

OPNET TECHNOLOGIES INC

Form 10-K/A

August 19, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

(Mark One)

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

For the fiscal year ended March 31, 2003

OR

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

Commission file number: 000-30931

OPNET TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of

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

Incorporation or organization)

7255 Woodmont Avenue, Bethesda, Maryland 20814-2959

(Address of principal executive offices) (Zip Code)

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

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

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

Common Stock, \$.001 par value

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, computed using the closing sale price of the registrant's Common Stock on September 30, 2002, as reported on the NASDAQ National Market, was approximately \$69.8 million.

The number of shares of the registrant's Common Stock outstanding on June 3, 2003 was 19,388,168.

DOCUMENTS INCORPORATED BY REFERENCE

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Certain portions of the registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on September 9, 2003, are incorporated by reference into Part III of this Form 10-K.

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EXPLANATORY NOTE

The purpose of this Amendment No. 1 to the Annual Report on Form 10-K of OPNET Technologies Inc. (the Company) for the year ended March 31, 2003 (the Original Form 10-K) is to restate our consolidated financial statements for fiscal 2003, 2002 and 2001 and to correspondingly modify related disclosures. This restatement is described in detail in note 19 of the notes to the consolidated financial statements. On August 13, 2003, we issued a press release that described our intention to restate these financial statements. The Company filed the press release as an exhibit to our Current Report on Form 8-K filed August 14, 2003.

Subsequent to the issuance of our consolidated financial statements as of March 31, 2003, we concluded that a portion of the revenue from certain software arrangements should be deferred to account for the value of certain free training offered by us to our customers. As a consequence, we restated our consolidated financial statements for the fiscal years ended March 31, 2003, 2002, and 2001 and the related quarterly financial information. For fiscal 2003, this restatement reduced our previously reported revenue from \$46.5 million to \$46.4 million and reduced our previously reported net income from \$2.8 million to \$2.7 million, but had no effect on our previously reported diluted earnings per common share of \$0.14. For fiscal 2002, the restatement reduced our previously reported revenue from \$44.8 million to \$44.6 million and reduced our previously reported net income from \$4.5 million to \$4.4 million, but had no effect on our previously reported diluted earnings per common share of \$0.22. For fiscal 2001, the restatement reduced our previously reported revenue from \$32.9 million to \$32.8 million, reduced our previously reported net income from \$2.9 million to \$2.8 million, and reduced our previously reported diluted earnings per common share from \$0.16 to \$0.15. Deferred revenue at March 31, 2003 increased from \$9.6 million to \$10.2 million and at March 31, 2002 increased from \$8.5 million to \$9.1 million. Retained earnings at March 31, 2003 decreased from \$17.3 million to \$16.9 million and at March 31, 2002 decreased from \$14.5 million to \$14.2 million.

Also, subsequent to the issuance of our consolidated financial statements as of March 31, 2003, we determined that amortization of acquired technology of \$504,000 and \$434,000 for fiscal 2003 and fiscal 2002, respectively, should be included as a cost of revenue rather than as an operating expense. This change has no impact on net income for any period. The accompanying consolidated financial statements have been restated to reflect this classification.

In addition to the restatement discussed above, we have made other reclassifications in our consolidated financial statements, which are described in note 1 of the notes to the consolidated financial statements.

We have amended and restated in its entirety each item of the Original Form 10-K that has been affected by the restatement and reclassifications. This Amendment No. 1 to Form 10-K does not reflect events occurring after the filing of the Original Form 10-K, or modify or update those disclosures (including disclosures relating to risks, uncertainties and other factors that may affect our future performance) in any way, except as required to reflect the effects of the restatement and reclassifications.

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OPNET TECHNOLOGIES, INC.

ANNUAL REPORT ON FORM 10-K/A

FOR THE FISCAL YEAR ENDED MARCH 31, 2003

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This Annual Report contains forward-looking statements that involve substantial risks and uncertainties. You can identify these statements by forward-looking words such as anticipate, believe, could, estimate, expect, intend, may, plan, potential, should, will, and You should read statements that contain these words carefully because they discuss our future expectations, contain projections of our future results of operations or of our financial position, or state other forward-looking information. We believe that it is important to communicate our future expectations to our investors. However, there may be events in the future that we are not able to predict accurately or control. The factors listed in this Annual Report on Form 10-K/A under Management's Discussion and Analysis of Financial Condition and Results of Operations Certain Factors That May Affect Future Results, as well as any cautionary language in this Annual Report on Form 10-K/A, provide examples of risks, uncertainties, and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should also carefully review the risks outlined in other documents that we file from time to time with the Securities and Exchange Commission, including our Quarterly Reports on Form 10-Q that we will file in fiscal 2004.

The forward-looking statements provided in this Annual Report on Form 10-K/A represent our expectations as of June 3, 2003. We anticipate that subsequent events and developments will cause our expectations to change. However, while we may elect to update this forward-looking information at some point in the future, we specifically disclaim any obligation to do so. This forward-looking information should not be relied upon as representing our expectations as of any date subsequent to May 30, 2003. IT Guru, Netbiz, OPNET®, OPNET Modeler®, SP Guru®, OPNET WDM Guru, OPNET Technologies, OPNETWORK®, and VNE Server are trademarks or service marks of OPNET. Other trademarks or service marks appearing in this Annual Report on Form 10-K/A are the property of their respective holders.

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

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Subsequent to the filing of our Annual Report on Form 10-K for the year ended March 31, 2003, we restated our consolidated financial statements to account for revenue attributable to certain free training classes and to change the classification of amortization of acquired technology. See Note 19 to our consolidated financial statements included under Item 8. Financial Statements and Supplementary Data for more information and a presentation of the impact of the restatement on our previously filed consolidated financial statements.

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report. The statement of operations data for the years ended March 31, 2003, 2002, and 2001 (referred to as fiscal 2003, fiscal 2002, and fiscal 2001, respectively), and the balance sheet data as of March 31, 2003 and 2002, are derived from, and are qualified by reference to, our audited consolidated financial statements included in this Annual Report. The balance sheet data as of March 31, 2001, 2000 and 1999 and the statement of operations data for the year ended March 31, 2000 and 1999 are derived from our consolidated financial statements, as restated, that are not included in this Annual Report. Historical results are not necessarily indicative of results that may be expected for any future period.

	Year Ended March 31,				
	2003	2002	2001	2000	1999
	(As Restated) (in thousands, except per share data)				
Statement of Operations Data:					
Revenues (1):					
New software license revenue	\$ 22,187	\$ 24,435	\$ 18,476	\$ 10,372	\$ 6,609
Software license updates and technical support	12,667	10,384	7,697	4,848	3,519
Professional services	11,573	9,743	6,592	3,934	1,790
Total revenues	46,427	44,562	32,765	19,154	11,918
Cost of revenues (1):					
New software license revenue	829	453	395	728	133
Software license updates and technical support	1,710	1,767	900	628	464
Professional services	4,637	4,102	3,850	2,247	785
Amortization of acquired technology	504	434			
Total cost of revenues	7,680	6,756	5,145	3,603	1,382
Gross profit	38,747	37,806	27,620	15,551	10,536
Operating expenses:					
Research and development	12,909	12,339	8,263	5,696	4,850
Sales and marketing	18,245	16,866	13,745	7,510	4,056
General and administrative	4,897	4,655	3,362	2,093	1,984
Purchased in-process research and development			770		

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Total operating expenses	36,051	33,860	26,140	15,299	10,890
Income (loss) from operations	2,696	3,946	1,480	252	(354)
Interest and other income, net	879	1,740	2,788	414	376
Income before provision for income taxes	3,575	5,686	4,268	666	22
Provision (benefit) for income taxes (2)	832	1,307	1,499	141	(132)
Net income	\$ 2,743	\$ 4,379	\$ 2,769	\$ 525	\$ 154
Basic net income applicable per common share	\$.14	\$.23	\$.17	\$.04	\$.01
Diluted net income per common share	\$.14	\$.22	\$.15	\$.04	\$.01
Weighted average shares outstanding (basic)	19,273	18,953	16,440	12,912	12,831
Weighted average shares outstanding (diluted)	19,974	20,014	17,977	14,367	13,626
Balance Sheet Data:					
Cash and cash equivalents	\$ 70,251	\$ 62,240	\$ 62,623	\$ 8,765	\$ 6,414
Total assets	100,641	95,317	92,389	16,891	13,237
Long-term debt	300	150			
Redeemable convertible preferred stock				6,948	6,934
Total stockholders' equity	86,388	82,656	76,236	3,361	2,680

- (1) Reflects reclassification of certain amounts. See Note 1 to our consolidated financial statements.
- (2) The provision for income taxes for the year ended March 31, 2002 includes non-recurring tax credits for incremental research and development expenditures totaling \$372, or \$.02 per common share.

