 |
| Total revenues | 56,453 | 46,427 | 44,562 | 32,765 | 19,154 |
| Cost of revenues: | | | | | |
| New software license revenue | 831 | 829 | 453 | 395 | 728 |
| Software license updates and technical support | 1,730 | 1,710 | 1,767 | 900 | 628 |
| Professional services | 7,510 | 4,637 | 4,102 | 3,850 | 2,247 |
| Amortization of acquired technology | 509 | 504 | 434 | | |
| Total cost of revenues | 10,580 | 7,680 | 6,756 | 5,145 | 3,603 |
| Gross profit | 45,873 | 38,747 | 37,806 | 27,620 | 15,551 |
| Operating expenses: | | | | | |
| Research and development | 13,040 | 12,909 | 12,339 | 8,263 | 5,696 |
| Sales and marketing | 19,446 | 18,245 | 16,866 | 13,745 | 7,510 |
| General and administrative | 5,717 | 4,897 | 4,655 | 3,362 | 2,093 |
| Purchased in-process research and development | | | | 770 | |
| Total operating expenses | 38,203 | 36,051 | 33,860 | 26,140 | 15,299 |
| Income from operations | 7,670 | 2,696 | 3,946 | 1,480 | 252 |
| Interest and other income, net | 594 | 879 | 1,740 | 2,788 | 414 |
| Income before provision for income taxes | 8,264 | 3,575 | 5,686 | 4,268 | 666 |
| Provision for income taxes ⁽¹⁾ | 2,506 | 832 | 1,307 | 1,499 | 141 |
| Net income | \$ 5,758 | \$ 2,743 | \$ 4,379 | \$ 2,769 | \$ 525 |
| Basic net income applicable per common share | \$.29 | \$.14 | \$.23 | \$.17 | \$.04 |

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| | | | | | |
|--|-----------|-----------|-----------|-----------|----------|
| Diluted net income per common share | \$.28 | \$.14 | \$.22 | \$.15 | \$.04 |
| Basic weighted average shares outstanding | 19,697 | 19,273 | 18,953 | 16,440 | 12,912 |
| Diluted weighted average shares outstanding | 20,650 | 19,974 | 20,014 | 17,977 | 14,367 |
| Balance Sheet Data (end of period): | | | | | |
| Cash, cash equivalents and marketable securities | \$ 81,493 | \$ 70,251 | \$ 62,240 | \$ 62,623 | \$ 8,765 |
| Total assets | 116,682 | 100,641 | 95,317 | 92,389 | 16,891 |
| Long-term debt | 300 | 300 | 150 | | |
| Redeemable convertible preferred stock | | | | | 6,948 |
| Total stockholders' equity | 96,371 | 86,388 | 82,656 | 76,236 | 3,361 |

- (1) The provision for income taxes for the year ended March 31, 2002 includes non-recurring tax credits for incremental research and development expenditures totaling \$372, or \$.02 per common share.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. This discussion and analysis contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth under **Certain Factors That May Affect Future Results** and elsewhere in this Annual Report on Form 10-K.

Overview

We are a provider of management software for networks and applications and related services that address, among others, application troubleshooting; network configuration and security auditing; network capacity and resiliency planning; application deployment planning; systems capacity planning; and network technology R&D. Our customers include corporate enterprises, government and defense agencies, network service providers, and network equipment manufacturers. Our solutions are designed to help our customers make better use of resources, reduce operational problems and improve competitiveness.

We operate in one reportable industry segment, the development and sale of computer software programs and related services. Our operations are principally in the U.S., and we have operations in Australia, Belgium, France, and the United Kingdom. We primarily depend upon our direct sales force to generate revenue in the U.S. Sales outside the U.S. are made through our international sales team as well as third-party distributors and value-added resellers, who generally are responsible for providing technical support and service to customers within their territory.

Our revenues are derived 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 exclude revenues derived from software license updates, which are included in software license updates and technical support revenues. Most 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 license updates and technical support under our maintenance agreements. We offer professional services, under both fee-for-service and fixed-price agreements, primarily to facilitate the adoption of our technology and to provide product customization and enhancements.

We consider our consulting services to be an integral part of our business model as they are centered on our software product offerings. Because our consulting services facilitate the adoption of our solutions, we believe that they ultimately generate additional sales of software licenses.

Our primary expenses are compensation and benefit costs and personnel-related costs such as costs for office facilities, communication services, and travel, which are a function of our worldwide headcount, and marketing expenses. These costs represented approximately 85% of total expenses for fiscal 2004.

The key strategies of our business plan include increasing sales to existing customers, increasing deal size by selling modules and introducing new products, improving our sales and marketing execution, and increasing our international presence. We have focused our sales, marketing, and other efforts on corporate enterprise and U.S. Government opportunities, and to a much lesser extent, service provider and network equipment manufacturer opportunities. Our focus and strategies are designed to increase revenue and profitability. Because of the uncertainty

surrounding the amount and timing of revenue growth, we expect to need to closely manage the increases in our total expenses as we implement these strategies.

Table of Contents**Summary of Our Fiscal 2004 Financial Performance**

During fiscal 2004, we increased revenue, gross profit, operating margins, diluted net income per common share, operating cash flow, cash and marketable securities, and deferred revenue. We believe that the improvement in our overall financial performance during fiscal 2004 was attributable to an improving economy and to executing our business plan.

The following table summarizes information on certain key metrics.

| | <u>Fiscal</u> <u>2004</u> | <u>Fiscal</u> <u>2003</u> | <u>Amount</u> <u>Change</u> | <u>Percentage</u> <u>Change</u> |
|--|------------------------------|------------------------------|--------------------------------|------------------------------------|
| (dollars in thousands, except per share data) | | | | |
| Operations Data: | | | | |
| Total revenue | \$ 56,453 | \$ 46,427 | \$ 10,026 | 21.6% |
| Total cost of sales | \$ 10,580 | \$ 7,680 | \$ 2,900 | 37.8% |
| Gross profit | \$ 45,873 | \$ 38,747 | \$ 7,126 | 18.4% |
| Gross profit as a percentage of total revenue (gross margin) | 81.3% | 83.5% | | |
| Total operating expenses | \$ 38,203 | \$ 36,051 | \$ 2,152 | 6.0% |
| Income from operations | \$ 7,670 | \$ 2,696 | \$ 4,974 | 184.5% |
| Income from operations as a percentage of total revenue (operating margin) | 13.6% | 5.8% | | |
| Net income | \$ 5,758 | \$ 2,743 | \$ 3,015 | 109.9% |
| Diluted net income per common share | \$ 0.28 | \$ 0.14 | \$ 0.14 | 100.0% |
| Total employees (period end) | 307 | 265 | 42 | 15.8% |
| Total average employees | 284 | 273 | 11 | 4.0% |
| Total consultants (period end) | 60 | 39 | 21 | 53.8% |
| Total quota-carrying sales persons (period end) | 44 | 36 | 8 | 22.2% |
| Financial Condition and Liquidity Data: | | | | |
| Cash, cash equivalents, and marketable securities (period end) | \$ 81,493 | \$ 70,251 | \$ 11,242 | 16.0% |
| Cash flows from operating activities | \$ 9,521 | \$ 8,170 | \$ 1,351 | 16.5% |
| Total deferred revenue (period end) | \$ 13,692 | \$ 10,178 | \$ 3,514 | 34.5% |

We achieved growth in all revenue categories during fiscal 2004. The growth in total revenue was generated primarily by sales of our products and services to corporate enterprises and the U.S. Government. In particular, revenue from transactions with the U.S. Government increased to approximately 44% of total revenues for fiscal 2004 from 39% of total revenues for fiscal 2003, which contributed approximately \$7 million, or 70% of overall revenue growth, in fiscal 2004. U.S. government customers, including the Department of Defense, utilize our software and professional services to take advantage of our extensive expertise and intellectual property in networking, applications, protocols, and server technology. Our ability to model and simulate end-to-end network and application performance is valuable in determining the impact of tactical or strategic changes to networks, planning for contingencies, and evaluating the impact of new network technologies and protocols. In addition, our solutions are scalable and address large, complex military systems and networks (i.e., mobile networks) with a variety of operationally proven, advanced predictive performance techniques. This enables the Department of Defense to use our software and services to achieve important transformational objectives such as network centricity and improved battlespace awareness.

Our international revenues increased 30.1% to \$11.6 million, or 20.5% of total revenue, for fiscal 2004. We expect revenues from sales outside the United States to continue to account for a significant portion of our total revenues in the future. International revenue in fiscal 2004 benefited from a more experienced direct sales force and our increased focus on corporate enterprises. Although sales to corporate enterprises is growing,

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our international business continues to be dependent upon service providers and network equipment manufacturers for a majority of its revenue. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets.

During fiscal 2004, the increase in the amount of total revenue significantly exceeded the increase in our cost of revenues resulting in an 18.4% increase in gross profit. Although our gross profit increased in absolute dollars in fiscal 2004, it declined as a percentage of total revenue. This decline was expected and was attributable to our implementation of strategies

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designed to expand our consulting business and our sales to U.S. government and corporate enterprise customers. These strategies produced increases in headcount and overhead costs for our consulting business as well as generally lower profit from a higher volume of business with U.S. government customers that tend to be less profitable than our contracts with other customers.

As a software company, we believe that our business model has the potential to generate operating margins of 20% or more. We demonstrated our operating leverage during fiscal 2004 as our 21.6% revenue growth significantly exceeded our 6% operating expense growth and produced a 13.6% operating margin. Also, diluted earnings per common share increased 100% during fiscal 2004 to \$0.28.

Trends That May Affect Our Business and Future Results

While we are cautiously optimistic that economic conditions will continue to improve and result in a stronger environment for information technology (IT) spending, an economic downturn or adverse change in the regulatory environment or business prospects for our customers may decrease our revenues or lower our growth rate. The demand for our products and services by corporate enterprise and U.S. government customers has been much stronger than the demand from service providers and network equipment manufacturers. We believe that lower business activity with service providers and network equipment manufacturers is primarily due to the challenging economy in which these businesses operate. We expect the overall challenging economy for service providers and network equipment manufacturers to continue, at least in the near term. Consequently, our revenue growth and financial results depend, in significant part, upon the economic health of corporate enterprises and U.S. government agencies and the general environment for IT spending.

