

OPNET TECHNOLOGIES INC  
Form 10-Q  
February 09, 2005  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**Form 10-Q**

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

For the quarterly period ended December 31, 2004

OR

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

(Commission file number: 000-30931)

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**OPNET TECHNOLOGIES, INC.**

(Exact name of registrant as specified in its charter)

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Delaware

7372

52-1483235

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(State or other jurisdiction of  
incorporation or organization)

(Primary Standard Industrial  
Classification Code Number)

(I.R.S. Employer  
Identification No.)

7255 Woodmont Avenue

Bethesda, MD 20814

(Address of principal executive office)

(240) 497-3000

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrants were required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.). Yes  No

The number of shares of the registrant's Common Stock outstanding on December 31, 2004 was 20,208,937.

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. Condensed Consolidated Financial Statements****OPNET TECHNOLOGIES, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except per share data)****(unaudited)**

	<b>December 31, 2004</b>	<b>March 31, 2004</b>
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 43,029	\$ 41,492
Marketable securities	37,640	40,001
Accounts receivable, net of \$293 and \$349 in allowance for doubtful accounts at December 31 and March 31, 2004, respectively	13,900	10,044
Unbilled accounts receivable	2,189	2,559
Deferred income taxes, prepaid expenses and other current assets	2,503	1,772
	<u>          </u>	<u>          </u>
Total current assets	99,261	95,868
Property and equipment, net	6,051	6,410
Intangible assets, net	1,470	1,240
Goodwill	15,818	12,212
Deferred income taxes and other assets	620	952
	<u>          </u>	<u>          </u>
Total assets	\$ 123,220	\$ 116,682
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 564	\$ 934
Accrued liabilities	4,378	4,218
Deferred and accrued income taxes	99	173
Deferred revenue	15,775	12,918
	<u>          </u>	<u>          </u>
Total current liabilities	20,816	18,243
Notes payable	300	300
Deferred rent	1,101	994
Deferred revenue	982	774
	<u>          </u>	<u>          </u>
Total liabilities	23,199	20,311
	<u>          </u>	<u>          </u>
Commitments and contingencies (Note 9)		

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Stockholders' equity:

Preferred stock- par value \$0.001; 5,000 shares authorized, no shares issued and outstanding at December 31 and March 31, 2004		
Common stock-par value \$0.001; 100,000 authorized; 26,343 and 26,184 shares issued at December 31 and March 31, 2004, respectively	26	26
Additional paid-in capital	78,640	77,808
Deferred compensation		(21)
Retained earnings	25,365	22,661
Accumulated other comprehensive loss	90	(3)
Treasury stock, at cost - 6,134 shares at December 31 and March 31, 2004	(4,100)	(4,100)
	<hr/>	<hr/>
Total stockholders' equity	100,021	96,371
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 123,220	\$ 116,682
	<hr/>	<hr/>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****OPNET TECHNOLOGIES, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
<b>Revenues:</b>				
New software licenses	\$ 7,793	\$ 7,113	\$ 21,578	\$ 19,987
Software license updates and technical support	4,998	3,940	14,617	10,907
Professional services	3,272	3,379	10,869	9,244
<b>Total revenues</b>	<b>16,063</b>	<b>14,432</b>	<b>47,064</b>	<b>40,138</b>
<b>Cost of revenues:</b>				
New software licenses	202	126	578	614
Software license updates and technical support	597	445	1,734	1,188
Professional services	2,367	2,048	7,128	5,302
Amortization of acquired technology	192	125	460	375
<b>Total cost of revenues</b>	<b>3,358</b>	<b>2,744</b>	<b>9,900</b>	<b>7,479</b>
<b>Gross profit</b>	<b>12,705</b>	<b>11,688</b>	<b>37,164</b>	<b>32,659</b>
<b>Operating expenses:</b>				
Research and development	3,780	3,144	10,836	9,450
Sales and marketing	5,867	4,964	16,568	14,044
General and administrative	2,475	1,438	5,865	4,208
<b>Total operating expenses</b>	<b>12,122</b>	<b>9,546</b>	<b>33,269</b>	<b>27,702</b>
<b>Income from operations</b>	<b>583</b>	<b>2,142</b>	<b>3,895</b>	<b>4,957</b>
Interest and other income, net	326	135	787	436
<b>Income before provision for income taxes</b>	<b>909</b>	<b>2,277</b>	<b>4,682</b>	<b>5,393</b>
Provision for income taxes	740	658	1,979	1,666
<b>Net income</b>	<b>\$ 169</b>	<b>\$ 1,619</b>	<b>\$ 2,703</b>	<b>\$ 3,727</b>
<b>Basic net income per common share</b>	<b>\$ 0.01</b>	<b>\$ 0.08</b>	<b>\$ 0.13</b>	<b>\$ 0.19</b>
<b>Diluted net income per common share</b>	<b>\$ 0.01</b>	<b>\$ 0.08</b>	<b>\$ 0.13</b>	<b>\$ 0.18</b>

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Basic weighted average common shares outstanding	20,168	19,759	20,129	19,605
Diluted weighted average common shares outstanding	20,758	20,906	20,626	20,489

See accompanying notes to condensed consolidated financial statements.