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

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

Restatement

We have restated our consolidated financial statements for fiscal 2003, 2002, and 2001 to account for certain free training offered by us to our customers and to change the classification of amortization of acquired technology. Subsequent to the issuance of our consolidated financial statements as of March 31, 2003, we concluded that the timing and amount of reported revenues from license transactions required revision in circumstances where customers had the right to attend certain free training classes. These revisions increased our previously reported deferred revenue in our consolidated balance sheets and reduced our previously reported revenue in our consolidated statements of operations. We also determined that amortization of acquired technology of \$504,000 and \$434,000 for fiscal 2003 and fiscal 2002, respectively, should be included as a cost of revenue rather than as an operating expense. This change in classification has no impact on net income.

See Note 19 *Restatement* in the accompanying notes to our consolidated financial statements for additional discussion regarding the restatement and the impact of the restatement on our consolidated statements of operations and consolidated balance sheets.

The following discussion reflects the effects of the restatement.

Reclassifications

Revenues and costs associated with the sale of periodic unspecified product updates (*license updates*) and technical support have been combined and presented as *Software license updates and technical support* in the accompanying consolidated statements of operations. These reclassifications had no impact on total revenues, net income or net income per common share in any period. See Note 1 *Significant Accounting Policies* *Reclassifications* in the accompanying notes to our consolidated financial statements for additional information regarding the reclassifications. The following discussion reflects the effects of these reclassifications.

Overview

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

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(license updates) and technical support under our maintenance agreements. We offer consulting services, generally under fixed-price agreements, primarily to provide product customization and enhancements and to facilitate the adoption of our technology.

Revenues from sales outside of the United States represented 19.2%, 20.6%, and 22.5% of our total revenues in fiscal 2003, 2002, and 2001, respectively. Sales outside the United States were primarily made through our Paris, France and Reading, United Kingdom offices as well as third-party distributors and value-added resellers, who are generally responsible for providing technical support and service to customers within their territory. We expect revenues from sales outside the United States to continue to account for a significant portion of our total revenues in the future. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets.

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NetMaker Acquisition. In March 2001, we acquired the NetMaker division of Make Systems, Inc. (NetMaker) for consideration of \$5.0 million and 650,000 shares of our common stock. NetMaker offered a sophisticated suite of products that address the operational and engineering needs of traditional and next-generation network service providers. The acquisition contributed key components that enabled us to broaden our product suite for the service provider market. The acquisition was accounted for using the purchase method. See Note 2 to our consolidated financial statements for additional information related to our acquisition of NetMaker.

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

Results of Operations

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

	Year Ended March 31,		
	2003	2002	2001
Revenues:			
New software licenses	47.8%	54.8%	56.4%
Software license updates and technical support	27.3	23.3	23.5
Professional services	24.9	21.9	20.1
Total revenues	100.0	100.0	100.0
Cost of revenues:			
New software licenses	1.8	1.0	1.2
Software license updates and technical support	3.7	4.0	2.7
Professional services	10.0	9.2	11.8
Amortization of acquired technology	1.1	1.0	
Total cost of revenues	16.6	15.2	15.7
Gross profit	83.4	84.8	84.3
Operating expenses:			
Research and development	27.8	27.7	25.2
Sales and marketing	39.3	37.9	41.9
General and administrative	10.5	10.4	10.3
Purchased research and development			2.3

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Total operating expenses	77.6	76.0	79.7
Income from operations	5.8	8.8	4.6
Interest and other income, net	1.9	3.9	8.5
Income before provision for income taxes	7.7	12.7	13.1
Provision for income taxes	1.8	2.9	4.6
Net income	5.9%	9.8%	8.5%

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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:

	Year Ended March 31,		
	2003	2002	2001
Cost of new software license revenues	3.7%	1.9%	2.1%
Cost of software license updates and technical support	13.5	17.0	11.7
Cost of professional service revenues	40.1	42.1	58.4

Revenues

New Software License Revenues. New software license revenues were \$22.2 million, \$24.4 million, and \$18.5 million in fiscal 2003, 2002, and 2001, respectively, representing a decrease of 9.2% in fiscal 2003 from fiscal 2002 and an increase of 32.3% in fiscal 2002 from fiscal 2001. For fiscal 2003, the decline in sales was due to discounts associated with pricing strategies and product bundling in fiscal 2003, which more than offset the increased revenue contributions from higher sales volumes to enterprise and U.S. government customers of *OPNET IT Guru*, *ACE*, *ACE Decode Module*, *NetDoctor*, *Flow Analysis*, *OPNET SP Guru*, and *OPNET VNE Server*, which was launched in fiscal 2003. For fiscal 2002, the growth in sales was due to increased overall demand for our products, revenue contribution from new products, increased penetration of international markets, expansion of marketing and direct sales force, and increased average transaction size. For fiscal 2002, a substantial growth in sales to enterprises of *OPNET IT Guru*, *ACE*, and modules launched in fiscal 2002, such as *ACE Decode Module*, *NetDoctor*, and *Flow Analysis*, combined with sales to service providers of two products launched in fiscal 2002, *OPNET SP Guru* and *OPNET WDM Guru*, offset a significant decline in sales to network equipment manufacturers of *OPNET Modeler*.

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

Software License Updates and Technical Support Revenues. Software license updates and technical support revenues were \$12.7 million, \$10.4 million, and \$7.7 million in fiscal 2003, 2002, and 2001, respectively, representing increases of 22.0% in fiscal 2003 from fiscal 2002 and 34.9% in fiscal 2002 from fiscal 2001. Software license updates and product support revenue growth rates are affected by the overall new software license revenue growth rates, as well as the renewal rate of annual maintenance contracts by existing customers. The increase in software license updates and product support revenues in fiscal 2003 and fiscal 2002 reflect increases in the overall customer installed base as compared to the prior year.

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

Professional Service Revenues. Professional service revenues were \$11.6 million, \$9.7 million, and \$6.6 million in fiscal 2003, 2002, and 2001, respectively, representing increases of 18.8% in fiscal 2003 from fiscal 2002 and of 47.8% in fiscal 2002 from fiscal 2001. Consulting services

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revenues comprise 88.3%, 85.0%, and 84.5% of professional service revenues for fiscal 2003, 2002, and 2001, respectively. The increases in professional service revenues were primarily due to growing demand for our consulting services, including engagements with U.S. government agencies. A consulting contract with the U.S. Department of Defense that contributed 21.4% of service revenue for the nine months ended December 31, 2002 expired on December 31, 2002. The U.S. Department of Defense issued a request for proposal for this program and we were awarded a new contract in January 2003. The initial funding under this contract for calendar year 2003 is \$2.2 million, compared to \$3.2 million in calendar year 2002. There are four successive option years under this contract which may be exercised by the U.S. Department of Defense in its discretion. In the event that we are not awarded additional funding under this contract, our results of operations could be adversely impacted. We do not expect significant growth in our service revenues in the near-term due to the mix of consulting contracts. Our ability to grow service revenues will be dependent on our ability to expand our installed base of customers and our ability to maintain several large consulting contracts with U.S. government agencies.

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International Revenues. Our international revenues decreased 2.8% to \$8.9 million, or 19.2% of total revenue, for fiscal 2003 from \$9.2 million, or 20.6% of total revenues, for fiscal 2002. Our international revenues increased 24.3% during fiscal 2002 from \$7.4 million, or 22.5% of total revenues, for fiscal 2001. Our international revenues are primarily generated in Europe and Japan. During fiscal 2003 and 2002, we expanded our operations outside the United States. International revenue in fiscal 2002 benefited from our expansion. The decline in fiscal 2003 reflects the challenging global economy and the shift of our customer base to enterprises. We believe that we will need to further expand our international sales, marketing and customer service functions to increase international revenue and we expect to continue experiencing fluctuations of international revenues in the future.

Cost of Revenues

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.

In connection with our acquisitions of NetMaker in March 2001 and WDM NetDesign in January 2002, we recorded acquired technology of \$2.5 million. Beginning in fiscal 2002, these acquired technologies are being amortized on a straight-line basis over five years. Amortization expense from acquired technology was \$504,000 and \$434,000 in fiscal 2003 and 2002, respectively, and was included in the cost of revenues in the consolidated statements of operations.

Cost of New Software License Revenues. Cost of software license revenues was \$829,000, \$453,000, and \$395,000 in fiscal 2003, 2002, and 2001, respectively. Gross margin on software licenses revenue decreased to 96.3% for fiscal 2003 from 98.1% for fiscal 2002. The increase in cost of software license revenues and the resulting lower gross margins in fiscal 2003 were primarily due to an increase in sales requiring royalty payments under licensing agreements. Gross margin on software licenses revenue increased to 98.1% for fiscal 2002 from 97.9% for fiscal 2001. The increase in the cost of new software license revenues for 2002 were primarily due to an increase in sales requiring royalty payments however, the mix of licensing agreements resulted in higher gross margins.

Cost of Software License Updates and Technical Support Revenues. Cost of software license updates and technical support revenues were \$1.7 million, \$1.8 million, and \$900,000 in fiscal 2003, 2002, and 2001, respectively. Gross margin on software license updates and technical support revenues increased to 86.5% for fiscal 2003 from 83.0% for fiscal 2002 due to the increase in revenue and only a slight change in costs. Gross margin on software license updates and technical support revenues decreased to 83.0% for fiscal 2002 from 88.3% for fiscal 2001 and costs in fiscal 2002 increased approximately \$900,000 from fiscal 2001 primarily due to additional personnel and related overhead costs required to support our installed base of customers.