We intend to take advantage of a gradually improving economy and expect to increase spending in all areas of our business in order to promote future growth. We anticipate the following trends and patterns over the next several quarters:

Total Revenue. Despite indications that the overall economy and IT industry is improving, we continue to see cautious capital spending by our current and potential customers. In line with our performance in fiscal 2004, we currently expect any future growth in revenue to come from sales to enterprise IT organizations and the U.S. Government. We expect revenue from sales to service providers and network equipments manufacturers to fluctuate from quarter to quarter with the potential for periods of declining license revenue. Our ability to increase professional service revenues will depend upon our ability to maintain several large consulting contracts with the U.S. Government and to attract and retain additional qualified consultants, including those with security clearances. As a result of these factors, we believe that we may experience a slower rate of growth, or even a decline, in overall revenues in the near-term.

International Revenue. Our international sales are impacted by the mix of direct and indirect sales channels and our focus on increasing sales to corporate enterprises. We believe that these factors impact the timing of sales orders as well as our ability to forecast future revenue. For example, international revenues for the fourth quarter of fiscal 2004 represented approximately 38% of total international revenue for the entire fiscal year. We expect international revenues for the first quarter of the fiscal year ending March 31, 2005 (fiscal 2005) to be lower than the fourth quarter of fiscal 2004. Although we expect overall international revenue growth in fiscal 2005, we currently expect to continue experiencing quarterly fluctuations of international revenues.

Gross Profit Margin. We anticipate an increase in the cost of professional services primarily from hiring additional consultants to support demand for our services. Our overall gross profit margin will be affected by the profitability of individual consulting engagements as well as the amount of gross profit from the sale of new software licenses and software license updates and technical support, which have substantially higher gross margins than the gross margin on professional service revenues. We expect gross profit margins around 80%.

Research and Development Expenses. 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 anticipate hiring additional engineers, and we expect to incur additional research and development expense in connection with such new hires. We expect the absolute dollar amount of these expenditures will continue to grow but could generally decrease as a percentage of total revenues in future periods. Our ability to decrease these expenses as a percentage of revenue will depend upon increases in our revenue growth, among other factors.

Sales and Marketing Expenses. We depend upon our direct sales model to generate revenue and believe that increasing the size of our quota-carrying sales team is essential for long-term growth. We plan to add four to five quota carrying sales

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persons over the next several quarters. 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 revenue in future periods.

General and Administrative Expenses. 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 increases in our revenue growth, among other factors.

Operating Margin. Through a combination of increases in capital spending by our customers, the operating leverage of our business model, and the execution of our business plan, we significantly increased our operating margin to 13.6% in fiscal 2004 from 5.8% in fiscal 2003. We expect our operating margin to expand at a much slower rate during fiscal 2005 as we increase spending to promote future revenue growth. Since a significant portion of our software license arrangements close in the latter part of each quarter, we may not be able to adjust our cost structure in the short-term to respond to lower than expected revenue, which would adversely impact our operating margin and earnings.

Acquisitions

WDM NetDesign Acquisition. In July 2001, we acquired a 20% interest in WDM NetDesign BVBA (WDM NetDesign) for consideration of \$399,000 and purchased an option for consideration of \$1,000 to acquire all remaining shares of WDM NetDesign. Through this acquisition, we collaborated on the development of optical network planning products with Comsof N.V., the owner of WDM NetDesign. In December 2001, we exercised our option to purchase the remaining shares of WDM NetDesign for approximately \$1.3 million. In January 2002, we purchased these shares by paying Comsof N.V. \$925,000 and issuing them 25,000 shares of our common stock. As a result of this acquisition, we now own WDM NetDesign's core technology in optical networking design and, with the addition of WDM NetDesign's employees, have greater engineering depth and technical expertise. This acquisition accounted for a significant portion of the \$573,000 increase in research and development expenses from fiscal 2002 to fiscal 2003. See Note 2 to our consolidated financial statements for additional information related to our acquisition of WDM NetDesign.

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 Bulletins No. 101 and No. 104, 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

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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

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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.

Revenue from sales to third-party distributors and resellers is generally recognized when all four of the SOP 97-2 revenue recognition criteria noted above are met and when these entities sell the software products to their customers. This is commonly referred to as the sell-through method.

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 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 March 31, 2004, accounts receivable totaled \$10 million, net of an allowance for doubtful accounts of \$341,000.

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 acquisitions of NetMaker in March 2001, WDM NetDesign in January 2002, and a software product for modeling voice communications in December 2003. 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 reasonableness. Changes in our assumptions at the time of future periodic reviews could result in impairment losses. As of March 31, 2004, intangible assets totaled \$1.2 million, net of accumulated amortization of \$1.4 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 March 31, 2004, 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 fiscal 2004, 2003 and 2002.

Table of Contents**Results of Operations**

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

| | Fiscal | Fiscal | Fiscal |
|---|-------------------|-------------------|-------------------|
| | 2004 | 2003 | 2002 |
| | <u> </u> | <u> </u> | <u> </u> |
| Revenues: | | | |
| New software licenses | 49.9% | 47.8% | 54.8% |
| Software license updates and technical support | 26.8 | 27.3 | 23.3 |
| Professional services | 23.3 | 24.9 | 21.9 |
| | <u> </u> | <u> </u> | <u> </u> |
| Total revenues | 100.0 | 100.0 | 100.0 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cost of revenues: | | | |
| New software licenses | 1.5 | 1.8 | 1.0 |
| Software license updates and technical support | 3.0 | 3.7 | 4.0 |
| Professional services | 13.3 | 10.0 | 9.2 |
| Amortization of acquired technology | 0.9 | 1.1 | 1.0 |
| | <u> </u> | <u> </u> | <u> </u> |
| Total cost of revenues | 18.7 | 16.6 | 15.2 |
| | <u> </u> | <u> </u> | <u> </u> |
| Gross profit | 81.3 | 83.4 | 84.8 |
| | <u> </u> | <u> </u> | <u> </u> |
| Operating expenses: | | | |
| Research and development | 23.2 | 27.8 | 27.7 |
| Sales and marketing | 34.4 | 39.3 | 37.9 |
| General and administrative | 10.1 | 10.5 | 10.4 |
| | <u> </u> | <u> </u> | <u> </u> |
| Total operating expenses | 67.7 | 77.6 | 76.0 |
| | <u> </u> | <u> </u> | <u> </u> |
| Income from operations | 13.6 | 5.8 | 8.8 |
| Interest and other income, net | 1.0 | 1.9 | 3.9 |
| | <u> </u> | <u> </u> | <u> </u> |
| Income before provision for income taxes | 14.6 | 7.7 | 12.7 |
| Provision for income taxes | 4.4 | 1.8 | 2.9 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income | 10.2% | 5.9% | 9.8% |
| | <u> </u> | <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:

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| | Fiscal | Fiscal | Fiscal |
|--|-----------------|-----------------|-----------------|
| | 2004 | 2003 | 2002 |
| | <u> </u> | <u> </u> | <u> </u> |
| Cost of new software license revenues | 3.0% | 3.7% | 1.9% |
| Cost of software license updates and technical support | 11.4 | 13.5 | 17.0 |
| Cost of professional service revenues | 57.2 | 40.1 | 42.1 |

Revenues

New Software License Revenues. New software license revenues were \$28.2 million, \$22.2 million, and \$24.4 million in fiscal 2004, 2003, and 2002, respectively, representing an increase of 26.9% in fiscal 2004 from fiscal 2003 and a decrease of 9.2% in fiscal 2003 from fiscal 2002. For fiscal 2004, the increase in license revenue was primarily due to higher sales volumes to enterprise and U.S. Government customers of the platform products *OPNET IT Guru* and *OPNET SP Guru*, and modules such as *ACE*, *ACE Decode Module*, *Flow Analysis*, *NetDoctor*, and *Wireless*, which were available throughout all of fiscal 2004 and 2003, as well as *OPNETVNE Server*, which was launched in June 2002. For fiscal 2003, the decline in license revenue was primarily due to discounts associated with pricing strategies and product bundling in fiscal 2003, which more than offset the increased revenue contributions from higher sales volumes

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to enterprise and U.S. government customers of *OPNET IT Guru*, *ACE*, *ACE Decode Module*, *NetDoctor*, *Flow Analysis*, *OPNET SP Guru*, and *OPNETVNE Server*.

Software License Updates and Technical Support Revenues. Software license updates and technical support revenues were \$15.2 million, \$12.7 million and \$10.4 million in fiscal 2004, 2003, and 2002, respectively, representing increases of 19.6% in fiscal 2004 from fiscal 2003 and 22.0% in fiscal 2003 from fiscal 2002. 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 in software license updates and product support revenues in fiscal 2004 and fiscal 2003 reflect increases in the overall customer installed base as compared to the prior year.

Professional Service Revenues.

The components of professional services for fiscal 2004, fiscal 2003, and fiscal 2002 were as follows:

| | Fiscal 2004 | Fiscal 2003 | Fiscal 2002 |
|--------------------------------------|------------------------|------------------------|------------------------|
| | (in millions) | | |
| Consulting services | \$ 11.5 | \$ 10.2 | \$ 8.3 |
| Training and other income | 1.6 | 1.4 | 1.4 |
| Professional services revenue | \$ 13.1 | \$ 11.6 | \$ 9.7 |

Professional service revenues were \$13.1 million, \$11.6 million and \$9.7 million in fiscal 2004, 2003 and 2002, respectively, representing increases of 13.5% in fiscal 2004 from fiscal 2003 and of 18.8% in fiscal 2003 from fiscal 2002. Consulting services revenues comprise 87.6%, 88.3%, and 85% of professional service revenues for fiscal 2004, 2003, and 2002, respectively. The increases in professional service revenues were primarily due to growing demand for our consulting services by U.S. government agencies, and to a lesser extent, enterprise customers. Revenue from consulting services provided to U.S. government agencies were \$8.5 million, \$7.1 million, and \$5.0 million, respectively, representing increases of 19.7% in fiscal 2004 from fiscal 2003 and 42% in fiscal 2003 from fiscal 2002.

In January 2003, we were awarded a re-competed consulting contract with the U.S. Department of Defense that contributed approximately \$3.1 million, \$3.3 million, and \$3.2 million of consulting revenues for fiscal 2004, fiscal 2003, and fiscal 2002, respectively. The funding under this contract for calendar year 2003 was \$3.1 million. Under the first of four possible contract extensions, the funding under this contract for calendar 2004 is \$3.5 million. The option years for calendar years 2005, 2006, and 2007 under this contract, may be exercised by the U.S. Department of Defense at its discretion. Our future results of operations could be adversely affected if any of the remaining options are not exercised, or the contract otherwise does not receive additional funding.