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

	<b>Nine Months Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,703	\$ 3,727
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,640	1,568
Provision for losses on accounts receivable		72
Deferred income taxes	451	(358)
Expense related to employee and other stock options	2	158
Changes in assets and liabilities:		
Accounts receivable	(3,486)	(1,680)
Prepaid expenses and other current assets	(618)	(827)
Other assets	(240)	(98)
Accounts payable	(370)	(104)
Accrued liabilities	(724)	960
Accrued income taxes	25	(82)
Tax benefit from exercise of stock options		957
Deferred revenue	2,982	2,145
Deferred rent	107	281
<b>Net cash provided by operating activities</b>	<b>2,472</b>	<b>6,719</b>
<b>Cash flows from investing activities:</b>		
Acquisition of businesses	(3,431)	
Purchase of property and equipment	(810)	(610)
Purchase of investments	(40,759)	(60,622)
Proceeds from sale/maturity of investments	43,120	16,000
Acquired technology		(179)
<b>Net cash used in investing activities</b>	<b>(1,880)</b>	<b>(45,411)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of common stock options	487	2,062
Proceeds from issuance of common stock under employee stock purchase plan	364	312
<b>Net cash provided by financing activities</b>	<b>851</b>	<b>2,374</b>
Effect of exchange rate changes on cash and cash equivalents	94	4
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>1,537</b>	<b>(36,314)</b>
Cash and cash equivalents, beginning of period	41,492	70,251



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Cash and cash equivalents, end of period	<u>\$ 43,029</u>	<u>\$ 33,937</u>
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See accompanying notes to condensed consolidated financial statements.

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**OPNET TECHNOLOGIES, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**1. Organization and Significant Accounting Policies**

**Organization.** OPNET Technologies, Inc. ( OPNET , the Company , we or us ) is a 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; Frankfurt, Germany; 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.

The accompanying condensed consolidated financial statements include our results and the results of our wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The interim condensed consolidated financial statements included herein are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and applicable rules and regulations of the Securities and Exchange Commission (the SEC ) regarding interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes thereto contained in the Company s Annual Report on Form 10-K, for the year ended March 31, 2004, filed with the SEC. The March 31, 2004 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures including notes required by GAAP. In the opinion of management, these interim condensed consolidated financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly our results for the interim periods. The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amount of revenues and expenses during the reporting periods. Actual results could differ from those estimates. In addition, our operating results for the three and nine months ended December 31, 2004 may not be indicative of the operating results for the full fiscal year or any other future period.

**Stock-Based Compensation.** We account for stock-based compensation given to employees using the intrinsic value method in accordance with Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and accordingly, recognize compensation expense for fixed stock option grants only when the exercise price is less than the quoted market price of the shares on the date of the grant. Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, 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 Opinion No. 25 to account for employee stock-based compensation arrangements. Companies that elect to use the intrinsic value method provided in APB Opinion 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 for the three and nine months ended December 31, 2004 and 2003, respectively, as if SFAS No. 123 had been applied in measuring compensation expense for all periods.

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	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2004	2003	2004	2003
	(In thousands, except per share data)			
Net income	\$ 169	\$ 1,619	\$ 2,703	\$ 3,727
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	(1)	8	2	26
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(812)	(1,018)	(2,563)	(2,983)
Pro forma net (loss) income	\$ (644)	\$ 609	\$ 142	\$ 770
Basic net income (loss) per common share:				
As reported	\$ 0.01	\$ 0.08	\$ 0.13	\$ 0.19
Pro forma	\$ (0.03)	\$ 0.03	\$ 0.01	\$ 0.04
Diluted net income (loss) per common share:				
As reported	\$ 0.01	\$ 0.08	\$ 0.13	\$ 0.18
Pro forma	\$ (0.03)	\$ 0.03	\$ 0.01	\$ 0.04

**2. Acquisition of Altaworks**

On October 6, 2004, OPNET completed the acquisition of Altaworks Corporation. Pursuant to the merger agreement, the purchase price, including assumed liabilities, totaled approximately \$3.4 million; the purchase price was paid in cash from the Company's working capital. The total estimated purchase price of approximately \$3.4 million consisted of the following:

	(in thousands)
Cash consideration	\$ 2,940
Acquisition costs	491
Total consideration and acquisition costs	\$ 3,431

We accounted for the acquisition using the purchase method of accounting. We have conducted a preliminary review and analysis of the purchase price allocation and expect to complete the analysis by the end of the fourth quarter of fiscal 2005. A summary of the assets acquired and liabilities assumed in the acquisition follows:

	(in thousands)
Current assets	\$ 74
Property, plant and equipment	11
Other assets	18
Acquired intangible assets (3-year, straight-line amortization)	690

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Goodwill	3,606
Current liabilities assumed	(968)
	<hr/>
Total consideration and acquisition costs	\$ 3,431
	<hr/>

The assets acquired and liabilities assumed were recorded at estimated fair values as determined by the Company's management based on information currently available and on current assumptions as to future operations. The Company obtained valuation services from an independent company to determine the fair value of acquired intangibles and their remaining useful lives.

The following pro forma quarterly financial information presents the combined results of operations of the Company and Altaworks, and gives effect to the acquisition of Altaworks as if it occurred on April 1, 2003. The pro forma condensed combined financial information set forth below reflects certain adjustments, including adjustments to reflect amortization of acquired intangibles and adjustments to the tax provision to reflect the tax benefit the combined group would have received from Altaworks' losses. However, pro forma results do not include any anticipated operating expense cost savings. The pro forma condensed combined financial information set forth below neither purports to represent what the consolidated results of operations or financial condition of the Company would actually have been if the Altaworks acquisition had in fact occurred on such date nor projects the future consolidated results of operations or financial condition of the Company.

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Pro forma financial information:

	Nine Months Ended December 31,	
	2004	2003
	(in thousands)	
Revenue	\$ 47,171	\$ 40,193
Net income	767	768
Basic net income per share	\$ 0.04	\$ 0.04
	<u>0.04</u>	<u>0.04</u>
Diluted net income per share	\$ 0.04	\$ 0.04
	<u>0.04</u>	<u>0.04</u>

Pro forma basic net income per share is computed using the weighted-average number of common shares outstanding as of the dates presented.