Cost of Professional Service Revenues. Cost of professional service revenues was \$4.6 million, \$4.1 million, and \$3.9 million in fiscal 2003, 2002, and 2001, respectively. Cost of service revenues increased 13.0% in fiscal 2003 from fiscal 2002. Gross margin on service revenues increased to 59.9% for fiscal 2003 from 57.9% for fiscal 2002. For fiscal 2003, gross margins improved due to the mix of consulting contracts. Cost of service revenues increased 6.5% in fiscal 2002 from fiscal 2001. Gross margin on service revenues increased to 57.9% in fiscal 2002 from 41.6% in fiscal 2001 due to a higher level of profitability in consulting and training services. We expect cost of service revenues as a percentage of service revenues to vary based primarily on the profitability of individual consulting engagements.

Operating Expenses

Research and Development. Research and development expenses were \$12.9 million, \$12.3 million, and \$8.3 million in fiscal 2003, 2002, and 2001, respectively, representing increases of 4.6% in fiscal 2003 from fiscal 2002 and 49.3% in fiscal 2002 from fiscal 2001. These increases were primarily due to increased headcount as a result of the NetMaker acquisition in March 2001 and the WDM NetDesign acquisition in January 2002, and increased staffing levels for developing new products as well as sustaining and upgrading existing products. The increase in fiscal 2002 was partially offset by a decrease in discretionary bonuses for fiscal 2002 compared to fiscal 2001.

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We believe that a significant level of research and development investment will be required to maintain our competitive position and broaden our product lines, as well as enhance the features and functionality of our current products. We expect that the absolute dollar amount of these expenditures will continue to grow but generally decrease as a percentage of total revenues in future periods. Our ability to decrease these expenses as a percentage of revenue will depend upon our revenue growth, among other factors.

Sales and Marketing. Sales and marketing expenses were \$18.2 million, \$16.9 million and \$13.7 million in fiscal 2003, 2002, and 2001, respectively. Sales and marketing expenses increased 8.2% in fiscal 2003 from fiscal 2002 and, as a percentage of total revenues, increased to 39.3% in fiscal 2003 from 37.8% in fiscal 2002. These increases are primarily due to an increase in the average size of our direct sales force in fiscal 2003 compared to fiscal 2002 due to the addition of sales offices in the United Kingdom and Australia in the second half of fiscal year 2002, and increases in international sales commissions to third parties and certain marketing costs. The increases were partially offset by lower travel and entertainment expenses, conference costs and advertising expenses. The 22.7% increase in fiscal 2002 from fiscal 2001 was primarily due to an increase in the size of our direct sales force, increased commissions associated with the growth in revenues, and higher conference costs. As a percentage of total revenues, sales and marketing expenses decreased to 37.8% in fiscal 2002 from 41.9% in fiscal 2001. This decrease resulted from a proportionally smaller increase in costs associated with developing market awareness for our new products relative to the higher level of revenues in fiscal 2002.

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. General and administrative expenses were \$4.9 million, \$4.7 million, and \$3.4 million in fiscal 2003, 2002, and 2001, respectively. The 5.2% increase in fiscal 2003 from fiscal 2002 is primarily due to higher personnel costs, insurance expense, and software maintenance costs associated with new financial systems. The increase in fiscal 2003 was partially offset by a decrease in professional fees for fiscal 2003 compared to fiscal 2002. The 38.5% increase in fiscal 2002 from fiscal 2001 was primarily due to higher legal, accounting and other professional fees, bad debt expense and personnel costs. The increase in fiscal 2002 was partially offset by a decrease in discretionary bonuses for fiscal 2002 compared to fiscal 2001.

We expect the dollar amount of general and administrative expenses to increase as we continue to expand our operations but generally decrease as a percentage of total revenues in future periods. Our ability to decrease these expenses as a percentage of revenues will depend upon our revenue growth, among other factors.

Purchased In-Process Research and Development. In connection with the NetMaker acquisition, we obtained an independent valuation to determine the fair value of the net assets acquired and to allocate the purchase price. We recorded an expense of \$770,000 in the fourth quarter of fiscal 2001 representing the write-off of the fair value of acquired in-process research and development that had not reached technological feasibility and had no alternative future use.

Interest and Other Income, Net

Interest and other income, net were \$879,000, \$1.7 million, and \$2.8 million in fiscal 2003, 2002 and 2001, respectively. The decrease in each period was primarily due to a reduction in interest income earned on our cash and cash equivalents due to the decline in interest rates throughout the periods.

Provision for Income Taxes

Our effective tax rates were 23%, 23% and 35% for fiscal 2003, 2002 and 2001, respectively. The effective tax rate differs from the statutory tax rate and varies from period to period due principally to the amount of income before taxes from various tax jurisdictions and the amount of tax credits available to us in each period from incremental research expenditures. In fiscal 2002, we conducted a review of our costs to determine their qualification for the increased research tax credit. As a result of this review, we generated an additional \$372,000 in non-recurring tax credits resulting from incremental research expenditures.

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We expect our effective tax rate in the near-term to range from 22% to 30%; however, future provisions for taxes will depend, among other things, on the mix and amount of worldwide income, the tax rates in effect for various tax jurisdictions and the amount of increased research tax credits.

Liquidity and Capital Resources

Since inception, we have funded our operations primarily through cash provided by operating activities and through the sale of equity securities. In August 2000, we completed our initial public offering in which we raised approximately \$54.1 million, net of underwriting discounts and offering expenses payable by us. As of March 31, 2003, we had cash and cash equivalents totaling \$70.3 million.

Cash provided by operating activities was \$8.2 million, \$4.4 million, and \$10.5 million for fiscal 2003, 2002 and 2001, respectively. Cash provided by operating activities is primarily derived from net income, as adjusted for non-cash items such as depreciation and amortization expense and changes in operating assets and liabilities. The increase in cash provided by operations in fiscal 2003 from fiscal 2002 was attributable to a decline in accounts receivable due to the timing of customer payments, a reduction in refundable taxes due to receipt of payments from tax authorities and the fiscal 2003 current tax provision, and an increase in deferred revenue from our software arrangements and growth in our installed customer base. The decrease in cash provided by operations in fiscal 2002 from fiscal 2001 was attributable to a decline in accrued liabilities, resulting from a decrease in accrued bonus compensation, an increase in billed accounts receivable due to our revenue growth, and an increase in refundable income taxes due to non-recurring tax credits for incremental research expenditures.

Cash used in investing activities was \$965,000, \$5.7 million, and \$11.1 million for fiscal 2003, 2002, and 2001, respectively. The funds were used to purchase property and equipment for our corporate headquarters in Bethesda, Maryland and to pay the cash portion of the purchase price of the NetMaker acquisition in March 2001 and the purchase price of the WDM NetDesign acquisition, net of cash acquired, in January 2002.

Cash provided by financing activities was \$778,000, \$913,000, and \$54.4 million for fiscal 2003, 2002, and 2001, respectively. Cash provided by financing activities reflects the proceeds received from the exercise of stock options, the sale of common stock under our 2000 Employee Stock Purchase Plan, the issuance of notes payable in fiscal 2003 and fiscal 2002, and the proceeds received in fiscal 2001 from our initial public offering, net of underwriting discounts and offering expenses.

We have a \$10.0 million credit facility with a commercial bank, which expires in June 2004. Borrowings under this line of credit bear interest at an annual rate equal to LIBOR plus 2% to 2.5%. We have currently used \$3.4 million of this facility for a letter of credit that secures the lease for our headquarters in Bethesda, Maryland. We had no outstanding borrowings under this line of credit facility as of March 31, 2003. See Note 12 to our consolidated financial statements for more information related to our credit facility.

As of March 31, 2003, our contractual commitments include operating leases for office facilities, notes payable in the amount of \$300,000, and a letter of credit in the amount of \$3.4 million. See Notes 11 and 12 to our consolidated financial statements for more information related to our contractual commitments.

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

Recently Issued Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections . SFAS No. 145 requires the classification of gains and losses from extinguishments of debt as extraordinary items only if they meet

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certain criteria for such classification in APB Opinion No. 30, Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions. Any gain or loss on extinguishments of debt classified as an extraordinary item in prior periods that does not meet the criteria must be reclassified to other income or expense. These provisions are effective for fiscal years beginning after May 15, 2002. Additionally, SFAS No. 145 requires sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. These lease provisions are effective for transactions occurring after May 15, 2002. We do not believe that the adoption of SFAS No. 145 will have a material effect on our consolidated financial position, results of operations, or cash flows.

In July 2002, the FASB issued Statement No. 146 (SFAS No. 146), Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 replaces Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. We do not believe that the adoption of SFAS No. 146 will have a material effect on our consolidated financial position, results of operations, or cash flows.

