

OPNET TECHNOLOGIES INC
Form 10-Q
February 07, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended December 31, 2005

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 incorporation or organization)

7372
(Primary Standard Industrial
Classification Code Number)

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

7255 Woodmont Avenue

Bethesda, MD 20814

(Address of principal executive office)

(240) 497-3000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer or large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of shares of the registrant's Common Stock outstanding on February 2, 2006 was 20,085,122.

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

| | December 31, 2005 | March 31, 2005 |
|---|------------------------------|---------------------------|
| | <u> </u> | <u> </u> |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 57,423 | \$ 38,171 |
| Marketable securities | 25,568 | 44,014 |
| Accounts receivable, net of \$180 in allowance for doubtful accounts at December 31, and March 31, 2005, respectively | 12,590 | 13,480 |
| Unbilled accounts receivable | 3,534 | 2,341 |
| Deferred income taxes, prepaid expenses and other current assets | 3,172 | 3,729 |
| | <u> </u> | <u> </u> |
| Total current assets | 102,287 | 101,735 |
| Property and equipment, net | 5,948 | 6,227 |
| Intangible assets, net | 704 | 1,279 |
| Goodwill | 14,639 | 14,639 |
| Deferred income taxes and other assets | 2,070 | 1,306 |
| | <u> </u> | <u> </u> |
| Total assets | \$ 125,648 | \$ 125,186 |
| | <u> </u> | <u> </u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,453 | \$ 828 |
| Accrued liabilities | 7,478 | 6,874 |
| Deferred and accrued income taxes | 245 | 380 |
| Deferred rent | 67 | |
| Deferred revenue | 16,115 | 14,824 |
| | <u> </u> | <u> </u> |
| Total current liabilities | 25,358 | 22,906 |
| Notes payable | 150 | 150 |
| Deferred rent | 1,065 | 1,107 |
| Deferred revenue | 727 | 1,058 |
| | <u> </u> | <u> </u> |
| Total liabilities | 27,300 | 25,221 |
| | <u> </u> | <u> </u> |
| Commitments and contingencies (Note 7) | | |

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Stockholders' equity:

| | | |
|---|-------------------|-------------------|
| Common stock—par value \$0.001; 100,000 authorized; 26,544 and 26,443 shares issued at December 31 and March 31, 2005, respectively; 20,060 and 20,309 shares outstanding at December 31 and March 31, 2005, respectively | 27 | 26 |
| Additional paid-in capital | 80,026 | 79,421 |
| Deferred compensation | | (15) |
| Retained earnings | 25,865 | 24,713 |
| Accumulated other comprehensive loss | (415) | (80) |
| Treasury stock, at cost 6,483 and 6,134 shares at December 31 and March 31, 2005, Respectively | (7,155) | (4,100) |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 98,348 | 99,965 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 125,648 | \$ 125,186 |
| | <u> </u> | <u> </u> |

See accompanying notes to condensed consolidated financial statements.

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

(in thousands, except per share data)

(unaudited)

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|---------------|-----------------------------------|-----------------|
| | 2005 | 2004 | 2005 | 2004 |
| Revenue: | | | | |
| New software licenses | \$ 8,436 | \$ 7,793 | \$ 22,646 | \$ 21,578 |
| Software license updates and technical support | 6,198 | 4,998 | 17,922 | 14,617 |
| Professional services | 5,464 | 3,272 | 14,271 | 10,869 |
| Total revenue | 20,098 | 16,063 | 54,839 | 47,064 |
| Cost of revenue: | | | | |
| New software licenses | 184 | 202 | 546 | 578 |
| Software license updates and technical support | 639 | 597 | 1,932 | 1,734 |
| Professional services | 3,517 | 2,367 | 9,961 | 7,128 |
| Amortization of acquired technology | 192 | 192 | 575 | 460 |
| Total cost of revenue | 4,532 | 3,358 | 13,014 | 9,900 |
| Gross profit | 15,566 | 12,705 | 41,825 | 37,164 |
| Operating expenses: | | | | |
| Research and development | 4,608 | 3,780 | 13,796 | 10,836 |
| Sales and marketing | 6,813 | 5,867 | 18,989 | 16,568 |
| General and administrative | 3,826 | 2,475 | 9,867 | 5,865 |
| Total operating expenses | 15,247 | 12,122 | 42,652 | 33,269 |
| Income (loss) from operations | 319 | 583 | (827) | 3,895 |
| Interest and other income, net | 746 | 326 | 1,873 | 787 |
| Income before provision for income taxes | 1,065 | 909 | 1,046 | 4,682 |
| (Benefit) provision for income taxes | (101) | 740 | (106) | 1,979 |
| Net income | \$ 1,166 | \$ 169 | \$ 1,152 | \$ 2,703 |
| Basic net income per common share | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |
| Diluted net income per common share | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |
| Basic weighted average common shares outstanding | 20,229 | 20,168 | 20,345 | 20,129 |

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| | | | | |
|--|--------|--------|--------|--------|
| Diluted weighted average common shares outstanding | 20,523 | 20,758 | 20,607 | 20,626 |
|--|--------|--------|--------|--------|

See accompanying notes to condensed consolidated financial statements.