**3. Intangible Assets**

Intangible assets consisted of the following:

	At December 31,	At March 31,
	2004	2004
	(in thousands)	
Acquired technology	\$ 3,372	\$ 2,682
Accumulated amortization	(1,902)	(1,442)
Intangible assets, net	\$ 1,470	\$ 1,240

Acquired technology relating to the NetMaker, WDM NetDesign, Anite and Altaworks acquisitions resulted in amortization expense for the three months ended December 31, 2004 and 2003 of \$191,500 and \$125,000, respectively. Amortization expense for the nine months ended December 31, 2004 and 2003 was \$459,500 and \$375,000 respectively. Amortization expense associated with Anite commenced in Q4 of FY 2004 and amortization associated with Altaworks commenced in Q3 of FY 2005. Amortization expense from acquired technology is included in cost of revenues in the condensed consolidated statements of operations. We currently expect amortization expense attributable to these acquisitions of \$651,000 in the fiscal year ending March 31, 2005, \$766,000 in fiscal year ending March 31, 2006, \$333,000 in the fiscal year ending March 31, 2007, \$151,000 in the fiscal year ending March 31, 2008, and \$29,000 in the fiscal year ending March 31, 2009.

**4. Earnings Per Share**

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The following is a reconciliation of the amounts used in calculating basic and diluted net income per common share for the three and nine months ended December 31, 2004 and 2003:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
(in thousands, except per share data)				
Net Income (Numerator):				
Basic and diluted net income	\$ 169	\$ 1,619	\$ 2,703	\$ 3,727
Shares (Denominator):				
Weighted average shares outstanding (basic)	20,168	19,759	20,129	19,605
Plus:				
Effect of other dilutive securities options	590	1,147	497	884
Weighted average shares outstanding (diluted)	20,758	20,906	20,626	20,489
Net income per common share:				
Basic	\$ 0.01	\$ 0.08	\$ 0.13	\$ 0.19
Diluted	\$ 0.01	\$ 0.08	\$ 0.13	\$ 0.18

**Table of Contents****5. Stockholders Equity**

During the nine months ended December 31, 2004, we received proceeds of approximately \$487,000 and issued 116,899 shares of common stock, pursuant to employee exercises of stock options. During the nine months ended December 31, 2004, employees purchased 41,705 shares of common stock under the OPNET 2000 Employee Stock Purchase Plan, resulting in proceeds to us of approximately \$364,000.

**6. Business Segment and Geographic Information**

We operate in one industry segment, the development and sale of computer software programs and related services. Revenues from transactions with U.S. government agencies were approximately 43% and 46% of total revenues for the three months ended December 31, 2004 and 2003, respectively, and 47% and 46% of total revenues for the nine months ended December 31, 2004 and 2003, respectively. Substantially all assets were held in the United States at December 31 and March 31, 2004. Revenues by geographic area and as a percentage of total revenues are as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
	(dollars in thousands)			
Geographic Area:				
United States	\$ 12,737	\$ 12,274	\$ 38,421	\$ 32,906
International	3,326	2,158	8,643	7,232
<b>Total revenue</b>	<b>\$ 16,063</b>	<b>\$ 14,432</b>	<b>\$ 47,064</b>	<b>\$ 40,138</b>
Geographic Area:				
United States	79.3%	85.0%	81.6%	82.0%
International	20.7	15.0	18.4	18.0
<b>Total revenue</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**7. Supplemental Cash Flow Information**

	Nine Months Ended December 31,	
	2004	2003
Cash paid for:	(in thousands)	

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Income taxes	\$ 2,503	\$ 1,377
Interest	36	48

**8. Comprehensive Income**

Comprehensive income includes net income, foreign currency translation adjustments, and unrealized gain or loss on marketable securities. The components of comprehensive income, net of tax, are as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31,</b>		<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	(in thousands)			
Net income	\$ 169	\$ 1,619	\$ 2,703	\$ 3,727
Foreign currency translation adjustments	(165)	48	(166)	(3)
Unrealized gain (loss) on marketable securities	9	7	73	7
<b>Total comprehensive income</b>	<b>\$ 13</b>	<b>\$ 1,674</b>	<b>\$ 2,610</b>	<b>\$ 3,731</b>



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**9. Commitments and Contingencies**

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the U.S. District Court of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. Based on a preliminary review, OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation. To date, no injunctive relief has been granted. The court has scheduled the matter for a jury trial beginning on September 20, 2005. Since the case is at a preliminary stage, we cannot predict the outcome of the claims, nor can we reasonably estimate a range of possible loss, if any, that may arise.

The Internal Revenue Service ( IRS ) is examining our federal corporate income tax returns for fiscal years ended March 31, 2002 and 2003. While the outcome of the IRS examination is not final at this time, we have reached a preliminary agreement with respect to the amount of tax deficiencies asserted. The tax deficiencies asserted relate to the research and development tax credits that we claimed on our tax returns for fiscal years ended March 31, 2002 and 2003. Based on the preliminary agreement we have reached with the IRS, we estimate that the aggregate amount of the research and development tax credits that will be disallowed on our tax returns for fiscal years ended March 31, 2002 and 2003 will be approximately \$350,000. As a result, our Q3 tax provision reflects the reversal of approximately \$350,000 of previously claimed research and development tax credits. Based on discussion with the IRS, we believe the results of the examination will be final by March 31, 2005.

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

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

The following discussion and analysis relate to our financial condition and results of operations for the three and nine months ended December 31, 2004 and 2003, and should be read in conjunction with our condensed consolidated financial statements and the related notes included elsewhere in this report. You should also read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes and *Management's Discussion and Analysis of Financial Condition and Results of Operations* contained in our Annual Report on Form 10-K for the year ended March 31, 2004, filed with the SEC. 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 Quarterly Report on Form 10-Q.

#### **Overview**

We are a provider of management software for networks and applications and related services that address, among others, application trouble shooting; 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, Germany, 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. Our software master license agreement provides our customers with the right to use our software either perpetually ( *perpetual licenses* ) or during a defined term, generally for 2 to 4 years ( *term licenses* ). For the nine months ended December 31, 2004, perpetual licenses represented approximately 96% of software license transactions. Substantially all of our software license arrangements include both perpetual licenses and software license updates and technical support. 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.

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 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 the need to closely manage the increases in our total expenses as we implement these strategies.