International Revenues. Our international revenues increased 29.7% to \$11.6 million, or 20.5% of total revenue, for fiscal 2004, from \$8.9 million, or 19.2% of total revenues, for fiscal 2003. Our international revenues decreased 2.8% during fiscal 2003 from \$9.2 million, or 20.6% of total revenues, for fiscal 2002. Our international revenues are primarily generated in Europe and Japan with a significant portion of our international business coming from service providers and network equipment manufacturers. During fiscal 2004, 2003, and 2002, we expanded

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our operations outside the United States through a combination of hiring additional direct sales persons in our foreign subsidiaries and increasing the number of distributors that resell our products outside the U.S. We also focused our efforts on increasing sales to corporate enterprises. International revenue in fiscal 2004 benefited from our expansion and increased focus on corporate enterprises. The decline in fiscal 2003 reflected the shift of our customer base to corporate enterprises and the effects of the challenging global economy at that time.

Cost of Revenues

Cost of new software license revenues consists primarily of royalties, media, manuals, and distribution costs. Cost of license updates and technical support revenues consists of royalties, media, distribution costs, and personnel-related costs in providing technical support. Cost of professional service revenues consists primarily of personnel-related costs in providing consulting and training to our customers. Gross margins on new software license revenues and software license updates and technical support

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revenues are 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.

Cost of New Software License Revenues. Cost of software license revenues was \$831,000, \$829,000 and \$453,000 in fiscal 2004, fiscal 2003, and fiscal 2002, respectively. Gross margin on software licenses revenue increased to 97% for fiscal 2004 from 96.3% for fiscal 2003. The increase in gross margin for fiscal 2004 was due to an increase in revenue and proportionately fewer license sales requiring royalty payments. Gross margin on software licenses revenue decreased to 96.3% for fiscal 2003 from 98.1% for fiscal 2002. The increase in cost of software license revenues and the resulting lower gross margins in fiscal 2003 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 \$1.7 million, \$1.7 million, and \$1.8 million in fiscal 2004, fiscal 2003, and fiscal 2002, respectively. Gross margin on software license updates and technical support revenues increased to 88.6% for fiscal 2004 from 86.5% in fiscal 2003. Gross margin on software license updates and technical support revenues in fiscal 2003 increased from 83.0% for fiscal 2002. Gross margins improved in fiscal 2004 and fiscal 2003 due to increases in revenue and only slight changes in costs.

Cost of Professional Service Revenues. Cost of professional service revenues was \$7.5 million, \$4.6 million, and \$4.1 million in fiscal 2004, fiscal 2003, and fiscal 2002, respectively. Gross margin on professional service revenues decreased to 42.8% for fiscal 2004 from 59.9% for fiscal 2003. The increase in cost of professional service revenues and the resulting lower gross margins were primarily due to an increase in headcount, overhead costs, subcontractor costs, recruiting expenses and certain other costs associated with specific consulting engagements. Gross margin on professional service revenues increased to 59.9% for fiscal 2003 from 57.9% for fiscal 2002 primarily due to the mix of consulting contracts. We expect the 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 \$13.0 million, \$12.9 million, and \$12.3 million in fiscal 2004, fiscal 2003, and fiscal 2002, respectively, representing increases of 1% in fiscal 2004 from fiscal 2003 and 4.6% in fiscal 2003 from fiscal 2002. These increases were primarily due to higher personnel costs as a result of the increased staffing levels for developing new products as well as sustaining and upgrading existing products. In fiscal 2004, the increase in costs was partially offset by lower overhead costs.

Sales and Marketing. Sales and marketing expenses were \$19.4 million, \$18.2 million and \$16.9 million in fiscal 2004, fiscal 2003, and fiscal 2002, respectively. The 6.6% increase in fiscal 2004 from fiscal 2003 was primarily due to higher commission costs associated with growth in revenues and increases in travel costs. As a percentage of total revenues, sales and marketing expenses decreased to 34.4% in fiscal 2004 from 39.3% in fiscal 2003. This decrease resulted from a proportionally smaller increase in costs associated executing our sales plan relative to the higher level of revenues achieved in fiscal 2004. Sales and marketing expenses increased 8.2% in fiscal 2003 from fiscal 2002 and, as a percentage of total revenues, increased to 39.3% in fiscal 2003 from 37.8% in fiscal 2002. These increases are primarily due to an increase in the average size of our direct sales force in fiscal 2003 compared to fiscal 2002 due to the addition of sales offices in the United Kingdom and Australia in the second half of fiscal year 2002, and increases in international sales commissions to third parties and certain marketing costs. The increases were partially offset by lower travel and entertainment expenses, conference costs and advertising expenses.

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General and Administrative. General and administrative expenses were \$5.7 million, \$4.9 million, and \$4.7 million in fiscal 2004, fiscal 2003, and fiscal 2002, respectively. The 16.7% increase in fiscal 2004 from fiscal 2003 was primarily due to higher audit fees, insurance costs, and personnel costs. The increases in fiscal 2004 were partially offset by lower bad debt costs. The 5.2% increase in fiscal 2003 from fiscal 2002 was primarily due to higher personnel costs, insurance expense, and software maintenance costs associated with new financial systems. The increase in fiscal 2003 was partially offset by a decrease in professional fees for fiscal 2003 compared to fiscal 2002.

Other Income (Expense)

Other income, net were \$594,000, \$879,000, and \$1.7 million in fiscal 2004, fiscal 2003 and fiscal 2002, 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.

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Provision for Income Taxes

Our effective tax rates were 30%, 23% and 23% for fiscal 2004, fiscal 2003 and fiscal 2002, respectively. 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. In fiscal 2002, we conducted a review of our costs to determine their qualification for the increased research tax credit. As a result of this review, we generated an additional \$372,000 in non-recurring tax credits resulting from incremental research expenditures.

We expect our effective tax rate in the near-term to range from 32% to 36%; 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 March 31, 2004, we had cash, cash equivalents and marketable securities totaling \$81.5 million.

Cash provided by operating activities was \$9.5 million, \$8.2 million, and \$4.4 million for fiscal 2004, 2003 and 2002, respectively. Cash provided by operating activities is primarily derived from net income, as adjusted for non-cash items such as depreciation and amortization expense, tax benefits from exercise of employee stock options, and changes in operating assets and liabilities. The increase in cash provided by operating activities in fiscal 2004 from fiscal 2003 was primarily attributable to higher net income and deferred revenue due to our revenue growth and increases in accrued liabilities and the tax benefit from the exercise of employee stock options. These increases were partially offset by an increase in accounts receivable resulting from our revenue growth. The increase in cash provided by operations in fiscal 2003 from fiscal 2002 was attributable to a decline in accounts receivable due to the timing of customer payments, a reduction in refundable taxes due to receipt of payments from tax authorities and the fiscal 2003 current tax provision, and an increase in deferred revenue from our software arrangements and growth in our installed customer base.

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Net cash used in investing activities was \$41.2 million, \$965,000, and \$5.7 million for fiscal 2004, 2003, and 2002, respectively. Investing activities include the purchase, sale or maturity of marketable securities, acquisition of property and equipment, and net expenditures for business and technology acquisitions. For fiscal 2004, we purchased \$67.5 million of marketable securities of which \$27.6 million were either sold or matured during the year. For fiscal 2004 and 2003, a majority of our capital expenditures were for information technology and software purchases. For fiscal 2002, capital expenditures were primarily for property and equipment for our corporate headquarters in Bethesda, Maryland. In fiscal 2002, funds were used to pay the cash portion of the purchase price of the NetMaker acquisition and the purchase price of the WDM NetDesign acquisition, net of cash acquired.

Cash provided by financing activities was \$2.9 million, \$778,000, and \$913,000 for fiscal 2004, 2003, and 2002, respectively. Cash provided by financing activities reflects the proceeds received from the exercise of stock options, the sale of common stock under our 2000 Employee Stock Purchase Plan, and the issuance of notes payable in fiscal 2003 and 2002.

We have commitments under certain contractual arrangements to make future payments for goods and services. These contractual arrangements secure the rights to various assets and services to be used in the future in the normal course of business. For example, we are contractually committed to make certain minimum lease payments for the use of property under operating lease agreements. In accordance with current accounting rules, the future rights and related obligations pertaining to such contractual arrangements are not reported as assets or liabilities on our consolidated balance sheets. We expect to fund these contractual arrangements with our cash and marketable securities and well as cash generated from operations in the normal course of business.

The following table summarizes our contractual arrangements at March 31, 2004, and the timing and effect that such commitments are expected to have on our liquidity and cash flow in future periods. In addition, the table summarizes the timing of principal payments on long-term debt obligations as reported on our consolidated balance sheet as of March 31, 2004.

| Contractual Obligations | Payments Due by Period | | | | |
|---|-------------------------------|-----------------------------|----------------------|----------------------|------------------------------|
| | Total | Less Than 1 Year | 1 3 Years | 3 5 Years | More than 5 Years |
| (dollars in thousands) | | | | | |
| Facilities Operating Lease Obligations | \$ 20,665 | \$ 3,052 | \$ 6,071 | \$ 6,190 | \$ 5,352 |
| Long-term Debt Obligations (including interest) | 378 | 24 | 154 | 166 | 34 |
| Minimum Royalty Payments | 1,000 | 400 | 600 | | |
| Total | \$ 22,043 | \$ 3,476 | \$ 6,825 | \$ 6,356 | \$ 5,386 |

See Notes 10 and 11 to our consolidated financial statements for additional information related to our facilities operating leases and long-term debt obligations. As of March 31, 2004, we have no material capital lease obligations, either individually or in the aggregate.

We do not have any off-balance sheet arrangements with unconsolidated entities or related parties and, accordingly, there are no off-balance sheet risks to our liquidity and capital resources from unconsolidated entities. In order to satisfy the security deposit requirements under our corporate office lease, we entered into an agreement with a commercial bank to issue an irrevocable standby letter of credit for approximately \$2.4 million for the benefit of our landlord. Our cash balances at the bank secure the letter of credit.

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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.

We believe that our current cash and cash equivalents, marketable securities, and cash generated from operations will be sufficient to meet our anticipated cash requirements for working capital and capital expenditures for at least the next 12 months.

Recently Issued Accounting Pronouncements

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities. In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. We adopted the provisions of Interpretation No. 46 effective January 1, 2003. We do not have any variable interest entities; thus adoption of Interpretation No. 46 did not have an impact on our consolidated results of operations or financial position.