In December 2002, the FASB issued SFAS No. 148 Accounting for Stock-Based Compensation- Transition and Disclosure- an amendment of SFAS No. 123 (SFAS No. 148). In response to a growing number of companies announcing plans to record expenses for the fair value of stock options, this statement amends SFAS No. 123 Accounting for Stock Based Compensation (SFAS No. 123) to provide alternative methods of voluntarily transitioning to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require disclosure of the method used to account for stock-based employee compensation and the effect of the method on reported results in both annual and interim financial statements. We have evaluated the provisions of SFAS No. 148 and will continue to account for stock-based compensation given to employees in accordance with APB No. 25. Under APB No. 25, we recognize compensation expense for fixed stock option grants only when the exercise price is less than the fair market value of the shares on the date of grant. Therefore, the adoption of SFAS No. 148 is not expected to have a material impact on our financial position or results of operations. We have adopted the additional disclosure provisions required by SFAS No. 148 in both our annual and quarterly reporting beginning March 31, 2003.

Critical Accounting Policies

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

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

For our software arrangements, a determination needs to be made for each arrangement regarding whether the percentage-of-completion contract accounting method should be used to recognize revenue or whether revenue can be recognized when the software is delivered and all of the conditions of SOP 97-2, as amended, are met. Contract accounting is required if our services are essential to the arrangement. In many cases, our

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services are essential to the arrangement because they involve customization and enhancements, and our fees are paid in stages based upon the completion of defined service deliverables. As a result, we typically recognize revenue from these arrangements using contract accounting, which generally results in recording revenue over a longer period of time. In other cases, our services are not essential to the arrangement and the realization of our license fee is not dependent on the completion of such services. In these situations, we recognize software license revenue when (1) persuasive evidence of an

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arrangement exists, (2) the product has been delivered, (3) the fee is fixed or determinable, and (4) collectibility is probable, which generally results in recording revenue earlier than when contract accounting is used. The determination of whether our services are essential involves significant judgment and could have a material impact on our results of operations from period to period to the extent that significant new arrangements are not accounted for using contract accounting.

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

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts receivable for estimated losses resulting from the inability of our customers to make required payments and for the limited circumstances when the customer disputes the amounts due us. Our methodology for determining this allowance requires significant estimates. In estimating the allowance, we consider the age of the receivable, the creditworthiness of the customer, the economic conditions of the customer's industry and general economic conditions. While we believe that the estimates we use are reasonable, should any of these factors change, our estimates will also change, which could affect the amount of our future allowance for doubtful accounts as well as future operating income. Specifically, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments to us, additional allowances could be required. As of March 31, 2003, accounts receivable totaled \$6.4 million, net of an allowance for doubtful accounts of \$333,000.

Valuation of Intangible Assets and Goodwill. We account for our goodwill and intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets . Our intangible assets consist of acquired technology related to our acquisition of NetMaker in March 2001 and WDM NetDesign in January 2002. They are recorded at cost and amortized on a straight-line basis over their expected useful lives of five years. We use the projected discounted cash flow method in valuing our acquired technology, using certain assumptions including revenue growth, cost levels, present value discount rate and working capital requirements. While we believe the assumptions used are reasonable, actual results will likely differ from those assumptions. Future cash flows are subject to change for a variety of internal and external factors. We will periodically review the value of acquired technology for reasonableness. Changes in our assumptions at the time of future periodic reviews could result in impairment losses. As of March 31, 2003, intangible assets totaled \$1.6 million, net of accumulated amortization of \$935,000. No impairment losses have been recorded to date.

Goodwill is recorded when the consideration paid for acquisitions exceeds the fair value of net tangible and intangible assets acquired. Goodwill is not amortized. We perform an annual review during our fourth quarter to identify any facts or circumstances that indicate the carrying value of goodwill is impaired. The review is based on various analyses including cash flow and profitability projections and the market capitalization of our common stock. Impairment, if any, is based on the excess of the carrying amount of goodwill over its fair value. As of March 31, 2003, we had goodwill of \$12.2 million. No impairment has been indicated to date.

Accounting for Software Development Costs. Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Development costs are capitalized beginning when a product's technological feasibility has been established and ending when the product is available for general release to our customers. Technological feasibility is reached when the product reaches the working model stage. To date, products and enhancements have generally reached technological feasibility and have been released for sale at substantially the same time and all research and development costs have been expensed. Consequently, no research and development costs were capitalized in fiscal 2003, 2002 and 2001.

Certain Factors That May Affect Future Results

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

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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;

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.

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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

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

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

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 39% and 23% of our total revenues for fiscal 2003 and 2002, respectively. Government sales entail a variety of risks including:

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

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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

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a finding that we overcharged the government, which could result in an adjustment to our previously reported operating results. If a government audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines, and suspension or debarment from doing business with U.S. federal government agencies.

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

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

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

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

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

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

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

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

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

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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.

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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 effectively market and sell our products, or we lose existing distributor relationships, we might not be able to increase our revenues. Our international distributors and original equipment manufacturers and resellers have no obligation to market or purchase our products. In addition, they could partner with our competitors, bundle or resell competitors' products, or internally develop products that compete with our products.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

greater difficulty in accounts receivable collection and longer collection periods;

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

potentially adverse tax consequences;

the effects of currency fluctuations; and

political and economic instability.

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

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

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

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

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

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

diversion of our resources;

injury to our reputation; and

increased support costs.

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

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

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

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

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

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

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

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

be time-consuming to defend;

result in costly litigation;

divert our management's attention and resources;

cause us to cease or delay product shipments; or

require us to enter into royalty or licensing agreements.

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

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adversely affect our business because we would not be able to sell the affected product without redeveloping it or incurring significant additional expense.

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

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

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

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

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

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

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

the transaction involves contingent payment terms or fees;

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

we are required to accept extended payment terms.

Because of the factors listed above and other specific requirements under accounting principles generally accepted in the United States for software revenue recognition, we must have very precise terms in our software arrangements in order to recognize revenue when we initially deliver software or perform services. Negotiation of mutually acceptable terms and conditions can extend the sales cycle, and sometimes we do not obtain terms and conditions that permit revenue recognition at the time of delivery.

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

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

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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 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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PART III

ITEM 14. CONTROLS AND PROCEDURES

We maintain a system of internal controls and procedures that are designed to provide reasonable assurance that information required to be disclosed by us in the reports that we file under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Chief Executive Officer and our Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2003, and have each concluded that, as of the evaluation date, such controls and procedures were effective, in all material respects, to ensure that required information will be disclosed on a timely basis in our reports filed under the Exchange Act.

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

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PART IV

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

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

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

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Independent Auditors' Report	22
Consolidated Balance Sheets as of March 31, 2003 and 2002	23
Consolidated Statements of Operations for the years ended March 31, 2003, 2002, and 2001	24
Consolidated Statements of Cash Flows for the years ended March 31, 2003, 2002, and 2001	25
Consolidated Statements of Changes in Stockholders' Equity for the years ended March 31, 2003, 2002, and 2001	26
Notes to Consolidated Financial Statements	27

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

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on the 19th day of August 2003.

OPNET TECHNOLOGIES, INC.

By:	/s/ Marc A. Cohen <hr/>
	Marc A. Cohen
	Chairman of the Board and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the 19th day of August 2003.

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

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INDEPENDENT AUDITORS REPORT

To the Board of Directors and Stockholders of

OPNET Technologies, Inc.

Bethesda, Maryland

We have audited the accompanying consolidated balance sheets of OPNET Technologies, Inc. and its subsidiaries (the Company) as of March 31, 2003 and 2002, and the related consolidated statements of operations, cash flows, and stockholders' equity for each of the three years in the period ended March 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended March 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 19, the accompanying financial statements have been restated.

DELOITTE & TOUCHE LLP

McLean, Virginia

April 23, 2003, August 18, 2003, as to the effects of the restatement discussed in Note 19

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

(in thousands)

	March 31,	
	2003	2002
	(As restated, see Note 19)	(As restated, see Note 19)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 70,251	\$ 62,240
Accounts receivable, net	6,420	7,403
Unbilled accounts receivable	933	1,331
Refundable income taxes		1,253
Deferred income taxes, prepaid expenses and other current assets	1,412	910
	<u>79,016</u>	<u>73,137</u>
Total current assets	79,016	73,137
Property and equipment, net	7,008	7,670
Intangible assets, net	1,566	2,067
Goodwill	12,212	12,212
Deferred income taxes and other assets	839	231
	<u>\$ 100,641</u>	<u>\$ 95,317</u>
Total assets	\$ 100,641	\$ 95,317
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 215	\$ 544
Accrued liabilities	2,756	2,362
Deferred and accrued income taxes	172	156
Deferred revenue	9,694	8,562
	<u>12,837</u>	<u>11,624</u>
Total current liabilities	12,837	11,624
Notes payable	300	150
Deferred rent	632	381
Deferred revenue	484	506
	<u>14,253</u>	<u>12,661</u>
Total liabilities	14,253	12,661
Commitments and contingencies (note 11)		
Stockholders' equity:		
Preferred stock 5,000 shares authorized; no shares issued and outstanding at March 31, 2003 and 2002		
Common stock 100,000 shares authorized; 25,522 and 25,220 shares issued at March 31, 2003 and 2002, respectively; 19,388 and 19,086 shares outstanding at March 31, 2003 and 2002, respectively	26	25
Additional paid-in capital	73,600	72,655

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Deferred compensation	(59)	(74)
Retained earnings	16,903	14,160
Accumulated other comprehensive income (loss)	18	(10)
Treasury stock 6,134 shares at March 31, 2003 and 2002	(4,100)	(4,100)
	<u> </u>	<u> </u>
Total stockholders' equity	86,388	82,656
	<u> </u>	<u> </u>
Total liabilities and stockholders' equity	\$ 100,641	\$ 95,317
	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements.