### **Acquisition**

On October 6, 2004, we completed the acquisition of Altaworks for a total purchase price of approximately \$3.4 million. As a result of the merger, we acquired all the assets and liabilities of Altaworks. We paid the purchase price in cash from working capital. As a result of the acquisition, we acquired two commercially available software products that provide advanced correlation and analysis technologies to our product portfolio for end-to-end application performance analysis and, with the addition of Altaworks employees, have greater engineering depth and technical expertise.

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This acquisition was accounted for as a purchase; consequently, operations of the acquired business will be included in our financial statements prospectively from the date of acquisition. See Note 2 to our condensed consolidated financial statements for additional information related to our acquisition of Altaworks.

**Summary of Our Financial Performance and Trends That May Affect Our Business and Future Results**

During the three months ended December 31, 2004 ( Q3 2005 ), as compared to the three months ended September 30, 2004 ( Q2 2005 ), revenue, gross profit, operating margins and deferred revenue increased. The approximately 13% sequential increase in total revenue in Q3 2005 positively impacted many of our key financial metrics. Conversely, we experienced a significant increase in operating costs that partially offset our increase in revenue. The significant increase in costs was primarily associated with the inclusion of operating expenses associated with our Altaworks acquisition and our Sarbanes-Oxley compliance efforts.

The following table summarizes information on certain key metrics:

	<b>Three Months Ended</b>		<b>Amount Change</b>	<b>Percentage Change</b>
	<b>December 31, 2004</b>	<b>September 30, 2004</b>		
(dollars in thousands, except per share data)				
<b>Operations Data:</b>				
Total revenue	\$ 16,063	\$ 14,214	\$ 1,849	13.0%
Total cost of sales	\$ 3,358	\$ 3,157	\$ 201	6.4%
Gross profit	\$ 12,705	\$ 11,057	\$ 1,648	14.9%
Gross profit as a percentage of total revenue (gross margin)	79.1%	77.8%		
Total operating expenses	\$ 12,122	\$ 10,599	\$ 1,523	14.4%
Income from operations	\$ 583	\$ 458	\$ 125	27.3%
Income from operations as a percentage of total revenue (operating margin)	3.6%	3.2%		
Net income	\$ 169	\$ 494	\$ (325)	(65.8)%
Diluted net income per common share	\$ 0.01	\$ 0.02	\$ (0.01)	(50.0)%
Total employees (period end)	357	338	19	5.7%
Total average employees	352	335	17	5.1%
Total consultants (period end)	70	64	6	9.4%
Total quota-carrying sales persons (period end)	47	52	(5)	(9.7)%
<b>Financial Condition and Liquidity Data:</b>				
Cash, cash equivalents, and marketable securities (period end)	\$ 80,669	\$ 84,413	\$ (3,744)	(4.5)%
Cash flows (used in) provided by operating activities	\$ (959)	\$ (652)	\$ (307)	(47.1)%
Total deferred revenue (period end)	\$ 16,757	\$ 14,080	\$ 2,677	19.1%

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The increase in total revenue in Q3 2005 from Q2 2005 was primarily attributable to the approximately 36% increase in new software license revenue. We generated a sequential increase in new software license revenue across our four major customer groups. We believe that our overall sales performance in Q3 2005 was due in part to our ability to close a significant number of the deals that slipped in Q2. We are continuing to pursue our implementation of plans to improve sales training and mentoring programs and to modify sales territory assignments. These continued efforts are designed to improve sales execution and minimize the disruptions normally associated with change. We believe that it could take several quarters for our plans to produce the intended results.

Our international revenues increased 28.4% to \$3.3 million, or 20.7% of total revenue for Q3 2005, from \$2.57 million, or 18.1% of total revenue for Q2 2005. We expect revenues from sales outside the United States to continue to account for a significant portion of our total revenues in the future but fluctuate from period to period. Sales to corporate enterprises are growing and accounted for the highest percentage of international revenue for Q3 2005 and Q2 2005. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets.

For Q3 2005, as compared to Q2 2005, the total revenue increase of \$1.85 million generated gross margins of 79.1%. Our gross margin for Q3 2005 increased from 77.8% for Q2 2005. The increase in gross margin was primarily due to license revenue contributing a higher percentage of total revenue in Q3 2005 (48.5%) as compared to Q2 2005 (40.4%).

We have been able to expand our operating margins in the past, and expect to do so in the future, through a combination of revenue growth, and the disciplined execution of our business plan. The operating leverage of our business model is driven by license revenue, which was demonstrated by the increase in our operating margin to 3.6% for Q3 2005 from 3.2% for Q2 2005. In Q3 2005 we absorbed the inclusion of Altworks operating expenses and significant costs associated with Sarbanes-Oxley compliance efforts, and still managed to expand operation margins in Q3 2005 as compared to Q2 2005.

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 for the three months ended December 31, 2004, we currently expect any future growth in revenue to come primarily 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 quarterly revenues in the near term.

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*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. As a result, we expect our international sales in absolute dollars and as a percentage of total revenue to fluctuate from quarter to quarter.

*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 from 76% to 80% in the near term.

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*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. In addition, the Altaworks acquisition will continue to result in higher research and development expenses. 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 persons in each of 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 Expense.* We expect the dollar amount of general and administrative expenses to increase as we continue to expand our operations. During Q4 of fiscal 2005, we anticipate incurring significant incremental costs for our Sarbanes-Oxley Section 404 compliance efforts and we expect that general and administrative expenses will increase in both absolute dollars and as a percentage of total revenue.

*Operating Margin.* 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. Our operating margin increased to 3.6% for Q3 2005 from 3.2% for Q2 2005 due primarily to the sequential increase in license revenue in Q3 2005. We remain committed to our long-term growth strategies and do not believe that adjustments to our cost structure are necessary at this time, but we intend to closely manage expenses.