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 nor have we entered into any derivative instruments or transactions that are subject to SFAS No. 133 or SFAS No. 149. We adopted SFAS No. 149, effective July 1, 2003. The adoption of this standard did not have an 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 are not currently a party to any of the types of financial instruments that are subject to SFAS No. 150.

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;

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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;

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.

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.

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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 funding under this contract for calendar year 2003 was \$3.1 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. In January 2004, U.S. Department of Defense exercised the first of four possible contract extensions. The funding under this contract for calendar year 2004 is \$3.5 million. Our results of operations could be adversely affected if any of the remaining options are not exercised, or the contract otherwise does not receive additional funding.

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

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%, 39% and 23% of our total revenues for fiscal 2004, fiscal 2003, and fiscal 2002, 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.

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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

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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.

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.

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 10.5 of *OPNET IT Guru*, which was released in May 2004, 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 even decline, if our target customers do not adopt and expand their use of our products. In addition, sales of our *OPNET Modeler* product, which we have been selling since 1987, have fluctuated from quarter-to-quarter, including periods of declining sales. Sales of our *OPNET Modeler* could decline in the future for a variety of reasons, including market saturation and the financial condition of network equipment manufacturers, and if 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

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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.

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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.

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 market and sell our products effectively, 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 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.

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 revenues are 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 revenues from consulting services, renewed maintenance agreements and purchase of additional software licenses, which represents a majority of our annual revenues. 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.

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Increases in professional service revenues as a percentage of total revenues could decrease overall margins.

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.

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 revenues.

Our future success and our ability to maintain our current level of revenues 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;

potentially adverse tax consequences;

the effects of currency fluctuations; and

political and economic instability.

We expect to face increased 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;

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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 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.

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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.

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 of America 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 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.

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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

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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.

ITEM 7A. 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.

At March 31, 2004, we had \$41.5 million in cash and cash equivalents and \$40.0 million in marketable securities. Based on our cash, cash equivalents, and marketable securities as of March 31, 2004, a hypothetical 10% increase/decrease in the interest rates would increase/decrease our annual interest income and cash flows by approximately \$75,000.

Although a majority of our revenue transactions outside the United States are denominated in U.S. dollars, we also conduct business through our subsidiaries in Australia, Belgium, France, and the United Kingdom, which exposes us to movement in currency exchange rates. As part of our risk management strategy, we do not enter into any foreign exchange derivative transactions. However, we manage our level of exposure at our foreign subsidiaries by denominating a majority of their sales and payment of their expenses in the local currencies of each subsidiary. 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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Our financial statements together with the related notes and the report of Deloitte & Touche LLP, independent auditors, are set forth in the Index to Financial Statements at Item 15 of this Form 10-K.

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

Not applicable.

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ITEM 9A. 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 March 31, 2004, 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.

During the three months ended March 31, 2004, there have been no changes to our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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 III

Certain information required by Part III is omitted from this Annual Report as we intend to file our definitive Proxy Statement for our Annual Meeting of Stockholders to be held on September 14, 2004, pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of the fiscal year covered by this Annual Report, and certain information included in the Proxy Statement is incorporated herein by reference.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

- (a) Executive Officers and Directors - The information in the section entitled Executive Officers and Directors of the Registrant in Part I hereof is incorporated herein by reference.
- (b) Directors - The information in the section entitled Election of Directors in the Proxy Statement is incorporated herein by reference.

The disclosure required by Item 405 of Regulations S-K is incorporated by reference to the section entitled Section 16(a) Beneficial Ownership Reporting Compliance in the Proxy Statement.

ITEM 11. EXECUTIVE COMPENSATION

The information in the sections entitled Compensation of Executive Officers, Compensation of Directors and Compensation Committee Interlocks and Insider Participation in the Proxy Statement is incorporated herein by reference.

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

The information in the sections entitled Equity Compensation Plan Information and Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement are incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information in the section entitled Certain Transactions in the Proxy Statement is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information in the section entitled Independent Auditor Fees and Other Matters in the Proxy Statement is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORMS 8-K

(a) The following documents are filed as part of this Form 10-K:

1. Financial Statements. The following financial statements of OPNET Technologies, Inc. are filed as part of this Form 10-K on the pages indicated:

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

| | Page |
|--|-------------|
| <u>Report of Independent Registered Public Accounting Firm</u> | 37 |
| <u>Consolidated Balance Sheets as of March 31, 2004 and 2003</u> | 38 |
| <u>Consolidated Statements of Operations for the years ended March 31, 2004, 2003, and 2002</u> | 39 |
| <u>Consolidated Statements of Cash Flows for the years ended March 31, 2004, 2003, and 2002</u> | 40 |
| <u>Consolidated Statements of Changes in Stockholders' Equity for the years ended March 31, 2004, 2003, and 2002</u> | 41 |
| <u>Notes to Consolidated Financial Statements</u> | 42 |

2. Schedules are omitted as the required information is inapplicable or the information is presented in the financial statements or related notes.
3. Exhibits. The exhibits listed in the Exhibits Index immediately preceding such exhibits are filed as part of this Annual Report on Form 10-K

(b) Reports on Forms 8-K

Current report on Form 8-K furnished to the SEC on April 29, 2004, furnished information under Item 7. Financial Statements, Pro Forma Financial Information and Exhibits and Item 12. Disclosure of Operations and Financial Condition of Form 8-K

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on the 14th day of June 2004.

OPNET TECHNOLOGIES, INC.

By: /s/ Marc A. Cohen
Marc A. Cohen

Chairman of the Board and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the 14th day of June 2004.

| <u>Signature</u> | <u>Title</u> |
|--|--|
| /s/ Marc A. Cohen Marc A. Cohen | Chairman of the Board of Directors and Chief Executive Officer Officer (Principal Executive Officer) |
| /s/ Alain J. Cohen Alain J. Cohen | President, Chief Technology Officer and Director |
| /s/ Joseph W. Kuhn Joseph W. Kuhn | Vice President and Chief Financial Officer (Principal Financial and Accounting Officer) |
| /s/ Steven G. Finn, PhD Steven G. Finn, PhD | Director |
| /s/ Ronald W. Kaiser Ronald W. Kaiser | Director |
| /s/ William F. Stasior William F. Stasior | Director |

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

OPNET Technologies, Inc.

Bethesda, Maryland

We have audited the accompanying consolidated balance sheets of OPNET Technologies, Inc. and subsidiaries (the Company) as of March 31, 2004 and 2003, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended March 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2004 and 2003, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

McLean, Virginia

June 11, 2004

Table of Contents**OPNET TECHNOLOGIES, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands)

| | March 31, | |
|---|-------------------|-------------------|
| | 2004 | 2003 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 41,492 | \$ 70,251 |
| Marketable securities | 40,001 | |
| Accounts receivable, net | 10,044 | 6,420 |
| Unbilled accounts receivable | 2,559 | 933 |
| Deferred income taxes, prepaid expenses and other current assets | 1,772 | 1,412 |
| | <u> </u> | <u> </u> |
| Total current assets | 95,868 | 79,016 |
| Property and equipment, net | 6,410 | 7,008 |
| Intangible assets, net | 1,240 | 1,566 |
| Goodwill | 12,212 | 12,212 |
| Deferred income taxes and other assets | 952 | 839 |
| | <u> </u> | <u> </u> |
| Total assets | <u>\$ 116,682</u> | <u>\$ 100,641</u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 934 | \$ 215 |
| Accrued liabilities | 4,218 | 2,756 |
| Deferred and accrued income taxes | 173 | 172 |
| Deferred revenue | 12,918 | 9,694 |
| | <u> </u> | <u> </u> |
| Total current liabilities | 18,243 | 12,837 |
| Notes payable | 300 | 300 |
| Deferred rent | 994 | 632 |
| Deferred revenue | 774 | 484 |
| | <u> </u> | <u> </u> |
| Total liabilities | <u>20,311</u> | <u>14,253</u> |
| Commitments and contingencies (note 10) | | |
| Stockholders' equity: | | |
| Preferred stock - 5,000 shares authorized; no shares issued and outstanding at March 31, 2004 and 2003 | | |
| Common stock - 100,000 shares authorized; 26,184 and 25,522 shares issued at March 31, 2004 and 2003, respectively; 20,050 and 19,388 shares outstanding at March 31, 2004 and 2003, respectively | 26 | 26 |
| Additional paid-in capital | 77,808 | 73,600 |
| Deferred compensation | (21) | (59) |
| Retained earnings | 22,661 | 16,903 |
| Accumulated other comprehensive (loss) income | (3) | 18 |
| Treasury stock - 6,134 shares at March 31, 2004 and 2003 | (4,100) | (4,100) |

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| | | |
|--|------------|------------|
| Total stockholders' equity | 96,371 | 86,388 |
| Total liabilities and stockholders' equity | \$ 116,682 | \$ 100,641 |

See accompanying notes to consolidated financial statements.

Table of Contents**OPNET TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)**

| | Year Ended March 31, | | |
|---|-----------------------------|-----------------|-----------------|
| | 2004 | 2003 | 2002 |
| Revenues: | | | |
| New software licenses | \$ 28,164 | \$ 22,187 | \$ 24,435 |
| Software license updates and technical support | 15,152 | 12,667 | 10,384 |
| Professional services | 13,137 | 11,573 | 9,743 |
| Total revenues | 56,453 | 46,427 | 44,562 |
| Cost of revenues: | | | |
| New software licenses | 831 | 829 | 453 |
| Software license updates and technical support | 1,730 | 1,710 | 1,767 |
| Professional services | 7,510 | 4,637 | 4,102 |
| Amortization of acquired technology | 509 | 504 | 434 |
| Total cost of revenues | 10,580 | 7,680 | 6,756 |
| Gross profit | 45,873 | 38,747 | 37,806 |
| Operating expenses: | | | |
| Research and development | 13,040 | 12,909 | 12,339 |
| Sales and marketing | 19,446 | 18,245 | 16,866 |
| General and administrative | 5,717 | 4,897 | 4,655 |
| Total operating expenses | 38,203 | 36,051 | 33,860 |
| Income from operations | 7,670 | 2,696 | 3,946 |
| Other income (expense): | | | |
| Interest income | 681 | 904 | 1,797 |
| Interest and other expense, net | (87) | (25) | (57) |
| | 594 | 879 | 1,740 |
| Income before provision for income taxes | 8,264 | 3,575 | 5,686 |
| Provision for income taxes | 2,506 | 832 | 1,307 |
| Net income | \$ 5,758 | \$ 2,743 | \$ 4,379 |
| Basic net income per common share | \$.29 | \$.14 | \$.23 |

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| | | | |
|-------------------------------------|--------|--------|--------|
| Diluted net income per common share | \$.28 | \$.14 | \$.22 |
|-------------------------------------|--------|--------|--------|

See accompanying notes to consolidated financial statements.