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

| | Nine Months Ended December 31, | |
|--|---|----------------|
| | 2005 | 2004 |
| Cash flows from operating activities: | | |
| Net income | \$ 1,152 | \$ 2,703 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,770 | 1,640 |
| Deferred income taxes | 699 | 451 |
| Non-cash stock option compensation expense | 12 | 2 |
| Loss on disposition of fixed assets | 2 | |
| Changes in assets and liabilities: | | |
| Accounts receivable | (303) | (3,486) |
| Prepaid expenses and other current assets | (326) | (618) |
| Other assets | (580) | (240) |
| Accounts payable | 625 | (370) |
| Accrued liabilities | 604 | (724) |
| Accrued income taxes | (135) | 25 |
| Tax benefit from exercise of stock options | (13) | |
| Deferred revenue | 960 | 2,982 |
| Deferred rent | 25 | 107 |
| Net cash provided by operating activities | 4,492 | 2,472 |
| Cash flows from investing activities: | | |
| Acquisition of Altaworks | | (3,431) |
| Purchase of property and equipment | (918) | (810) |
| Purchase of investments | (22,922) | (40,759) |
| Proceeds from sale/maturity of investments | 41,412 | 43,120 |
| Net cash provided by (used in) investing activities | 17,572 | (1,880) |
| Cash flows from financing activities: | | |
| Acquisition of treasury stock | (3,055) | |
| Proceeds from exercise of common stock options | 125 | 487 |
| Proceeds from issuance of common stock under employee stock purchase plan | 497 | 364 |
| Net cash (used in) provided by financing activities | (2,433) | 851 |
| Effect of exchange rate changes on cash and cash equivalents | (379) | 94 |
| Net increase in cash and cash equivalents | 19,252 | 1,537 |
| Cash and cash equivalents, beginning of period | 38,171 | 41,492 |

| | | |
|--|------------------|------------------|
| Cash and cash equivalents, end of period | <u>\$ 57,423</u> | <u>\$ 43,029</u> |
|--|------------------|------------------|

See accompanying notes to condensed consolidated financial statements.

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OPNET TECHNOLOGIES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except per share data)

(unaudited)

1. Organization and Significant Accounting Policies

Organization. OPNET Technologies, Inc., or OPNET is a provider of management software for networks and applications. Our solutions address: application performance management, network configuration management, capacity planning, and network research and development. OPNET differentiates itself from traditional management providers by focusing on analytics. Traditional management tools emphasize monitoring and reporting, which are inherently reactive processes. In contrast, OPNET focuses on algorithms and modeling to rapidly troubleshoot and resolve performance problems; and, even more importantly, to proactively prevent problems from occurring. 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, as well as through an original equipment manufacturer agreement with Cisco Systems, Inc. and, to a lesser extent, several resellers and other original equipment manufacturers. Internationally, we conduct research and development through our wholly-controlled subsidiary in Ghent, Belgium and market our products through our wholly-owned subsidiaries in Paris, France; Frankfurt, Germany; Slough, United Kingdom; and Sydney, Australia; third-party distributors; and value-added resellers. OPNET is headquartered in Bethesda, Maryland and has offices in Cary, North Carolina; Dallas, Texas; Santa Clara, California and Nashua, New Hampshire.

The accompanying condensed consolidated financial statements include our results and the results of our wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The interim condensed consolidated financial statements included herein are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, and applicable rules and regulations of the Securities and Exchange Commission, or SEC regarding interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes thereto contained in the Company's Annual Report on Form 10-K, for the year ended March 31, 2005, filed with the SEC. The March 31, 2005 condensed consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures including notes required by GAAP. In the opinion of management, these interim condensed consolidated financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly our results for the interim periods. The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities as of the date of the financial statements, as well as the reported amount of revenue and expenses during the reporting periods. Actual results could differ from those estimates. In addition, our operating results for the three and nine months ended December 31, 2005 may not be indicative of the operating results for the full fiscal year or any other future period.