## **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 under the residual method 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 . Revenues from software license arrangements are recognized when all of the following criteria are met as set forth in paragraph 8 of SOP 97-2: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, and (4) collectibility is probable. We define each of these four criteria as follows:

*Persuasive evidence of an arrangement exists.* For license arrangements with end-users, it is our customary practice to have a written contract, which is signed by both the end user and us, or a purchase order from those end users who have either previously negotiated a software license agreement with us or accept the terms and conditions of our standard shrink wrap software master license agreement. Sales to distributors, resellers, and value-added resellers (collectively referred to as resellers ) are currently only made outside of North America and are evidenced by a master agreement governing the relationship, which is signed by both the reseller and us, together with a purchase order on a transaction-by-transaction basis. To further evidence an arrangement, our master agreement requires that the reseller provide to us copies of the end user s purchase order and executed copies of software master

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license agreements and maintenance agreements with the end user.

***Delivery has occurred.*** Physical delivery of our software products to end users or resellers (collectively referred to as customers ) is considered to have occurred upon the transfer of media containing our software products to a common



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carrier. Occasionally, software products are delivered electronically to end users. Electronic delivery is deemed to occur after end users have been provided with access codes that allow them to take immediate possession of the software. If a software arrangement includes undelivered software products or services that are essential to the functionality of delivered software products, delivery is not considered to have occurred until these software products or services are delivered.

***The fee is fixed or determinable.*** It is our policy to not provide customers the right to any adjustments or refund of any portion of their license fees paid, acceptance provisions, cancellation privileges, or rights of return. Our normal payment terms for our software products and services currently range from net 30 days to net 90 days and primarily vary based on the country in which an agreement is executed. Payments that extend beyond our normal payment terms from the contract date but that are due within six months are generally deemed to be fixed or determinable based on our successful collection history on such arrangements, and thereby satisfy the required criteria for revenue recognition. Arrangements with payment terms extending beyond these customary payment terms are considered not to be fixed or determinable, and revenues from such arrangements are recognized as payments become due and payable.

***Collectibility is probable.*** Collectibility is assessed on a customer-by-customer basis. We typically sell to customers for whom there is a history of successful collection. New customers are subject to a credit review process that evaluates the customer's ability to pay. If we determine from the outset of an arrangement that collectibility is not probable, revenues are recognized as cash is collected.

When several elements, including software licenses, software license updates and technical support, and professional services, are sold to a customer through a single arrangement, the revenues from such multiple-element arrangements are allocated to each element based upon the residual method, whereby the fair value, as determined in reliance on vendor-specific objective evidence (or VSOE), of the undelivered elements of the arrangement is deferred, and revenue is recognized for the delivered elements (generally software licenses) when the criteria set forth in paragraph 8 of SOP 97-2 are met. VSOE of fair value for each element of an arrangement is based upon the normal pricing and discounting practices when the element is sold separately and, for software license updates and technical support, is additionally measured by the renewal rate offered to the customer in our maintenance agreement. We have established VSOE of fair value for software license updates and technical support, consulting services, and training. We normally do not sell separately software licenses. Therefore, we do not have VSOE of fair value for software licenses. If we cannot objectively determine the fair value of any undelivered element included in bundled software and service arrangements, we defer revenue until all elements are delivered, services have been performed or until fair value can objectively be determined. In instances when any one of the criteria set forth in paragraph 8 of SOP 97-2 are not met, we will either defer recognition of the software license revenue until the criteria are met or will recognize the software license revenue on a ratable basis, as the case may be, as required by SOPs 97-2 and 98-9.

In situations when a customer has the right to use our software for 12 months or less, or when the arrangement fee for a term license includes the right to use our software and receive software license updates and technical support, revenue is recognized ratably on a monthly basis over the license term.

We provide periodic unspecified product updates and technical support to our customers through maintenance contracts. Software license updates and technical support revenues from maintenance contracts are deferred and recognized ratably over the term of the maintenance agreement, typically 12 months. Payments for maintenance fees (on initial order or on renewal) are generally made in advance and are nonrefundable.

Revenues from professional services are recognized in the period the services are performed, provided that collection of the related receivable is reasonably assured. Professional services fees are generally based on hourly or daily rates; however, for services rendered under fixed-price contracts, revenue is recognized monthly using the percentage-of-completion method. We estimate the percentage-of-completion based on the total hours incurred to date as a percentage of total hours required to complete. When total cost estimates exceed the fixed price, we accrue for the estimated losses immediately. 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

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

Our software products are fully functional upon delivery. Some of our software arrangements include consulting services sold separately under consulting engagement contracts. When services under these arrangements are not considered essential to the functionality of the software they qualify as service transactions as defined in SOP 97-2, and we recognize revenue as

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services are performed based upon VSOE of fair value for these services. When we enter into consulting services arrangements that are bundled with software and the consulting services are considered essential to the functionality of the software, revenue under the entire arrangement is recognized using the percentage-of-completion method of contract accounting under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Software license revenue is generally recognized in our consolidated statement of operations earlier under SOP 97-2 than when contract accounting is required under SOP 81-1. The more significant factors considered in determining whether the consulting services are considered essential to the functionality of the software include the nature of services (i.e., significant customization, modification, or alteration of software products), degree of risk, availability of services from other vendors, timing of payments, and impact of milestones or acceptance criteria on the realizability of the software license fee. The determination of whether our consulting services are essential involves significant judgment and could have a material impact on our results of operations from period to period to the extent that significant new arrangements are not accounted for using contract accounting. If there is a significant uncertainty about the project completion or receipt of payment for the consulting services, revenue is deferred until the uncertainty is sufficiently resolved.

*Allowance for Doubtful Accounts.* We maintain an allowance for doubtful accounts 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. 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 December 31, 2004, accounts receivable totaled \$13.9 million, net of allowance for doubtful accounts of \$293,000.