Table of Contents**OPNET TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

| | Year Ended March 31, | | |
|--|-----------------------------|--------------|----------------|
| | 2004 | 2003 | 2002 |
| Cash flows from operating activities: | | | |
| Net income | \$ 5,758 | \$ 2,743 | \$ 4,379 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 2,087 | 2,129 | 2,020 |
| Loss on disposition of fixed assets | 30 | | |
| Provision for losses on accounts receivable | 61 | 360 | 361 |
| Deferred income taxes | 192 | (752) | 455 |
| Expense related to stock options | 172 | 97 | 83 |
| Changes in assets and liabilities, net of effects from acquisitions: | | | |
| Billed and unbilled accounts receivable | (5,311) | 1,021 | (3,406) |
| Loans to employees | | | 231 |
| Prepaid expenses and other current assets | (493) | (369) | 1,576 |
| Refundable income taxes | | 1,253 | (824) |
| Deposits and other assets | (69) | (53) | 5 |
| Accounts payable | 719 | (329) | 30 |
| Accrued liabilities | 1,462 | 394 | (2,198) |
| Accrued income taxes | (98) | 80 | (189) |
| Tax benefit from exercise of employee stock options | 1,135 | 235 | 857 |
| Deferred revenue | 3,514 | 1,110 | 727 |
| Deferred rent | 362 | 251 | 322 |
| Net cash provided by operating activities | 9,521 | 8,170 | 4,429 |
| Cash flows from investing activities: | | | |
| Purchase of property and equipment | (1,013) | (965) | (3,278) |
| Purchase of investments | (67,546) | | |
| Proceeds from sale/maturity of investments | 27,564 | | |
| Acquisition of NetMaker division of Make Systems, Inc. | | | (1,156) |
| Acquisition of WDM Net Design, net of cash acquired | | | (1,279) |
| Acquired technology | (183) | | |
| Net cash used in investing activities | (41,178) | (965) | (5,713) |
| Cash flows from financing activities: | | | |
| Proceeds from exercise of common stock options | 2,626 | 318 | 384 |
| Issuance of common stock under employee stock purchase plan | 312 | 310 | 379 |
| Proceeds from issuance of note payable | | 150 | 150 |
| Net cash provided by financing activities | 2,938 | 778 | 913 |
| Effect of exchange rate changes on cash and cash equivalents | (40) | 28 | (12) |

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| | | | |
|--|-----------|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents | (28,759) | 8,011 | (383) |
| Cash and cash equivalents, beginning of year | 70,251 | 62,240 | 62,623 |
| Cash and cash equivalents, end of year | \$ 41,492 | \$ 70,251 | \$ 62,240 |

See accompanying notes to consolidated financial statements.

Table of Contents**OPNET TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**

(in thousands)

| | Common Stock | | | Additional Paid in Capital | Treasury Stock | | Deferred Compensation | Accumulated Other Retained Earnings | Comprehensive Income | Total Stockholders Equity |
|--|------------------|-----------------------|--------|----------------------------------|----------------|------------|--------------------------|--|-------------------------|---------------------------------|
| | Shares Issued | Shares Outstanding | Amount | | Shares | Amount | | | | |
| Balance, April 1, 2001 | 24,901 | 18,767 | \$ 25 | \$ 70,708 | 6,134 | \$ (4,100) | \$ (180) | \$ 9,781 | \$ 2 | \$ 76,236 |
| Net income | | | | | | | | 4,379 | | 4,379 |
| Foreign currency translation | | | | | | | | | (12) | (12) |
| Total comprehensive income | | | | | | | | | | 4,367 |
| Issuance of common stock: | | | | | | | | | | |
| Exercise of options | 261 | 261 | | 384 | | | | | | 384 |
| Employee stock purchase plan | 33 | 33 | | 379 | | | | | | 379 |
| Acquisition | 25 | 25 | | 350 | | | | | | 350 |
| Share options cancelled | | | | (23) | | | 23 | | | |
| Tax benefit from exercise of stock options | | | | 857 | | | | | | 857 |
| Amortization of deferred compensation | | | | | | | 83 | | | 83 |
| Balance, March 31, 2002 | 25,220 | 19,086 | 25 | 72,655 | 6,134 | (4,100) | (74) | 14,160 | (10) | 82,656 |
| Net income | | | | | | | | 2,743 | | 2,743 |
| Foreign currency translation | | | | | | | | | 28 | 28 |
| Total comprehensive income | | | | | | | | | | 2,771 |
| Issuance of common stock: | | | | | | | | | | |
| Exercise of options | 259 | 259 | 1 | 318 | | | | | | 319 |
| Employee stock purchase plan | 43 | 43 | | 310 | | | | | | 310 |
| Tax benefit from exercise of stock options | | | | 235 | | | | | | 235 |
| Deferred compensation | | | | 82 | | | (82) | | | |

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| | | | | | | | | | | |
|--|--------|--------|-------|-----------|-------|------------|---------|-----------|--------|-----------|
| Amortization of deferred compensation | | | | | | | 97 | | | 97 |
| Balance, March 31, 2003 | 25,522 | 19,388 | 26 | 73,600 | 6,134 | (4,100) | (59) | 16,903 | 18 | 86,388 |
| Net income | | | | | | | | 5,758 | | 5,758 |
| Foreign currency translation | | | | | | | | | (40) | (40) |
| Unrealized gain on marketable securities | | | | | | | | | 19 | 19 |
| Total comprehensive income | | | | | | | | | | 5,737 |
| Issuance of common stock: | | | | | | | | | | |
| Exercise of options | 625 | 625 | | 2,625 | | | | | | 2,625 |
| Employee stock purchase plan | 37 | 37 | | 315 | | | | | | 315 |
| Tax benefit from exercise of stock options | | | | 1,135 | | | | | | 1,135 |
| Deferred compensation | | | | 133 | | | (133) | | | |
| Amortization of deferred compensation | | | | | | | 171 | | | 171 |
| Balance, March 31, 2004 | 26,184 | 20,050 | \$ 26 | \$ 77,808 | 6,134 | \$ (4,100) | \$ (21) | \$ 22,661 | \$ (3) | \$ 96,371 |

See accompanying notes to consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts in thousands, except per share data)

1. Organization and Significant Accounting Policies

Organization. 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; 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; Slough, 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.

Principles of Consolidation. The consolidated financial statements include the results of OPNET Technologies, Inc. and its wholly-owned subsidiaries: OPNET Technologies SAS; OPNET Technologies Limited; OPNET Technologies, BVBA; OPNET Technologies, Pty. Ltd.; and OPNET Analysis, Inc. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents. Cash and cash equivalents consist of deposits in banks and all highly liquid investments with maturities of three months or less when purchased.

Marketable Securities. We have determined that all of our investments are marketable securities 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 consolidated balance sheets under the caption Accumulated other comprehensive income. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in the Interest income line item on the accompanying consolidated statements of operations. Realized gains and losses on available-for-sale securities are included in the Interest income line item on the consolidated statements of operations. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in the Interest income line item on the consolidated statements of operations.

Supplemental Cash Flow Information.

| | Year ended March 31, | | |
|---|----------------------|--------|--------|
| | 2004 | 2003 | 2002 |
| Cash paid during the fiscal year for: | | | |
| Income taxes | \$ 1,432 | \$ 514 | \$ 987 |
| Interest | 57 | 56 | 45 |
| Non-cash financing and investing activities: | | | |
| Issuance of common stock for acquisition | \$ | \$ | \$ 350 |
| Unrealized gain on marketable securities | | 19 | |

Concentration of Credit Risk. Financial instruments that potentially subject us to a concentration of credit risk consist principally of cash, marketable securities and accounts receivable. We generally do not require collateral on accounts receivable, as the majority of our customers are large, well-established companies, or government entities.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts in thousands, except per share data)

We maintain our cash balances at several financial institutions. The Federal Deposit Insurance Corporation insures the bank accounts up to \$100,000. Although balances exceed that amount, we have not experienced any losses in such accounts and believe we are not exposed to any significant credit risk to cash.

Fair Value of Financial Instruments. The fair value of our cash and cash equivalents, marketable securities, accounts receivable, accounts payable, accrued expenses and note payable approximates their respective carrying amounts.

Software Development Costs. Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. We consider technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility has been established, any additional costs are capitalized in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Through March 31, 2004, software development has been substantially completed concurrently with the establishment of technological feasibility and, accordingly, no costs have been capitalized to date.

Property and Equipment. Property and equipment are stated at cost. Depreciation on property and equipment is computed using the straight-line method over the estimated useful lives of the assets, of five to seven years. Leasehold improvements are depreciated over the shorter of the estimated useful life of the assets or the term of the related lease. Repairs and maintenance are expensed as incurred.

Intangible Assets. Intangible assets consist of acquired technology. Intangible assets are originally recorded at cost and amortized on a straight-line basis over their expected useful lives of five years in accordance with SFAS No. 142, Goodwill and Other Intangible Assets (SFAS No. 142).

Goodwill. In accordance with SFAS No. 142, goodwill is not amortized and is tested for impairment annually during our fourth quarter and whenever events and circumstances occur indicating that goodwill might be impaired. There has been no impairment as of March 31, 2004.

Valuation of Long-Lived Assets. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, we review our long-lived assets, including property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be fully recoverable. If the total of the expected undiscounted future net cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between the fair value and carrying amount of the asset.

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Revenue Recognition. 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. We recognize revenue based on the provisions of the American Institute of Certified Public Accountants 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 Bulletins No. 101 and No. 104, Revenue Recognition in Financial Statements.

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. Our new software license revenues consist of perpetual and term license sales of software products. New software license revenues are recognized when these criteria are met: persuasive evidence of an arrangement exists, delivery and acceptance of the software has occurred, the software license fee is fixed or determinable, and collectibility is probable. In instances when any of the four criteria are not met, we defer recognition of software license revenues until the criteria are met. When the sale of the software product requires us to make significant enhancements, customization or modifications to the software that are essential to its functionality, software license revenues and consulting fees are recognized using contract accounting under SOP 81-1.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts in thousands, except per share data)

We do not allow software returns because customers are able to evaluate our software products before purchasing them. Typically, our software license fees are due within a twelve-month period from delivery to our customers. If the fee due from the customer is not fixed or determinable, including payment terms greater than twelve months from delivery, revenue is recognized as payments become due and all other conditions for revenue recognition have been satisfied.