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

(in thousands, except per share data)

	Year Ended March 31,		
	2003	2002	2001
	(As restated, see Note 19)	(As restated, see Note 19)	(As restated, see Note 19)
Revenues:			
New software licenses	\$ 22,187	\$ 24,435	\$ 18,476
Software license updates and technical support	12,667	10,384	7,697
Professional services	11,573	9,743	6,592
Total revenues	46,427	44,562	32,765
Cost of revenues:			
New software licenses	829	453	395
Software license updates and technical support	1,710	1,767	900
Professional services	4,637	4,102	3,850
Amortization of acquired technology	504	434	
Total cost of revenues	7,680	6,756	5,145
Gross profit	38,747	37,806	27,620
Operating expenses:			
Research and development	12,909	12,339	8,263
Sales and marketing	18,245	16,866	13,745
General and administrative	4,897	4,655	3,362
Purchased in-process research and development			770
Total operating expenses	36,051	33,860	26,140
Income from operations	2,696	3,946	1,480
Other income (expense):			
Interest income	904	1,797	2,845
Interest expense and other income (expense), net	(25)	(57)	(57)
	879	1,740	2,788
Income before provision for income taxes	3,575	5,686	4,268
Provision for income taxes	832	1,307	1,499

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Net income	\$ 2,743	\$ 4,379	\$ 2,769
Basic net income per common share	\$.14	\$.23	\$.17
Diluted net income per common share	\$.14	\$.22	\$.15

See accompanying notes to consolidated financial statements.

Table of Contents**OPNET TECHNOLOGIES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	Year Ended March 31,		
	2003	2002	2001
	(As restated, see Note 19)	(As restated, see Note 19)	(As restated, see Note 19)
Cash flows from operating activities:			
Net income	\$ 2,743	\$ 4,379	\$ 2,769
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,129	2,020	1,396
Provision for losses on accounts receivable	360	361	25
Deferred income taxes	(752)	455	(399)
In-process research and development			770
Expense related to stock options	97	83	190
Changes in assets and liabilities, net of effects from acquisitions:			
Billed and unbilled accounts receivable	1,021	(3,406)	(2,434)
Loans to employees		231	
Prepaid expenses and other current assets	(369)	1,576	(743)
Refundable income taxes	1,253	(824)	144
Deposits and other assets	(53)	5	(13)
Accounts payable	(329)	30	344
Accrued liabilities	394	(2,198)	3,883
Accrued income taxes	80	(189)	93
Tax benefit from exercise of employee stock options	235	857	238
Deferred revenue	1,110	727	4,251
Deferred rent	251	322	29
Net cash provided by operating activities	8,170	4,429	10,543
Cash flows from investing activities:			
Purchase of property and equipment	(965)	(3,278)	(6,222)
Acquisition of NetMaker division of Make Systems, Inc.		(1,156)	(4,905)
Acquisition of WDM Net Design, net of cash acquired		(1,279)	
Net cash used in investing activities	(965)	(5,713)	(11,127)
Cash flows from financing activities:			
Proceeds from exercise of common stock options	318	384	317
Issuance of common stock under employee stock purchase plan	310	379	67
Proceeds from issuance of note payable	150	150	
Proceeds from sale of common stock			59,800
Costs incurred for initial public offering			(5,732)
Purchase of treasury stock			(12)

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Net cash provided by financing activities	778	913	54,440
Effect of exchange rate changes on cash and cash equivalents	28	(12)	2
Net increase (decrease) in cash and cash equivalents	8,011	(383)	53,858
Cash and cash equivalents, beginning of year	62,240	62,623	8,765
Cash and cash equivalents, end of year	\$ 70,251	\$ 62,240	\$ 62,623

See accompanying notes to consolidated financial statements

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

(in thousands)

	Common Stock				Treasury Stock			Accumulated		Total Stockholders Equity
	Shares Issued	Shares Outstanding	Amount	Additional Paid-In Capital	Shares	Amount	Deferred Compensation	Retained Earnings	Other Comprehensive Income	
								(As restated, see Note 19)		(As restated, see Note 19)
Balance, March 31, 2000 (as previously reported)	17,079	10,951	\$ 17	\$ 623	6,128	\$ (4,010)	\$ (287)	\$ 7,125		\$ 3,468
Prior period adjustments, see Note 19								(107)		(107)
Balance, March 31, 2000 (as restated, see Note 19)	17,079	10,951	17	623	6,128	(4,010)	(287)	7,018		3,361
Net income (as restated, see Note 19)								2,769		2,769
Foreign currency translation									2	2
Total comprehensive income (as restated, see Note 19)										2,771
Proceeds from sale of common stock, net	4,600	4,600	5	54,063						54,068
Conversion of Series A redeemable convertible preferred stock	2,172	2,172	2	6,952						6,954
Issuance of common stock:										
Exercise of options	395	395		317						317
Employee stock purchase plan	5	5		67						67
Acquisition	650	650	1	8,287						8,288
Share options cancelled				(10)			10			
Tax benefit from exercise of stock options				238						238
Purchase of treasury stock		(6)		171	6	(90)				81
Amortization of deferred compensation							97			97
Other								(6)		(6)
Balance, March 31, 2001 (as restated, see Note 19)	24,901	18,767	25	70,708	6,134	(4,100)	(180)	9,781	2	76,236
Net income (as restated, see Note 19)								4,379		4,379
Foreign currency translation									(12)	(12)
Total comprehensive income (as restated, see Note 19)										4,367
Issuance of common stock:										
Exercise of options	261	261		384						384
Employee stock purchase plan	33	33		379						379
Acquisition	25	25		350						350
Share options cancelled				(23)			23			
Tax benefit from exercise of stock options				857						857

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Amortization of deferred compensation							83			83
Balance, March 31, 2002 (as restated, see Note 19)	25,220	19,086	25	72,655	6,134	(4,100)	(74)	14,160	(10)	82,656
Net income (as restated, see Note 19)								2,743		2,743
Foreign currency translation									28	28
Total comprehensive income (as restated, see Note 19)										2,771
Issuance of common stock:										
Exercise of options	259	259	1	318						319
Employee stock purchase plan	43	43		310						310
Tax benefit from exercise of stock options				235						235
Deferred compensation				82			(82)			
Amortization of deferred compensation							97			97
Balance, March 31, 2003 (as restated, see Note 19)	25,522	19,388	\$ 26	\$ 73,600	6,134	\$ (4,100)	\$ (59)	\$ 16,903	\$ 18	\$ 86,388

See accompanying notes to consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

1. Organization and Significant Accounting Policies

Organization. OPNET Technologies, Inc. (OPNET , we or us) provides intelligent network management software that enables users in network operations, planning, engineering and application development to optimize the performance and availability of their networks and networked applications. 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-owned subsidiary in Ghent, Belgium and market our products through our wholly-owned subsidiaries in Paris, France; Reading, United Kingdom; and Sydney, Australia; third-party distributors, and value-added resellers. We are headquartered in Bethesda, MD and have offices in Cary, NC; Dallas, TX; and Santa Clara, CA.

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

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

Cash and Cash Equivalents. Cash equivalents consist of deposits in banks and highly liquid investments with an original maturity of three months or less. These investments are primarily composed of overnight repurchase agreements, money market funds, obligations issued by various federal governmental agencies and commercial paper. Cash equivalents are stated at amortized cost, which approximates fair value due to the highly liquid nature and short maturities of the underlying securities.

Supplemental Cash Flow Information.

Year ended March 31,

2003 2002 2001

Taxes and interest paid:

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Cash paid for income taxes during the year	\$ 514	\$ 987	\$ 1,425
Cash paid for interest	56	45	36
Non-cash financing and investing activities:			
Issuance of common shares for acquisition	\$	\$ 350	\$ 8,288
Conversion of preferred stock			6,954
Accrued tenant allowance			1,058

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

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

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

Software Development Costs. Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

been established. We consider technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility has been established, any additional costs are capitalized in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed. Through March 31, 2003, software development has been substantially completed concurrently with the establishment of technological feasibility and, accordingly, no costs have been capitalized to date.

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

Intangible Assets. Intangible assets consist of acquired technology. Intangible assets are originally recorded at cost and amortized on a straight-line basis over their expected useful lives of five years.