*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, a software product for modeling voice communications in December 2003 and Altaworks in October 2004. They are recorded at cost and amortized on a straight-line basis over their expected useful lives of five years, except for the intangible assets acquired from the Altaworks acquisition, which are amortized on a straight-line basis over three 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 December 31, 2004, intangible assets totaled \$1.47 million, net of accumulated amortization of \$1.9 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 December 31, 2004, we had goodwill of \$15.8 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 during the three months ended December 31, 2004.

**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:

	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2004	2003	2004	2003
<b>Revenues:</b>				
New software licenses	48.5%	49.3%	45.8%	49.8%
Software license updates and technical support	31.1	27.3	31.1	27.2
Professional services	20.4	23.4	23.1	23.0
<b>Total revenues</b>	<b>100.00</b>	<b>100.0</b>	<b>100.00</b>	<b>100.0</b>
<b>Cost of revenues:</b>				
New software licenses	1.3	0.9	1.2	1.5
Software license updates and technical support	3.7	3.1	3.7	3.0
Professional services	14.7	14.2	15.1	13.2
Amortization of acquired technology	1.2	0.8	1.0	0.9
<b>Total cost of revenues</b>	<b>20.9</b>	<b>19.0</b>	<b>21.0</b>	<b>18.6</b>
<b>Gross profit</b>	<b>79.1</b>	<b>81.0</b>	<b>79.0</b>	<b>81.4</b>
<b>Operating expenses:</b>				
Research and development	23.5	21.8	23.1	23.6
Sales and marketing	36.5	34.4	35.2	35.0
General and administrative	15.4	10.0	12.5	10.4
<b>Total operating expenses</b>	<b>75.5</b>	<b>66.2</b>	<b>70.7</b>	<b>69.0</b>
Income from operations	3.6	14.8	8.3	12.3
Interest and other income, net	2.0	1.0	1.7	1.1
Income before provision for income taxes	5.7	15.8	9.9	13.4
Provision for income taxes	4.6	4.6	4.2	4.1
<b>Net income</b>	<b>1.1%</b>	<b>11.2%</b>	<b>5.7%</b>	<b>9.3%</b>

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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	Three Months Ended		Nine Months Ended	
	December 31,		December 31,	
	2004	2003	2004	2003
<b>Cost of Revenues:</b>				
New software licenses	2.6 %	1.8 %	2.7 %	3.1 %
Software license updates and technical support	11.9	11.3	11.9	10.9
Professional services	72.3	60.6	65.6	57.4

**Table of Contents***Revenues*

*New Software License Revenues.* New software license revenues were \$7.79 million and \$7.11 million for the three months ended December 31, 2004 and 2003, respectively, representing an increase of 9.6%. For the three months ended December 31, 2004, as compared to the same period in fiscal 2004, the increase in license revenue was primarily due to higher sales to corporate enterprise customers. New software license revenues were \$21.58 million and \$19.99 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 8.0%.

*Software License Updates and Technical Support Revenues.* Software license updates and technical support revenues were \$5.0 million and \$3.94 million for the three months ended December 31, 2004 and 2003, respectively, representing an increase of 26.9%. Software license updates and technical support revenues were \$14.62 million and \$10.91 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 34.0%. 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 for the three and nine months ended December 31, 2004, as compared to the same period in fiscal 2004, reflect increases in the overall customer-installed base.

*Professional Service Revenues.*

The components of professional services for the three and nine months ended December 31, 2004 and 2003 were as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>December 31,</b>		<b>December 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
	<b>(in millions)</b>			
Consulting services	\$ 3.0	\$ 3.0	\$ 9.8	\$ 8.1
Training and other income	.3	.4	1.1	1.1
<b>Professional services revenue</b>	<b>\$ 3.3</b>	<b>\$ 3.4</b>	<b>\$ 10.9</b>	<b>\$ 9.2</b>

Professional service revenues were approximately \$3.27 million and \$3.38 million for the three months ended December 31, 2004 and 2003, respectively, representing a decrease of 3.2%. Consulting services revenues comprise 90.9% and 87.4% of professional services revenue for the three months ended December 31, 2004 and 2003, respectively. Professional service revenues were approximately \$10.87 million and \$9.24 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 17.6%. Consulting services revenues comprise 89.9% and 87.0% of professional services revenue for the nine month ended December 31, 2004 and 2003, respectively. The increase for the nine months ended December 31, 2004 as compared to the same period in the prior fiscal year was primarily due to growing demand for our consulting services by U.S. government agencies.

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

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contract for calendar year 2003 was \$3.1 million. Under the first of four possible contract extensions, the funding under this contract for calendar year 2004 is \$4.0 million.

In January 2005, we were awarded the re-competed contract option for calendar year 2005 in the amount of \$2.5 million. The option years for calendar years 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 were \$3.3 million and \$2.16 million for the three months ended December 31, 2004 and 2003, respectively. Our international revenues increased as a percentage of total revenue to 20.7% for the three months ended December 31, 2004 from 15.0% for the same period in fiscal 2004. Our international revenues increased 19.5% to \$8.64 million for the nine months ended December 31, 2004, from \$7.23 million for the same period in fiscal 2004. Our international revenues increased as a percentage of total revenue to 18.4% for the nine months ended December 31, 2004 from 18.0% for the same period in fiscal 2004. Our international revenues are primarily generated in Europe and Japan. Historically,

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a significant portion of our international business has come from service providers and network equipment manufacturers. We have focused our efforts on increasing sales to corporate enterprises. International revenue from corporate enterprises comprised the largest percentage of international revenue for the three and nine months ended December 31, 2004.

*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 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 \$202,000 and \$126,000 for the three months ended December 31, 2004 and 2003, respectively. Gross margin on software licenses revenue decreased to 97.4% for the three months ended December 31, 2004 from 98.2% for the same period in fiscal 2004. Cost of software license revenues was \$578,000 and \$614,000 for the nine months ended December 31, 2004 and 2003, respectively. Gross margin on software licenses revenue increased to 97.4% for the nine months ended December 31, 2004 from 96.9% for the same period in fiscal 2004. The changes in gross margin for the three and nine months ended December 31, 2004 as compared to the same periods in fiscal 2004 were primarily due to the proportionate amount of license sales requiring royalty payments.