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. License updates consist of the right to unspecified software updates on a when-and-if-available basis and are entered into in connection with the initial software license purchase. License updates and technical support may be renewed upon expiration of the term. Customers can purchase license updates separately from technical support. Revenue from license updates and technical support is deferred and recognized as revenue on a straight-line basis over the term of the maintenance agreement.

Revenues under multiple-element arrangements, which typically include new software licenses, consulting services, training and maintenance agreements sold together, are allocated to each element in the arrangement primarily using the residual method based upon the fair value of the undelivered elements, which is specific to us (vendor-specific objective evidence of fair value or VSOE). This means that we defer revenue from the arrangement fee equivalent to the fair value of the undelivered elements. Discounts, if any, are applied to the delivered elements, usually software licenses, under the residual method. If we have established VSOE for all elements in the arrangement any discount is applied proportionately to each element. For periodic unspecified product updates and technical support agreements, VSOE is based upon either the renewal rate specified in each contract or the price charged when sold separately. For consulting services and training, VSOE is based upon the rates charged for these services when sold separately. For software licenses, VSOE is based on the price charged or to be charged when sold separately. If the only undelivered elements in an arrangement are periodic unspecified updates or technical support agreements for which we are unable to establish VSOE, all revenue is recognized ratably over the contract period.

Professional services revenues consist of fees from consulting services and training and are recognized as the services are performed. When we enter into consulting service arrangements that include significant modifications to the software that are essential to the customer s use and the arrangement is bundled with software, revenue under the entire arrangement is recognized under the percentage-of-completion method. In these circumstances, revenue that is recognized is allocated to new software license revenues and professional service revenues based on our standard price lists. We estimate the percentage-of-completion based on our estimate of total hours to complete the project as a percentage of total hours incurred and the estimated hours to complete.

We sell new software licenses, license updates and technical support agreements to distributors at predetermined prices. Sales to distributors are not contingent upon resale of the software to the end user. In most cases, we provide license updates and technical support agreements directly to distributors and the distributors provide support to the end customer. Revenues from sales to distributors are recorded at the amounts charged and in the same manner as all other new software license, license updates and technical support sales. Amounts received in advance of revenue recognition are classified as deferred revenue.

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Income Taxes. The income tax provision includes income taxes currently payable plus the net change during the year in deferred tax assets or liabilities. Deferred tax assets and liabilities reflect the differences between the carrying value under GAAP and the tax basis of assets and liabilities using enacted statutory tax rates in effect for the period in which the differences are expected to reverse.

Advertising Costs. Advertising costs are expensed as incurred and were \$392, \$316, and \$401 for the fiscal years ended March 31, 2004, 2003 and 2002, respectively.

Foreign Currency Transactions. Revenues denominated in foreign currencies are translated at the average exchange rates during the period. Gains or losses on foreign exchange are reported in the consolidated statements of operations.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts in thousands, except per share data)

Foreign Currency Translation. The results of operations for our international subsidiaries are translated from the designated functional currencies into U.S. dollars using average exchange rates during each period. Assets and liabilities are translated using exchange rates at the end of each period. Translation gains and losses are reported as a component of accumulated other comprehensive income in stockholders' equity.

Comprehensive Income. Certain revenues, expenses, gains and losses are recognized in comprehensive income but excluded from net income. Comprehensive income includes net income, foreign currency translation adjustments, and unrealized gains on marketable securities.

Earnings per Share. Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares and participating preferred shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted into common shares for all periods presented.

Indemnifications. The Company accounts for guarantees in accordance with Financial Accounting Standards Board (FASB) issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (Interpretations No. 45). Interpretation 45 elaborates on the disclosures required in financial statements concerning obligations under certain guarantees. It also clarifies the requirements related to the recognition of liabilities by a guarantor at the inception of certain guarantees. The provisions related to recognizing a liability at inception of the guarantee do not apply to product warranties or indemnification provisions in the Company's software license agreements. 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 products infringe 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 claims are outstanding as of March 31, 2004. 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. However, we do not believe that these indemnification provisions will have a material adverse effect on our 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 system. 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. SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, permits the use of either a fair-value based method or the intrinsic value method provided in APB No. 25 to account

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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, as amended, had been applied in measuring compensation expense for all periods.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(dollar and share amounts in thousands, except per share data)

The following table illustrates the effect on net income and related net income per share for fiscal years ended March 31, 2004, 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, as amended:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|-----------------|-----------------|
| Net income | \$ 5,758 | \$ 2,743 | \$ 4,379 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 25 | 49 | 83 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (4,044) | (3,743) | (3,035) |
| Pro forma net income (loss) | <u>\$ 1,739</u> | <u>\$ (951)</u> | <u>\$ 1,427</u> |
| Basic net income (loss) per common share: | | | |
| As reported | \$.29 | \$.14 | \$.23 |
| Pro forma | \$.09 | \$ (.05) | \$.08 |
| Diluted net income (loss) per common share: | | | |
| As reported | \$.28 | \$.14 | \$.22 |
| Pro forma | \$.08 | \$ (.05) | \$.07 |

Recently Issued Accounting Pronouncements. In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities. In general, a variable interest entity is a corporation, partnership, trust, or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Interpretation No. 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. We adopted the provisions of Interpretation No. 46 effective January 1, 2003. We do not have any variable interest entities; thus adoption of Interpretation No. 46 did not have an impact on our consolidated results of operations or financial position.

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 nor have we entered into any derivative instruments or transactions that are subject to SFAS No. 133 or SFAS No. 149. We adopted SFAS No. 149, effective July 1, 2003. The adoption of this standard did not have an effect on our consolidated results of operations or financial position.

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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 are not currently a party to any of the types of financial instruments that are subject to SFAS No. 150.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****2. Acquisition**

In July 2001, we entered into an agreement (the Share Purchase Agreement) with Comsof N.V., a Belgium company and the owner of WDM NetDesign BVBA (WDM NetDesign), through which the companies collaborated on the development of optical network planning products. Under the Share Purchase Agreement, OPNET acquired a 20% interest in WDM NetDesign for consideration of \$399 and purchased an option for consideration of \$1 to acquire all remaining shares of WDM NetDesign. In December 2001 we exercised our option to purchase the remaining shares of WDM NetDesign for \$1,275. On January 4, 2002, we purchased these shares by paying Comsof N.V. \$925 and issuing them 25 shares of our common stock valued at approximately \$350. The value of the 25 shares of common stock issued was based on the average market price of our common stock over the two-day period before and after the purchase option was exercised. In connection with this acquisition, we incurred expenses of \$98 and recorded a deferred tax credit of \$201. The deferred tax credit results from acquired technology not being deductible for tax reporting purposes. As a result of this acquisition, we now own WDM NetDesign's core technology in optical networking design and a strong assembled workforce.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition:

| | |
|------------------------|----------|
| Cash | \$ 145 |
| Other Current Assets | 91 |
| Property and Equipment | 11 |
| Technology | 500 |
| Goodwill | 1,291 |
| Current Liabilities | (23) |
| Deferred Revenue | (42) |
| | <hr/> |
| Net Assets Acquired | \$ 1,973 |
| | <hr/> |

We accounted for our initial investment in WDM NetDesign using the equity method. The purchase of the remaining shares of WDM NetDesign was accounted for by the purchase method of accounting and, accordingly, the results of operations have been included in our consolidated results from the January 2002 acquisition date. The purchase price allocation resulted in \$500 for acquired technology, which is being amortized over five years and \$182 in net tangible assets acquired. The \$1,291 excess purchase price over the fair value of assets acquired was allocated to goodwill, which is not deductible for tax purposes.

The following unaudited pro forma financial information for the year ended March 31, 2002, assumes the acquisition of WDM NetDesign occurred as of the beginning of the year ended March 31, 2002, after giving effect to certain adjustments, including the amortization of intangible assets. The unaudited pro forma financial information includes WDM NetDesign's results of operations for the nine months ended March 31, 2002, as WDM NetDesign commenced operations in July 2001. The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the results of operations that may occur in the future, or that would have occurred if the business combinations had been in effect on the dates indicated.

| | <u>2002</u> |
|-------------------------------------|-------------|
| Revenues | \$ 44,657 |
| Net income (loss) | 4,320 |
| Basic net income (loss) per share | \$.23 |
| Diluted net income (loss) per share | \$.22 |

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****3. Marketable Securities**

Marketable securities as of March 31, 2004, consist of the following:

| | <u>Amortized Cost</u> | <u>Gross Unrealized Gain</u> | <u>Gross Unrealized Loss</u> | <u>Market Value</u> |
|------------------------------|---------------------------|--------------------------------------|--------------------------------------|-------------------------|
| Corporate bonds and notes | \$ 10,915 | \$ 3 | \$ 1 | \$ 10,917 |
| U.S. Government agencies | 29,067 | 18 | 1 | 29,084 |
| Marketable securities | \$ 39,982 | \$ 21 | \$ 2 | \$ 40,001 |

Our marketable securities have maturity dates of less than one year.

4. Intangible Assets

Our intangible assets consist of acquired technology related to our acquisitions of NetMaker in March 2001, WDM NetDesign in January 2002, and a software product for modeling voice communications in December 2003. The gross carrying amount acquired technology and related accumulated amortization consisted of the following at March 31, 2004 and 2003:

| | <u>2004</u> | <u>2003</u> |
|-------------------------------|-----------------|-----------------|
| Acquired technology | \$ 2,682 | \$ 2,501 |
| Accumulated amortization | (1,442) | (935) |
| Intangible assets, net | \$ 1,240 | \$ 1,566 |

Amortization expense from acquired technology was \$509, \$504, and \$434 for the years ended March 31, 2004, 2003, and 2002, respectively. Amortization expense from acquired technology is included in cost of revenues in the consolidated statements of operations. We expect amortization expense of \$536 in each of the fiscal years ending March 31, 2005 and 2006, \$103 in the year ending March 31, 2007, \$36 in the fiscal year ending March 31, 2008, and \$29 in the fiscal year ending March 31, 2009.