Goodwill. Goodwill is not amortized and is tested for impairment annually during our fourth quarter and whenever events and circumstances occur indicating that goodwill might be impaired. There has been no impairment as of March 31, 2003.

Valuation of Long-Lived Assets. We review our long-lived assets, including property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be fully recoverable. If the total of the expected undiscounted future net cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between the fair value and carrying amount of the asset.

Revenue Recognition. We derive revenues from three primary sources: (1) new software licenses, (2) software license updates and technical support, and (3) professional services, which include consulting and training services. We recognize revenue based on the provisions of the American Institute of Certified Public Accountants Statement of Position (SOP) No. 97-2, Software Revenue Recognition , as amended by SOP No. 98-9, Modification of SOP No. 97-2, Software Revenue Recognition, With Respect to Certain Transactions , SOP No. 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts and the Securities and Exchange Commission Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements.

New software license revenues represent all fees earned from granting customers licenses to use our software, and excludes revenues derived from software license updates, which are included in software license updates and technical support revenues. Our new software license revenues consist of perpetual and term license sales of software products. New software license revenues are recognized when these criteria are met: persuasive evidence of an arrangement exists, delivery and acceptance of the software has occurred, the software license fee is fixed or determinable, and collectibility is probable. In instances when any of the four criteria are not met, we defer recognition of software license revenues until the criteria are met. When the sale of the software product requires us to make significant enhancements, customization or

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modifications to the software that are essential to its functionality, software license revenues and consulting fees are recognized using contract accounting under SOP 81-1.

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

Software license updates and technical support revenues represent fees associated with the sale of periodic unspecified product updates (license updates) and technical support under our maintenance agreements. License updates consist of the right to unspecified software updates on a when-and-if-available basis and are entered into in connection with the initial software license purchase. License updates and technical support may be renewed upon expiration of the term. Customers can purchase license updates separately from technical support. Revenue from

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

license updates and technical support is deferred and recognized as revenue on a straight-line basis over the term of the maintenance agreement.

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

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

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

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

Advertising Costs. Advertising costs are expensed as incurred and were \$316, \$401, and \$587 for the fiscal years ended March 31, 2003, 2002 and 2001, respectively.

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

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

Comprehensive Income. Certain revenues, expenses, gains and losses are recognized in comprehensive income but excluded from net income. For fiscal year 2003, 2002 and 2001 comprehensive income includes net income and gains and losses from foreign currency translations.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

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

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

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

The following table illustrates the effect on net income and related net income per share for fiscal years ended March 31, 2003, 2002 and 2001, had compensation cost for employee stock-based compensation plans been determined based upon the fair value method prescribed under SFAS No. 123:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Net income	\$ 2,743	\$ 4,379	\$ 2,769
	49	83	97

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Add: Stock-based employee compensation expense included in reported net income, net of related tax effects

Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects

	(3,743)	(3,035)	(1,187)
Pro forma net income (loss)	\$ (951)	\$ 1,427	\$ 1,679
Basic net income (loss) per common share:			
As reported	\$.14	\$.23	\$.17
Pro forma	\$ (.05)	\$.08	\$.10
Diluted net income (loss) per common share:			
As reported	\$.14	\$.22	\$.15
Pro forma	\$ (.05)	\$.07	\$.09

Reclassifications. Revenues and costs associated with the sale of license updates and technical support have been combined and presented as Software license updates and technical support in the accompanying consolidated statements of operations. License updates revenues of \$8,155 and \$1,863 for the fiscal years ended March 31, 2003 and 2002, respectively, were reclassified from license revenues to software license updates and technical support revenues. Cost of license updates revenues of \$71 and \$6 for the fiscal years ended March 31, 2003 and 2002, respectively, were reclassified from cost of license revenues to cost of software license updates and technical support revenues. Technical support revenues of \$4,512, \$8,521, and \$7,697 for fiscal years ended March 31, 2003, 2002, and 2001, respectively, were reclassified from services revenues to software license updates and technical support revenues. Cost of technical support revenues of \$1,639, \$1,761, and \$900 for fiscal years ended March 31, 2003, 2002, and 2001, respectively, were reclassified from cost of services revenues to cost of software license updates and technical support revenues. These reclassifications had no impact on total revenues, net income or net income per common share in any period.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Certain other reclassifications have been made to the prior-year financial statements to conform to the current-year presentation.

Recently Issued Accounting Pronouncements. In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections . SFAS No. 145 requires the classification of gains and losses from extinguishments of debt as extraordinary items only if they meet certain criteria for such classification in APB Opinion No. 30, Reporting the Results of Operations, Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions. Any gain or loss on extinguishments of debt classified as an extraordinary item in prior periods that does not meet the criteria must be reclassified to other income or expense. These provisions are effective for fiscal years beginning after May 15, 2002. Additionally, SFAS No. 145 requires sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. These lease provisions are effective for transactions occurring after May 15, 2002. We do not believe that the adoption of SFAS No. 145 will have a material effect on our consolidated financial position, results of operations, or cash flows.

In July 2002, the FASB issued Statement No. 146 (SFAS No. 146), Accounting for Costs Associated with Exit or Disposal Activities . SFAS No. 146 replaces Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. SFAS No. 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. We do not believe that the adoption of SFAS No. 146 will have a material effect on our consolidated financial position, results of operations, or cash flows.

In December 2002, the FASB issued SFAS No. 148 Accounting for Stock-Based Compensation- Transition and Disclosure- an amendment of SFAS No. 123 (SFAS No. 148). In response to a growing number of companies announcing plans to record expenses for the fair value of stock options, this statement amends SFAS No. 123 Accounting for Stock Based Compensation (SFAS No. 123) to provide alternative methods of voluntarily transitioning to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require disclosure of the method used to account for stock-based employee compensation and the effect of the method on reported results in both annual and interim financial statements. We have evaluated the provisions of SFAS No. 148 and will continue to account for stock-based compensation given to employees in accordance with APB No. 25. Under APB No. 25, we recognize compensation expense for fixed stock option grants only when the exercise price is less than the fair market value of the shares on the date of grant. Therefore, the adoption of SFAS No. 148 is not expected to have a material impact on our financial position or results of operations. We have adopted the additional disclosure provisions required by SFAS No. 148 in both our annual and quarterly reporting beginning March 31, 2003.

2. Acquisitions

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NetMaker. In March 2001, OPNET Development Corp., our wholly-owned subsidiary, acquired substantially all of the assets and operations of the NetMaker division of Make Systems, Inc. (NetMaker), pursuant to an Asset Purchase Agreement (the Asset Purchase Agreement).

The aggregate purchase price for the acquisition was approximately \$14,200 and, pursuant to the Asset Purchase Agreement, we agreed to pay \$5,000 and issued 650 shares of our common stock, valued at \$8,288 in exchange for NetMaker s assets. The value of the 650 shares of common stock was based on the average market price of our common stock over the two-day period before and after the announcement date of the acquisition. The cash component of the acquisition price was available from cash on hand. Of the cash payable pursuant to the Asset Purchase Agreement, \$800 was held in escrow for a period of one year to secure certain indemnification obligations, and was released to Make Systems, Inc. on April 1, 2002.

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The acquisition was accounted for by the purchase method of accounting and, accordingly, the results of operations have been included in our consolidated results from the acquisition date. The assets acquired and liabilities assumed as part of the transaction were recorded at estimated fair values. Independent valuations were obtained to determine the fair value of the net assets acquired and to allocate the purchase price. The purchase price allocation resulted in a \$770 charge to earnings for the fair value of acquired in-process research and development that had not reached technological feasibility, \$2,000 for acquired technology, which is being amortized over five years and \$725 in net tangible assets acquired. The \$10,704 excess purchase price over the fair value of assets acquired was allocated to goodwill, which is deductible for tax purposes. We withheld \$210 of the purchase price to provide for adjustments, if any, related to the completion of the closing balance sheet audit. During the year ended March 31, 2002, goodwill was adjusted by approximately \$217 for modifications to initial purchase accounting estimates in relation to the NetMaker acquisition.

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

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

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

We accounted for our initial investment in WDM NetDesign using the equity method. The purchase of the remaining shares of WDM NetDesign was accounted for by the purchase method of accounting and, accordingly, the results of operations have been included in our consolidated results from the January 2002 acquisition date. The purchase price allocation resulted in \$500 for acquired technology, which is being amortized over five years and \$182 in net tangible assets acquired. The \$1,291 excess purchase price over the fair value of assets acquired was allocated to

goodwill, which is not deductible for tax purposes.