*Cost of Software License Updates and Technical Support Revenues.* Cost of software license updates and technical support revenues were \$597,000 and \$445,000 for the three months ended December 31, 2004 and 2003, respectively. Gross margin on software license updates and technical support revenues decreased to 88.1% for the three months ended December 31, 2004 from 88.7% for the same period in fiscal 2004. Cost of software license updates and technical support revenues were \$1.73 million and \$1.19 million for the nine months ended December 31, 2004 and 2003, respectively. Gross margin on software license updates and technical support revenues decreased to 88.2% for the nine months ended December 31, 2004 from 89.1% for the same period in fiscal 2004. The increases in cost of software license updates and technical support revenues for the three and nine months ended December 31, 2004 as compared to the same periods in fiscal 2004 were due to increases in headcount necessary to support our increasing customer base and higher royalty payments related to sales of software updates.

*Cost of Professional Service Revenues.* Cost of professional service revenues was \$2.37 million and \$2.05 million for the three months ended December 31, 2004 and 2003, respectively. Gross margin on professional service revenues decreased to 27.7% for the three months ended December 31, 2004 from 39.4% for the same period in fiscal 2004. Cost of professional service revenues was \$7.13 million and \$5.3 million for the nine months ended December 31, 2004 and 2003, respectively. Gross margin on professional service revenues decreased to 34.5% for the nine months ended December 31, 2004 from 42.6% for the same period in fiscal 2004. The increases in cost of professional service revenues and the resulting lower gross margins were primarily due to an increase in our consulting staff to meet demand for our services and additional overhead costs required to support growth.

*Operating Expenses*

*Research and Development.* Research and development expenses were \$3.78 million and \$3.14 million for the three months ended December 31, 2004 and 2003, respectively, representing an increase of 20.2%. Research and development expenses were \$10.84 million and \$9.45 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 14.7%. The increases were primarily due to



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higher personnel costs as a result of the Altaworks acquisition and increased staffing levels required for developing new products as well as sustaining and upgrading existing products.

*Sales and Marketing.* Sales and marketing expenses were \$5.87 million and \$4.96 million for the three months ended December 31, 2004 and 2003, respectively, representing an increase of 18.2%. Sales and marketing expenses were \$16.57 million and \$14.04 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 18.0%. The increases were primarily due to higher personnel costs as a result of increased staffing levels, higher commission expense resulting from increased sales performance and higher costs associated with marketing activities necessary to pursue our business plan.

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*General and Administrative.* General and administrative expenses were \$2.48 million and \$1.44 million for the three months ended December 31, 2004 and 2003, respectively, representing an increase of 72.1%. General and administrative expenses were \$5.87 million and \$4.21 million for the nine months ended December 31, 2004 and 2003, respectively, representing an increase of 39.4%. The increases were primarily due to increased professional service costs associated with Sarbanes-Oxley compliance efforts and increased staffing levels necessary to pursue our business plan.

### *Interest and Other Income, net*

Interest and other income, net, was \$326,000 and \$135,000 for the three months ended December 31, 2004 and 2003, respectively. Interest and other income, net, was \$787,000 and \$436,000 for the nine months ended December 31, 2004 and 2003, respectively. The increases were primarily due to an increase in interest income earned on our cash and cash equivalents and marketable securities. The increase in interest income is primarily the result of an increase in the aggregate balance of cash, cash equivalents, and marketable securities together with an increase in interest rates for the three and nine months ended December 31, 2004 as compared to the same periods in fiscal 2004.

### *Provision for Income Taxes*

Our effective tax rates were 81.4% and 29% for the three months ended December 31, 2004 and 2003, respectively. Our effective tax rates were 43% and 31% for the nine months ended December 31, 2004 and 2003, respectively. The increase in our effective tax rates for the three and nine month periods ended December 31, 2004 as compared to the same periods in fiscal 2004 is primarily due to the estimated tax deficiency of \$350,000 related to an IRS examination of research and development tax credits claimed on our corporate tax returns for fiscal 2002 and 2003. See Contingencies disclosed below for additional information related to the IRS examination. 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.

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

## **Liquidity and Capital Resources**

Since inception, we have funded our operations primarily through cash provided by operating activities and through the sale of equity securities. In August 2000, we completed our initial public offering in which we raised approximately \$54.1 million, net of underwriting discounts and offering expenses payable by us. As of December 31, 2004, we had cash, cash equivalents and marketable securities totaling \$80.7 million.

Cash provided by operating activities was \$2.5 million and \$6.7 million for the nine months ended December 31, 2004 and 2003, respectively. Cash provided by operating activities is primarily derived from net income, as adjusted for non-cash items such as depreciation and amortization expense, tax benefits from exercise of employee stock options, and changes in operating assets and liabilities. The decrease in cash provided by operating activities for the nine months ended December 31, 2004 as compared to the same period in fiscal 2004 was primarily attributable to lower net income and growth of accounts receivable. These decreases were partially offset by an increase in deferred revenue.

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Net cash used in investing activities was \$1.9 million and \$45.4 million for the nine months ended December 31, 2004 and 2003, respectively. Investing activities include the purchase, sale or maturity of marketable securities, expenditures for property and equipment, and acquisitions of businesses and technologies. For the nine months ended December 31, 2004, funds were used to acquire businesses of \$3.4 million, purchase marketable securities of \$40.8 million, and purchase property and equipment of \$810,000. Proceeds from the sale/maturity of investments were \$43 million for the nine months ended December 31, 2004. For the nine months ended December 31, 2003, funds were used to purchase marketable securities of \$60.6 million, and purchase property and equipment of \$610,000. Proceeds from the sale/maturity of investments were \$16 million for the nine months ended December 31, 2003.