5. Goodwill

Goodwill in the aggregate amount of \$12,212 was recorded in connection with the acquisitions of NetMaker in March 2001 and WDM NetDesign in January 2002. There were no changes in the total carrying amount of goodwill for the years ended March 31, 2004 and 2003.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****6. Property and Equipment**

Property and equipment consisted of the following at March 31, 2004 and 2003:

| | <u>2004</u> | <u>2003</u> |
|--------------------------------|-------------------|-------------------|
| Computer equipment | \$ 5,788 | \$ 5,446 |
| Leasehold improvements | 4,102 | 4,122 |
| Purchased software | 1,680 | 1,348 |
| Office furniture and equipment | 1,686 | 1,661 |
| | <u> </u> | <u> </u> |
| Total | 13,256 | 12,577 |
| Less: accumulated depreciation | (6,846) | (5,569) |
| | <u> </u> | <u> </u> |
| Property and equipment, net | <u>\$ 6,410</u> | <u>\$ 7,008</u> |

Depreciation expense for fiscal years ended March 31, 2004, 2003, and 2002 was \$1,578, \$1,625, and \$1,586, respectively.

7. Accrued Liabilities

Accrued liabilities consisted of the following at March 31, 2004 and 2003:

| | <u>2004</u> | <u>2003</u> |
|----------------------------------|-------------------|-------------------|
| Accrued compensation and bonuses | \$ 2,675 | \$ 1,590 |
| Other | 1,543 | 1,166 |
| | <u> </u> | <u> </u> |
| Total | <u>\$ 4,218</u> | <u>\$ 2,756</u> |

8. Income Taxes

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The components of the provision for income taxes for the years ended March 31, 2004, 2003 and 2002, were as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-----------------|---------------|-----------------|
| Current provision: | | | |
| Federal | \$ 1,811 | \$ 1,227 | \$ 600 |
| State | 464 | 284 | 188 |
| Foreign | 39 | 73 | 64 |
| | <u>2,314</u> | <u>1,584</u> | <u>852</u> |
| Deferred provision (benefit): | | | |
| Federal | 345 | (667) | 337 |
| State | 59 | (85) | 118 |
| Foreign | (212) | | |
| | <u>192</u> | <u>(752)</u> | <u>455</u> |
| Total provision for income taxes | <u>\$ 2,506</u> | <u>\$ 832</u> | <u>\$ 1,307</u> |

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)**

At March 31, 2004 and 2003, respectively, the components of our deferred tax assets and deferred tax liabilities were as follows:

| | <u>2004</u> | <u>2003</u> |
|---|----------------|----------------|
| Deferred tax assets: | | |
| Accrued vacation expense | \$ 315 | \$ 260 |
| Deferred revenue | 360 | 321 |
| In-process research and development | 237 | 252 |
| Deferred rent | 383 | 239 |
| Research and development tax credit carry forward | 572 | 516 |
| Accelerated book amortization of acquired technology | 310 | 201 |
| Bad debt reserve | 131 | 126 |
| Foreign net operating loss carry forward | 212 | |
| Other temporary differences | (1) | 7 |
| | <u>2,519</u> | <u>1,922</u> |
| Deferred tax liabilities: | | |
| Accelerated depreciation | (364) | (317) |
| Tax amortization of goodwill | (850) | (550) |
| Tax liability related to WDM NetDesign acquisition (see Note 2) | (110) | (148) |
| Tax accounting for unbilled accounts receivable | (544) | (260) |
| | <u>(1,868)</u> | <u>(1,275)</u> |
| Net deferred tax asset | <u>\$ 651</u> | <u>\$ 647</u> |

The provision for income taxes for fiscal years ended March 31, 2004, 2003 and 2002 differs from the amount computed by applying the statutory U.S. Federal income tax rate to income before taxes as a result of the following:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|-------------|-------------|-------------|
| Statutory U.S. Federal rate | 34% | 34% | 34% |
| Increase (decrease) in taxes resulting from: | | | |
| State income taxes net of Federal benefit | 4 | 4 | 4 |
| Tax credits | (8) | (15) | (16) |
| Foreign tax credit and other permanent differences, net | | | 1 |
| | <u>—</u> | <u>—</u> | <u>—</u> |

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| | | | |
|--------------------|-----|-----|-----|
| Effective tax rate | 30% | 23% | 23% |
|--------------------|-----|-----|-----|

At March 31, 2004, we had a research and development tax credit carry forward of approximately \$572 which will expire in the year 2024.

For the fiscal year ended March 31, 2004, our French subsidiary had a foreign net operating loss carry forward of approximately \$600 which can be carried forward indefinitely. Cumulative undistributed earnings of foreign subsidiaries, for which no U.S. income or foreign withholding taxes have been recorded, were approximately \$260 at March 31, 2004. Such earnings are expected to be reinvested indefinitely. Determination of the amount of unrecognized deferred tax liability with respect to such earnings is not practicable. The additional taxes on the earnings of foreign subsidiaries, if remitted, would be partially offset by U.S. tax credits for foreign taxes already paid. While there are no specific plans to distribute the undistributed earnings in the immediate future, where economically appropriate to do so, such earnings may be remitted.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)**

We believe that it is more likely than not that our net deferred tax asset of \$651 will be realized. Therefore, no valuation allowance was recorded at March 31, 2004. Our assessment was based upon our history of profitability, estimates of future taxable income, and the period over which the tax benefits will be realized.

9. Related Party Transactions

We sell consulting services to certain customers through OPNET Analysis, Inc., which was wholly-owned by one of our executive officers. OPNET Analysis, Inc. became a wholly-owned subsidiary of ours in April 2001 and is included in our consolidated financial statements for fiscal year 2002.

10. Commitments and Contingencies

Our corporate office and principal facility is located in Bethesda, Maryland and consists of approximately 60,000 square feet of office space held under a lease that expires on January 31, 2011, exclusive of renewal options. The lease provides for two five-year renewal options. The rent is subject to escalation based upon a consumer price indexed adjustment of up to 3% each year. The lease also requires us to maintain a security deposit of approximately \$2,400 in the form of a bank letter of credit, as discussed in Note 11, which is subject to annual reductions based upon meeting certain minimum financial requirements.

In addition, we lease office space under noncancelable operating leases. The leases for office space contain escalation clauses that provide for increased rentals based primarily on increases in real estate taxes, operating expenses, or the average consumer price index. Total rent expense under all leases for fiscal years 2004, 2003, and 2002 was \$3,229, \$3,201, and \$3,068, respectively. At March 31, 2004, future minimum lease payments required under noncancelable leases were as follows:

| <u>Year ending March 31,</u> | |
|-------------------------------------|------------------|
| 2005 | \$ 3,052 |
| 2006 | 3,062 |
| 2007 | 3,009 |
| 2008 | 3,058 |
| 2009 | 3,132 |
| Thereafter | 5,352 |
| Total minimum lease payments | \$ 20,665 |

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 adverse effect on our financial condition or results of operations.

11. Credit Agreements and Notes Payable

Effective June 10, 2002, we entered into a credit facility with a commercial bank. The credit facility permitted the use of funds for general corporate purposes and the issuance of letters of credit up to a maximum of \$10,000 in the aggregate. Borrowings under the credit facility were limited to 80% of eligible accounts receivable. We used the facility to issue an irrevocable letter of credit for approximately \$2,400 to satisfy the security deposit requirements for our corporate office lease. Upon a default, as defined in the corporate office lease agreement, and written notice from the landlord to us, the landlord had the right to draw upon the letter of credit in whole or in part. Interest was payable monthly, based on LIBOR plus the applicable margin ranging from 2% to 2.5% as stated in the loan agreement. The credit facility included a fee in the amount of 0.25% per annum on the unused portion of the credit facility. The credit facility was collateralized by our accounts receivable. The loan agreement contained customary affirmative and negative covenants including a restriction on the payment of dividends and a financial covenant requiring that we not exceed a

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)**

ratio of Funded Debt to EBITDA of 2.5:1.0 as such terms are defined in the loan agreement. We decided not to renew the credit facility and it expired June 10, 2004. As of March 31, 2004, we had no borrowings under the available credit facility, and available borrowings at that date were approximately \$5,600.

In December 2001, we received proceeds from a \$150 loan from the Department of Economic Development of Montgomery County, Maryland, under the Sunny Day Fund Initiative. The loan is subject to multiple maturity dates and has a 5% annual interest rate. The principal amount and any accrued interest will be deferred if we meet certain conditions regarding the hiring of full time employees. In December 2006, the principal amount and any accrued interest outstanding may convert to a grant if we achieve certain requirements related to employment.

In November 2002, we received proceeds from a \$150 loan from the Department of Economic Development of the State of Maryland under the Maryland Economic Development Assistance Fund. The loan is subject to multiple maturity dates and has a 4.83% annual interest rate. The principal amount and any accrued interest will be deferred if we meet certain conditions regarding the hiring of full time employees. In December 2007, the principal amount and any accrued interest are payable in full; however, these amounts may be reduced or converted to a grant if we achieve certain requirements related to employment.

12. Employee Benefit Plan

Effective August 1, 1993, we established a 401(k) retirement plan (the Plan) covering all eligible employees, as defined. Eligible employees who are at least 21 years old may participate. Under the terms of the Plan, participants may defer a portion of their salaries as employee contributions. We make matching contributions and may make discretionary and extra contributions. Employee contributions and extra contributions made by us are 100% vested immediately. In general, our matching and discretionary contributions vest ratably over a five-year period. Our expense under this Plan for fiscal years ended March 31, 2004, 2003 and 2002 was \$582, \$567, and \$549, respectively.

13. Earnings per Share

The following is a reconciliation of the amounts used in calculating basic and diluted net income per common share for fiscal years ended March 31, 2004, 2003 and 2002:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|------------------------------|-------------|-------------|-------------|
| Net Income (Numerator): | | | |
| Basic and diluted net income | \$ 5,758 | \$ 2,743 | \$ 4,379 |

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| | | | |
|---|-------------------|-------------------|-------------------|
| Shares (Denominator): | | | |
| Weighted average shares outstanding (basic) | 19,697 | 19,273 | 18,953 |
| Plus: | | | |
| Effect of other dilutive securities - options | 953 | 701 | 1,061 |
| | <u> </u> | <u> </u> | <u> </u> |
| Weighted average shares outstanding (diluted) | 20,650 | 19,974 | 20,014 |
| | <u> </u> | <u> </u> | <u> </u> |
| Net income per common share: | | | |
| Basic | \$.29 | \$.14 | \$.23 |
| Diluted | \$.28 | \$.14 | \$.22 |

We had options for the purchase of 715, 2,192, and 804 common shares that were excluded from the diluted average shares outstanding for the fiscal years ended March 31, 2004, 2003, and 2002 respectively, because their effect was antidilutive.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****14. Equity Based Compensation Plans**

Stock Option Plans. Our Amended and Restated 2000 Stock Incentive Plan (the "2000 Plan") provides for the granting of incentive and nonqualified stock options to purchase up to 4,943 shares of OPNET common stock. The number of shares available for issuance will automatically increase on the first trading day of each calendar year by an amount equal to 3% of the shares of common stock outstanding on the last trading day of the preceding calendar year, not to exceed an annual increase of 1,500 shares. Options are granted for terms of up to 10 years, and generally vest over periods ranging from one to six years from the date of grant.