Pro Forma Financial Information. The following unaudited pro forma financial information for the years ended March 31, 2002 and 2001, assumes the acquisitions of the NetMaker division and WDM NetDesign occurred as of the beginning of the respective year, after giving effect to certain adjustments, including the amortization of intangible assets. Further, the pro forma results of operations do not include the write-off of in-process research and development and the related tax effects. The effects of the combined pro forma statements resulted in a net loss before income taxes and as a result, pro forma net loss excludes any provision or benefit for income taxes. The unaudited pro forma financial information includes the NetMaker division's results of operations as presented in NetMaker's Statements of Net Revenues and Direct Operating Expenses for the year ended December 31, 2000 and 1999, and WDM NetDesign's

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results of operations for the nine months ended March 31, 2002, as WDM NetDesign commenced operations in July 2001. The financial statements for the NetMaker division exclude certain expenses not directly attributable to the NetMaker division and therefore do not represent a full financial statement presentation of the NetMaker division and are not necessarily indicative of the operating results had the NetMaker division operated on a standalone basis. The pro forma results have been prepared for comparative purposes only and are not necessarily indicative of the results of operations that may occur in the future, or that would have occurred if the business combinations had been in effect on the dates indicated.

	<u>2002</u>	<u>2001</u>
Revenues	\$ 44,657	\$ 34,585
Net income (loss)	4,320	(291)
Basic net income (loss) per share	\$.23	\$ (.02)
Diluted net income (loss) per share	\$.22	\$ (.02)

3. Intangible Assets

Intangible assets consisted of the following at March 31, 2003 and 2002:

	<u>2003</u>	<u>2002</u>
Acquired technology	\$ 2,501	\$ 2,501
Accumulated amortization	(935)	(434)
Intangible assets, net	<u>\$ 1,566</u>	<u>\$ 2,067</u>

Acquired technologies relating to the NetMaker and WDM NetDesign acquisitions resulted in amortization expense of \$504 and \$434 for the years ended March 31, 2003 and 2002, respectively. Amortization expense from acquired technologies is included in cost of revenues in the Consolidated Statements of Operations. During the year ended March 31, 2001, we recorded amortization expense of \$458 relating to a marketing support rights agreement that expired in March 2001. The amortization of the marketing support rights agreements is included in Sales and Marketing expense on the Consolidated Statements of Operations. We expect amortization expense of \$500 in each of the fiscal years ending March 31, 2004, 2005 and 2006, and \$66 for the year ending March 31, 2007.

4. Goodwill

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The following table sets forth the activity in our goodwill for the years ended March 31, 2003 and 2002:

	<u>2003</u>	<u>2002</u>
Balance, beginning of period	\$ 12,212	\$ 10,704
Adjustment to initial goodwill estimate		217
Goodwill acquired during the year		1,291
	<u> </u>	<u> </u>
Balance, end of period	\$ 12,212	\$ 12,212
	<u> </u>	<u> </u>

Goodwill was recorded in connection with the NetMaker and WDM NetDesign acquisitions. See Note 2 for more information.

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****5. Property and Equipment**

Property and equipment consisted of the following at March 31, 2003 and 2002:

	2003	2002
	<u> </u>	<u> </u>
Computer equipment	\$ 5,446	\$ 4,869
Leasehold improvements	4,122	4,071
Purchased software	1,348	1,013
Office furniture and equipment	1,661	1,641
	<u> </u>	<u> </u>
Total	12,577	11,594
Less: accumulated depreciation	(5,569)	(3,924)
	<u> </u>	<u> </u>
Property and equipment, net	<u>\$ 7,008</u>	<u>\$ 7,670</u>

Depreciation expense for fiscal years ended March 31, 2003, 2002, and 2001 was \$1,625, \$1,586, and \$1,065, respectively.

6. Accrued Liabilities

Accrued liabilities consisted of the following at March 31, 2003 and 2002:

	2003	2002
	<u> </u>	<u> </u>
Accrued compensation and bonuses	\$ 1,590	\$ 1,269
Other	1,166	1,093
	<u> </u>	<u> </u>
Total	<u>\$ 2,756</u>	<u>\$ 2,362</u>

7. Income Taxes

The components of the provision for income taxes for the years ended March 31, 2003, 2002 and 2001, were as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Current provision:			
Federal	\$ 1,227	\$ 600	\$ 1,345
State	284	188	553
Foreign	73	64	
	<u>1,584</u>	<u>852</u>	<u>1,898</u>
Deferred provision (benefit):			
Federal	(667)	337	(301)
State	(85)	118	(98)
	<u>(752)</u>	<u>455</u>	<u>(399)</u>
Total provision for income taxes	<u>\$ 832</u>	<u>\$ 1,307</u>	<u>\$ 1,499</u>

At March 31, 2003 and 2002, respectively, the components of our deferred tax assets and deferred tax liabilities were as follows:

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	<u>2003</u>	<u>2002</u>
Deferred tax assets:		
Accrued vacation expense	\$ 260	\$ 190
Deferred revenue	321	205
In-process research and development	252	285
Deferred rent	239	151
Research and development tax credit carry forward	516	419
Accelerated book amortization of acquired technology	201	
Bad debt reserve	126	81
Other temporary differences	7	87
	<u>1,922</u>	<u>1,418</u>
Deferred tax liabilities:		
Accelerated amortization		(106)
Accelerated depreciation	(317)	(337)
Tax amortization of goodwill	(550)	(422)
Tax liability related to WDM NetDesign acquisition (see Note 2)	(148)	(201)
Tax accounting for unbilled accounts receivable	(260)	(478)
	<u>(1,275)</u>	<u>(1,544)</u>
Net deferred tax (liability) asset	<u>\$ 647</u>	<u>\$ (126)</u>

The provision for income taxes for fiscal years ended March 31, 2003, 2002 and 2001 differs from the amount computed by applying the statutory U.S. Federal income tax rate to income before taxes as a result of the following:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Statutory U.S. Federal rate	34%	34%	34%
Increase (decrease) in taxes resulting from:			
State income taxes net of Federal benefit	4	4	7
Tax credits	(15)	(16)	(8)
Foreign tax credit and other permanent differences, net		1	2
	<u>23%</u>	<u>23%</u>	<u>35%</u>

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At March 31, 2003, we had a research and development tax credit carry forward of approximately \$516 which will expire in the year 2023. Cumulative undistributed earnings of foreign subsidiaries, for which no U.S. income or foreign withholding taxes have been recorded, approximated \$257 at March 31, 2003. Such earnings are expected to be reinvested indefinitely. Determination of the amount of unrecognized deferred tax liability with respect to such earnings is not practicable. The additional taxes on the earnings of foreign subsidiaries, if remitted, would be partially offset by U.S. tax credits for foreign taxes already paid. While there are no specific plans to distribute the undistributed earnings in the immediate future, where economically appropriate to do so, such earnings may be remitted.

8. Initial Public Offering

On August 1, 2000, the registration statement for our initial public offering of 4,000 shares of Common Stock became effective. The offering closed on August 7, 2000, yielding proceeds of approximately \$46,814 after deducting underwriting discounts and commissions and offering expenses payable by us. The underwriters of the offering also exercised their over-allotment option to purchase an additional 600 shares, which closed on August 9, 2000, raising an

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additional \$7,254 in net proceeds. Upon the closing of the offering, the Series A Redeemable Convertible Preferred Stock was converted into 2,172 shares of Common Stock as discussed in Note 9.

On June 27, 2000, in connection with our initial public offering of common stock, the Board of Directors approved a three-for-two split of common stock. All references to the number of common shares and per share amounts have been restated to reflect the effect of the split for all periods presented.

On July 28, 2000, we filed our Second Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware to increase our authorized capital stock to 105,160 shares, consisting of 100,000 shares of Common Stock, par value \$0.001 per share, 5,000 shares of undesignated preferred stock, par value of \$0.001 per share and 160 shares of Series A redeemable convertible preferred stock, par value of \$0.001 per share.

On August 7, 2000, we filed our Third Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware to adjust our authorized capital stock to 105,000 shares, consisting of 100,000 shares of Common Stock, par value \$0.001 per share and 5,000 shares of undesignated preferred stock, par value of \$0.001 per share.

9. Redeemable Convertible Preferred Stock

On September 30, 1997, we entered into a Series A Redeemable Convertible Preferred Stock Purchase Agreement (the Agreement) with two investors. We authorized 160 shares of the Series A Redeemable Convertible Preferred Stock (the Series A Preferred Stock) and issued and sold 145 shares, \$.001 par value per share, for \$7,001. Upon closing of our initial public offering as disclosed in Note 8, the Series A Preferred Stock, net of unamortized issue costs of \$47, was automatically converted into common stock.

The difference between the carrying amounts of the Series A Preferred Stock and the redemption amount represented the cost of issuance. This amount was accreted pro rata over the period beginning on the issuance date and ending on the prescribed redemption dates. Accretion amounted to \$6 for the year ended March 31, 2001.

10. Related Party Transactions

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We sell consulting services to certain customers through OPNET Analysis, Inc., which was wholly-owned by one of our executive officers. Such sales totaled \$94 during fiscal year 2001. OPNET Analysis, Inc. became a wholly-owned subsidiary of ours in April 2001 and is included in our consolidated financial statements for fiscal year 2002.

In January 2000 we amended an officer's option agreement that allowed him to purchase 150 shares of our common stock. He exercised the options in full on the date of the amendment and borrowed \$231 from us to pay income taxes he incurred upon purchasing the shares under the option agreement. This borrowing was evidenced by a full recourse promissory note that bore an annual interest rate of 6%. This loan and related accrued interest was repaid in May 2001.