Cash provided by financing activities was \$851,000 and \$2.4 million for the nine months ended December 31, 2004 and 2003, respectively. Cash provided by financing activities reflects the proceeds received from the exercise of stock options and the sale of common stock under our 2000 Employee Stock Purchase Plan.

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As of December 31, 2004, our contractual commitments include operating leases for office facilities, notes payable in the amount of \$300,000, and a letter of credit in the amount of \$2.8 million.

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

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.

## **Contingencies**

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the U.S. District Court of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. Based on a preliminary review, OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation. To date, no injunctive relief has been granted. The court has scheduled the matter for a jury trial beginning on September 20, 2005. Since the case is at a preliminary stage, we cannot predict the outcome of the claims, nor can we reasonably estimate a range of possible loss, if any, that may arise.

The Internal Revenue Service ( IRS ) is examining our federal corporate income tax returns for fiscal years ended March 31, 2002 and 2003. While the outcome of the IRS examination is not final at this time, we have reached a preliminary agreement with respect to the amount of tax deficiencies asserted. The tax deficiencies asserted relate to the research and development tax credits that we claimed on our tax returns for fiscal years ended March 31, 2002 and 2003. Based on the preliminary agreement we have reached with the IRS, we estimate that the aggregate amount of the research and development tax credits that will be disallowed on our tax returns for fiscal years ended March 31, 2002 and 2003 will be approximately \$350,000. As a result, our Q3 tax provision reflects the reversal of approximately \$350,000 of previously claimed research and development tax credits. Based on discussion with the IRS, we believe the results of the examination will be final by March 31, 2005.

## **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 Report and presented elsewhere by management from time to time.

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

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

that could affect our operating results include:

the timing of large orders;

changes in the proportion of software arrangements requiring contract accounting;

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

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

the cost and time required to develop new software products;

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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.

*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, the U.S. Department of Defense exercised the first of four possible contract extensions. The funding under this contract for calendar year 2004 is \$4.0 million. In January 2005, the U.S. Department of Defense exercised the second of four possible contract extensions. The funding under this contract for calendar year 2005 is \$2.5 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.

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*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 47% and 46% of our total revenues for the nine months ended December 31, 2004 and 2003, respectively. Government sales entail a variety of risks including:

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

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

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

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

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

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

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



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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.

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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 11.0 of *OPNET IT Guru*, which was released in December 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 vary from three months to more than a year. During the sales process, the customer may decide not to purchase or may reduce proposed orders of our products for various reasons, including changes in budgets and purchasing priorities. Our prospective customers routinely require education regarding the use and benefit of our products. This may also lead to delays in receiving customers' orders.

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

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

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

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.*

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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.

*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;

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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;

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.

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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.

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.



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*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.

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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.*

We completed the NetMaker, WDM NetDesign, and Altaworks acquisition in March 2001, January 2002, and October 2004, respectively. We may continue to acquire or make investments in companies, products or technologies if opportunities arise. Any acquisition could be expensive, disrupt our ongoing business, distract our management and employees, and adversely affect our financial results and the market price of our common stock. We may not be able to identify suitable acquisition or investment candidates, and if we do identify suitable candidates, we may not be able to make these acquisitions or investments on commercially acceptable terms or at all. If we make an acquisition, we could have difficulty integrating the acquired technology, employees, or operations. In addition, the key personnel of the acquired company may decide not to work for us.

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

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

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

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

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At December 31, 2004, we had \$43.0 million in cash and cash equivalents and \$37.6 million in marketable securities. Based on our cash, cash equivalents, and marketable securities as of December 31, 2004, a hypothetical 10% increase/decrease in the interest rates would increase/decrease our annual interest income and cash flows by approximately \$156,000.

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

### **ITEM 4. CONTROLS AND PROCEDURES**

We maintain a system of internal controls and procedures that are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Chief Executive Officer and our Acting Chief Financial Officer have evaluated

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the effectiveness of our disclosure controls and procedures as of December 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 December 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.

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**PART II. OTHER INFORMATION**

**ITEM 1. Legal Proceedings**

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the U.S. District Court of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. Based on a preliminary review, OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation. To date, no injunctive relief had been granted; the court has scheduled the matter for a jury trial beginning on September 20, 2005.

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

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

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

As of December 31, 2004, the proceeds from the offering have 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, MD, (ii) \$6.2 million of acquisition and acquisition-related expenses for the NetMaker acquisition, (iii) \$1.4 million of the purchase price for WDM NetDesign and (iv) \$3.4 million of acquisition and acquisition-related expenses for the Altaworks acquisition. None of these amounts were paid directly or indirectly to any director, officer, or general partner of us or their associates, persons owning 10% or more of any class of our equity securities, or any affiliate of us. We have not allocated any of the remaining net proceeds to any identifiable uses. We may also use a portion of the net proceeds to acquire businesses, products, or technologies that are complementary to our business. Pending their use, we have invested the net proceeds in investment grade, interest-bearing securities.

**ITEM 6. Exhibits**

Exhibits: See Exhibit Index

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OPNET TECHNOLOGIES, INC.  
(Registrant)

By:           /s/ Mel Wesley          

Date: February 9, 2005

Name: Mel Wesley  
Title: Chief Financial Officer (Acting)

**Table of Contents****OPNET TECHNOLOGIES, INC.****EXHIBIT INDEX****Exhibit**

<b>Number</b>	<b>Description</b>	<b>Source</b>
2.1	Agreement and Plan of Merger, dated September 3, 2004, by and among OPNET Technologies, Inc., N Company Acquisition Corp. and Altaworks Corporation	Incorporated by reference from exhibit 2.1 to Current Report on Form 8-K dated October 12, 2004
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).
*31.1	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended	Exhibit 31.1 to this Quarterly Report on Form 10-Q.
*31.2	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended	Exhibit 31.2 to this Quarterly Report on Form 10-Q.
*32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit 32.1 to this Quarterly Report on Form 10-Q.
*32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Exhibit 32.2 to this Quarterly Report on Form 10-Q.

\* filed herewith