Our 1993 Incentive Stock Option Plan (the "1993 Plan") provides for the granting of incentive stock options to purchase up to 3,000 shares of common stock of the Company. Options are granted for terms of up to 10 years, and generally vest over periods ranging from one to six years from the date of grant. The Board of Directors approved a resolution to make no further grants of options or stock awards under the 1993 Plan upon approval of the 2000 Plan.

A summary of option transactions is as follows:

| | Shares | Weighted Average Exercise Price |
|-----------------------------|---------------|--|
| Outstanding, April 1, 2001 | 2,460 | 7.18 |
| Granted | 1,655 | 10.73 |
| Exercised | (261) | 1.47 |
| Canceled | (441) | 9.79 |
| Outstanding, March 31, 2002 | 3,413 | 9.00 |
| Granted | 1,033 | 6.04 |
| Exercised | (259) | 1.23 |
| Canceled | (204) | 10.32 |
| Outstanding, March 31, 2003 | 3,983 | 7.71 |
| Granted | 364 | 12.20 |
| Exercised | (625) | 4.20 |
| Canceled | (123) | 9.98 |
| Outstanding March 31, 2004 | 3,599 | 9.76 |

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| | | |
|-----------------------------|-------|------|
| Exercisable, March 31, 2004 | 1,720 | 9.81 |
|-----------------------------|-------|------|

At March 31, 2004, options outstanding and exercisable were as follows:

| Options Outstanding | | | | Options Exercisable | |
|----------------------|--------------|--|--|---------------------|--|
| Exercise Price Range | Shares | Weighted Average Life Remaining | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| \$ 0.36 | 5 | 1.0 years | \$ 0.36 | 5 | \$ 0.36 |
| 1.47 - 2.00 | 254 | 1.7 years | 1.79 | 254 | 1.79 |
| 4.00 - 5.85 | 921 | 8.2 years | 5.72 | 222 | 5.48 |
| 6.71 - 9.66 | 218 | 7.9 years | 8.24 | 148 | 8.01 |
| 10.59 - 14.63 | 2,000 | 7.3 years | 11.93 | 974 | 12.05 |
| 15.42 - 19.50 | 201 | 7.2 years | 18.72 | 117 | 19.50 |
| | <u>3,599</u> | | | <u>1,720</u> | |

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)**

The weighted average fair value at date of grant for options granted during fiscal years 2004, 2003 and 2002 was \$8.18, \$4.17, and \$7.86 per share, respectively. The weighted average assumptions are follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|-------------------------|-------------|-------------|-------------|
| Risk-free interest rate | 3.24% | 3.35% | 4.59% |
| Expected dividend yield | 0.00% | 0.00% | 0.00% |
| Expected life | 4 years | 4 years | 4 years |
| Volatility factor | 98% | 98% | 105% |

At various dates during the year ended March 31, 2000, we granted a total of 260 options to employees with exercise prices below the estimated fair market value at the dates of grant. The weighted average exercise price of these options was \$2.57. We recorded compensation expense relating to those options of \$24, \$49 and \$83 for the years ended March 31, 2004, 2003 and 2002, respectively.

During the fiscal year ended March 31, 2003, we granted options to purchase 35 shares of our common stock to members of our advisory board. As a result, we initially recorded \$82 of deferred compensation representing the estimated fair value of the options. The assumptions used to determine the fair value of the options granted were as follows: risk free interest rate 1.54%, expected dividend yield 0.0%, expected life 2 years, and volatility 79%. During the year ended March 31, 2004, we marked-to-market the estimated fair value of the options during their vesting period and recorded \$74 of additional deferred compensation. We amortized \$109 and \$47 of this deferred compensation to expense for the years ended March 31, 2004 and 2003, respectively.

During the fiscal year ended March 31, 2004, we granted options to purchase 10 shares of our common stock to members of our advisory board. As a result, we initially recorded \$74 of deferred compensation representing the estimated fair value of the options. The assumptions used to determine the fair value of the options granted were as follows: risk free interest rate 1.84%, expected dividend yield 0.0%, expected life 2 years, and volatility 68%. We marked-to-market the estimated fair value of the options during their vesting period and recorded a \$15 reduction in deferred compensation during the year ended March 31, 2004. We amortized \$38 of this deferred compensation to expense for the year ended March 31, 2004.

Employee Stock Purchase Plan. During fiscal year 2001, the Board of Directors approved the adoption of the 2000 Employee Stock Purchase Plan (the ESPP), which provides all eligible employees, including members of the Board of Directors who are employees, to collectively purchase up to a total of 300 shares of our common stock. An employee may authorize a payroll deduction up to a maximum of 10% of his or her compensation during the plan period. The purchase price for each share purchased is the lesser of 85% of the closing price of the common stock on the first or last day of the plan period. A total of 38, 43, and 33 shares of our common stock were issued under the ESPP in fiscal year ended March 31, 2004, 2003 and 2002, respectively.

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In March 2000, the Board of Directors approved the adoption of the 2000 Director Stock Option Plan, which provides for the automatic annual granting of options to purchase stock to our Directors, who are not our employees, for up to a total of 225 shares of our common stock.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****15. Comprehensive Income**

Comprehensive income includes net income, foreign currency translation adjustments, and net unrealized gain on marketable securities. Total comprehensive income for fiscal years ended March 31, 2004, 2003, and 2002 is summarized as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|--|-------------------|-------------------|-------------------|
| Net income | \$ 5,758 | \$ 2,743 | \$ 4,379 |
| Foreign currency translation adjustments | (40) | 28 | (12) |
| Net unrealized gain on marketable securities | 19 | | |
| | <u> </u> | <u> </u> | <u> </u> |
| Total comprehensive income | \$ 5,737 | \$ 2,771 | \$ 4,367 |
| | <u> </u> | <u> </u> | <u> </u> |

16. Business Segment and Geographic Area Information

We operate in one industry segment, the development and sale of computer software programs and related services. For the years ended March 31, 2004, 2003 and 2002, revenues from transactions with U.S. government agencies were approximately 44%, 39%, and 23% of total revenues, respectively. No single customer accounted for 10% or more of revenues for fiscal 2004. In addition, there were no sales to any customers within a single country except for the United States where such sales accounted for 10% or more of total revenues. Our assets were primarily held in the United States for the fiscal years ended March 31, 2004, 2003 or 2002.

Revenues by geographic destination and as a percentage of total revenues for fiscal years ended March 31, 2004, 2003 and 2002 are as follows:

| | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---------------------------------------|-------------------|-------------------|-------------------|
| Geographic Area by Destination | | | |
| United States | \$ 44,859 | \$ 37,513 | \$ 35,392 |
| International | 11,596 | 8,914 | 9,170 |
| | <u> </u> | <u> </u> | <u> </u> |
| | \$ 56,455 | \$ 46,427 | \$ 44,562 |
| | <u> </u> | <u> </u> | <u> </u> |
| | 2004 | 2003 | 2002 |

| Geographic Area by Destination | _____ | _____ | _____ |
|---------------------------------------|--------|--------|--------|
| United States | 79.5% | 80.8% | 79.4% |
| International | 20.5 | 19.2 | 20.6 |
| | _____ | _____ | _____ |
| | 100.0% | 100.0% | 100.0% |
| | _____ | _____ | _____ |

17. Valuation and Qualifying Accounts

The following table sets forth activity in our accounts receivable reserve account:

| Year ended, | Balance at | Charges to | | Balance at |
|--------------------|-------------------|-------------------|-------------------|-------------------|
| | Beginning | Expenses | Deductions | End of |
| | of Period | Expenses | Deductions | Period |
| | _____ | _____ | _____ | _____ |
| March 31, 2004 | \$ 333 | \$ 61 | \$ 53 | \$ 341 |
| March 31, 2003 | 203 | 360 | 230 | 333 |
| March 31, 2002 | 113 | 361 | 271 | 203 |

Deductions represent write-offs of receivables previously reserved.

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(dollar and share amounts in thousands, except per share data)

18. Quarterly Financial Data (Unaudited)

| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> |
|--|--------------------------|---------------------------|--------------------------|---------------------------|
| Year Ended March 31, 2004 | | | | |
| Revenues | \$ 12,305 | \$ 13,401 | \$ 14,432 | \$ 16,315 |
| Gross profit | 10,010 | 10,961 | 11,688 | 13,214 |
| Income from operations | 904 | 1,911 | 2,142 | 2,713 |
| Net income | 764 | 1,344 | 1,619 | 2,031 |
| Basic net income applicable per common share | \$.04 | \$.07 | \$.08 | \$.10 |
| Diluted net income per common share | \$.04 | \$.07 | \$.08 | \$.10 |
| | <u>First Quarter</u> | <u>Second Quarter</u> | <u>Third Quarter</u> | <u>Fourth Quarter</u> |
| Year Ended March 31, 2003 | | | | |
| Revenues | \$ 11,153 | \$ 11,112 | \$ 11,804 | \$ 12,358 |
| Gross profit | 9,158 | 9,292 | 9,902 | 10,395 |
| Income from operations | 314 | 423 | 921 | 1,038 |
| Net income | 432 | 513 | 834 | 964 |
| Basic net income applicable per common share | \$.02 | \$.03 | \$.04 | \$.05 |
| Diluted net income per common share | \$.02 | \$.03 | \$.04 | \$.05 |

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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. |
| *21 | Subsidiaries of the Registrant | Exhibit 21 to this Annual Report on Form 10-K. |
| *23 | Consent of Deloitte & Touche LLP | Exhibit 23 to this Annual Report on Form 10-K. |
| *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 Annual Report on Form 10-K. |
| *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 Annual Report on Form 10-K. |
| *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 Annual Report on Form 10-K. |
| *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 Annual Report on Form 10-K. |

* filed herewith