11. Commitments and Contingencies

On June 2, 2000, we executed a new office lease agreement and relocated our corporate and principal operational offices to Bethesda, Maryland. We took possession of the premises, consisting of approximately 60,000 square feet of office space, in February 2001. The lease is for ten years with two five-year renewal options. The rent is subject to escalation based upon a consumer price indexed adjustment of up to 3% each year. The lease also requires us to maintain a security deposit of approximately \$3,400 in the form of a bank letter of credit, as discussed in Note 12, which is subject to annual reductions based upon meeting certain minimum financial requirements.

In addition, we lease office space under noncancelable operating leases. The leases for office space contain escalation clauses that provide for increased rentals based primarily on increases in real estate taxes, operating expenses, or the average consumer price index. Total rent expense under all leases for fiscal years 2003, 2002, and 2001 was

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\$3,201, \$3,068, and \$1,182, respectively. At March 31, 2003, future minimum lease payments required under noncancelable leases were as follows:

<u>Year ending March 31,</u>	
2004	\$ 2,675
2005	2,846
2006	2,830
2007	2,894
2008	2,963
Thereafter	8,387
	<hr/>
Total minimum lease payments	\$ 22,595

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

12. Credit Agreements and Notes Payable

Effective June 10, 2002, we entered into a \$10,000 credit facility with a commercial bank. The credit facility permits the use of funds for general corporate purposes and the issuance of letters of credit up to a maximum of \$10,000 in the aggregate. Borrowings under the credit facility are limited to 80% of eligible accounts receivable. We used the facility to issue a letter of credit for approximately \$3,400 to satisfy the security deposit requirements for our corporate office lease. Interest is payable monthly, based on LIBOR plus the applicable margin ranging from 2% to 2.5% as stated in the loan agreement. The credit facility includes a fee in the amount of 0.25% per annum on the unused portion of the credit facility. The credit facility is collateralized by our accounts receivable. The loan agreement contains customary affirmative and negative covenants including a restriction on the payment of dividends and a financial covenant requiring that we not exceed a ratio of Funded Debt to EBITDA of 2.5:1.0 as such terms are defined in the loan agreement. The credit facility expires June 10, 2004. As of March 31, 2003, we had no borrowings under the available credit facility.

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

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

13. Employee Benefit Plan

Effective August 1, 1993, we established a 401(k) retirement plan (the Plan) covering all eligible employees, as defined. Eligible employees who are at least 21 years old may participate. Under the terms of the Plan, participants may defer a portion of their salaries as employee contributions. We make matching contributions and may make discretionary and extra contributions. Employee contributions and extra contributions made by us are 100% vested immediately. In general, our matching and discretionary contributions vest ratably over a five-year period. Our expense under this Plan for fiscal years ended March 31, 2003, 2002 and 2001 was \$567, \$549, and \$386, respectively.

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The following is a reconciliation of the amounts used in calculating basic and diluted net income per common share for fiscal years ended March 31, 2003, 2002 and 2001:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Income (Numerator):			
Net income applicable to common shares	\$ 2,743	\$ 4,379	\$ 2,763
Plus:			
Accretion of transaction costs on redeemable convertible preferred stock			6
Net income (basic and diluted)	\$ 2,743	\$ 4,379	\$ 2,769
Shares (Denominator):			
Weighted average shares outstanding	19,273	18,953	15,673
Plus:			
Participating redeemable convertible preferred stock			767
Weighted average shares outstanding (basic)	19,273	18,953	16,440
Plus:			
Effect of other dilutive securities Options	701	1,061	1,537
Weighted average shares outstanding (diluted)	19,974	20,014	17,977
Net income per common share:			
Basic net income per common share	\$.14	\$.23	\$.17
Diluted net income per common share	\$.14	\$.22	\$.15

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

15. Equity Based Compensation Plans

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

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

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A summary of option transactions is as follows:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Outstanding, March 31, 2000	1,765	\$ 1.32
Granted	1,228	13.43
Exercised	(395)	0.80
Canceled	(138)	6.26
	<u>2,460</u>	<u>7.18</u>
Outstanding, March 31, 2001	2,460	7.18
Granted	1,655	10.73
Exercised	(261)	1.47
Canceled	(441)	9.79
	<u>3,413</u>	<u>9.00</u>
Outstanding, March 31, 2002	3,413	9.00
Granted	1,033	6.04
Exercised	(259)	1.23
Canceled	(204)	10.32
	<u>3,983</u>	<u>8.67</u>
Outstanding, March 31, 2003	3,983	8.67
	<u>1,262</u>	<u>8.22</u>
Exercisable, March 31, 2003	1,262	8.22

At March 31, 2003, options outstanding and exercisable were as follows:

<u>Options Outstanding</u>				<u>Options Exercisable</u>	
<u>Exercise Price</u>	<u>Shares</u>	<u>Weighted</u>	<u>Weighted</u>	<u>Shares</u>	<u>Weighted</u>
<u>Range</u>		<u>Average</u>	<u>Average</u>		<u>Average</u>
		<u>Life Remaining</u>	<u>Exercise</u>		<u>Exercise</u>

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			Price		Price
\$ 0.36	135	1.2 years	\$ 0.36	51	\$ 0.36
1.47 - 2.00	488	2.8 years	1.79	409	1.74
4.00 - 5.85	1,075	9.2 years	5.71	60	4.83
6.71 - 9.66	281	8.9 years	8.20	90	8.32
10.59 - 14.63	1,835	7.9 years	11.93	568	12.26
19.50	169	7.5 years	19.50	84	19.50
	3,983			1,262	

The weighted average fair value at date of grant for options granted during fiscal years 2003, 2002 and 2001 was \$4.17, \$7.86, and \$9.40 per share, respectively. The weighted average assumptions are follows:

	2003	2002	2001
Risk-free interest rate	3.35%	4.59%	5.95%
Expected dividend yield	0.00%	0.00%	0.00%
Expected life	4 years	4 years	4 years
Volatility factor	98 %	105%	92 %

During the fiscal year ended March 31, 2001, a non-employee of the Company rescinded his exercise of 6 nonqualified stock options. We agreed to reacquire the shares previously issued under the option exercise and granted 6 new options at the same exercise price with a weighted average fair value of \$80. Under Topic No. D-93, Accounting for the Rescission of the Exercise of Employee Stock Options, for rescission transactions prior to January 1, 2001 we may account for the rescission transaction as a modification of the original options resulting in a new measurement date.

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As a result, we recorded additional compensation cost of \$93. We recognized the additional compensation cost on the date of the rescission.

At various dates during the year ended March 31, 2000, we granted a total of 260 options to employees with exercise prices below the estimated fair market value at the dates of grant. The weighted average exercise price of these options was \$2.57. We recorded compensation expense relating to those options of \$49, \$83 and \$107 for the year ended March 31, 2003, 2002 and 2001.

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

Employee Stock Purchase Plan. During fiscal year 2001, the Board of Directors approved the adoption of the 2000 Employee Stock Purchase Plan (the ESPP), which provides all eligible employees, including members of the Board of Directors who are employees, to collectively purchase up to a total of 300 shares of our common stock. An employee may authorize a payroll deduction up to a maximum of 10% of his or her compensation during the plan period. The purchase price for each share purchased is the lesser of 85% of the closing price of the common stock on the first or last day of the plan period. A total of 43, 33 and 5 shares of our common stock were issued under the ESPP in fiscal year ended March 31, 2003, 2002 and 2001, respectively.

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

16. Business Segment and Geographic Area Information

We operate in one industry segment, the development and sale of computer software programs and related services. For the years ended March 31, 2003 and 2002 revenues from transactions with U.S. government agencies were approximately 39% and 23% of total revenues, respectively. No single customer accounted for 10% or more of revenues for fiscal 2001. In addition, there were no sales to any customers within a single country except for the United States where such sales accounted for 10% or more of total revenues. Our assets were primarily held in the United States for the fiscal years ended March 31, 2003, 2002 or 2001.

Revenues by geographic destination and as a percentage of total revenues for fiscal years ended March 31, 2003, 2002 and 2001 are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Geographic Area by Destination			
United States	\$ 37,513	\$ 35,392	\$ 25,387
International	8,914	9,170	7,378
	<u>\$ 46,427</u>	<u>\$ 44,562</u>	<u>\$ 32,765</u>
	<u>2003</u>	<u>2002</u>	<u>2001</u>
Geographic Area by Destination			
United States	80.8%	79.4%	77.5%
International	19.2	20.6	22.5
	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Table of Contents**OPNET TECHNOLOGIES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(dollar and share amounts in thousands, except per share data)****17. Valuation and Qualifying Accounts**

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

	Balance at			Balance at
	Beginning	Charges to		End of
	of Period	Expenses	Deductions	Period
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Year ended,				
March 31, 2003	\$ 203	\$ 360	\$ 230	\$ 333
March 31, 2002	113	361	271	203
March 31, 2001				