Stock-Based Compensation. The Company accounts for stock-based compensation given to employees using the intrinsic value method in accordance with Accounting Principles Board, or APB Opinion No. 25, Accounting for Stock Issued to Employees, and accordingly, recognizes compensation expense for fixed stock option grants when the exercise price is less than the quoted market price of the shares on the date of the grant. SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, permits the use of either a fair-value based method or the intrinsic value method provided in APB No. 25 to account for employee stock-based compensation arrangements. Companies that elect to use the intrinsic value method provided in APB No. 25 are required to disclose the pro forma net income (loss) and earnings (loss) per share that would have resulted from the use of the fair value method. We have provided below the pro forma disclosures of the effect on net income and earnings per share as if SFAS No. 123, as amended, had been applied in measuring compensation expense for all periods.

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| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------------------|-----------|-------------------|----------|
| | December 31, | | December 31, | |
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands, except per share data) | | | |
| Net income | \$ 1,166 | \$ 169 | \$ 1,152 | \$ 2,703 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | | (1) | 12 | 2 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (432) | (812) | (1,317) | (2,563) |
| Pro forma net income (loss) | \$ 734 | \$ (644) | \$ (153) | \$ 142 |
| Basic net income (loss) per common share: | | | | |
| As reported | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |
| Pro forma | \$ 0.04 | \$ (0.03) | (0.01) | \$ 0.01 |
| Diluted net income (loss) per common share: | | | | |
| As reported | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |
| Pro forma | \$ 0.04 | \$ (0.03) | (0.01) | \$ 0.01 |

2. Intangible Assets

Intangible assets consisted of the following:

| | At December 31, 2005 | At March 31, 2005 |
|--------------------------|-------------------------|----------------------|
| | (in thousands) | |
| Acquired technology | \$ 3,372 | \$ 3,372 |
| Accumulated amortization | (2,668) | (2,093) |
| Intangible assets, net | \$ 704 | \$ 1,279 |

Acquired technology relating to the NetMaker, WDM NetDesign, Anite and Altaworks acquisitions resulted in amortization expense for the three months ended December 31, 2005 and 2004 of \$192 and \$192, respectively. Acquired technology relating to the NetMaker, WDM NetDesign, Anite and Altaworks acquisitions resulted in amortization expense for the nine months ended December 31, 2005 and 2004 of \$575 and \$460, respectively. Amortization expense associated with Anite commenced in Q4 of fiscal 2004, amortization associated with Altaworks commenced in Q3 of fiscal 2005. Amortization expense from acquired technology is included in cost of revenue in the condensed consolidated statements of operations. We currently expect amortization expense attributable to these acquisitions of \$766 in the fiscal year ending March 31, 2006, \$333 in fiscal year ending March 31, 2007, \$151 in the fiscal year ending March 31, 2008, and \$29 in the fiscal year ending March 31, 2009.

Table of Contents**3. Earnings Per Share**

The following is a reconciliation of the amounts used in calculating basic and diluted net income per common share for the three and nine months ended December 31, 2005 and 2004:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|---------|-----------------------------------|----------|
| | 2005 | 2004 | 2005 | 2004 |
| (in thousands, except per share data) | | | | |
| Net income (numerator): | | | | |
| Basic and diluted net income | \$ 1,166 | \$ 169 | \$ 1,152 | \$ 2,703 |
| Shares (denominator): | | | | |
| Weighted average shares outstanding (basic) | 20,229 | 20,168 | 20,345 | 20,129 |
| Plus: | | | | |
| Effect of other dilutive securities options | 294 | 590 | 262 | 497 |
| Weighted average shares outstanding (diluted) | 20,523 | 20,758 | 20,607 | 20,626 |
| Net income per common share: | | | | |
| Basic | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |
| Diluted | \$ 0.06 | \$ 0.01 | \$ 0.06 | \$ 0.13 |

4. Stockholders Equity

During the three months ended December 31, 2005 and 2004, respectively, we received proceeds of approximately \$75 and \$93 and issued 14,335 and 30,256 shares of common stock, pursuant to employee exercises of stock options. During the three months ended December 31, 2005 and 2004, respectively, employees purchased 37,777 and 25,500 shares of common stock under the OPNET 2000 Employee Stock Purchase Plan, resulting in proceeds of \$258 and \$183.

During the nine months ended December 31, 2005 and 2004, respectively, we received proceeds of approximately \$125 and \$487 and issued 28,293 and 116,899 shares of common stock, pursuant to employee exercises of stock options. During the nine months ended December 31, 2005 and 2004, respectively, employees purchased 72,469 and 41,705 shares of common stock under the OPNET 2000 Employee Stock Purchase Plan, resulting in proceeds of approximately \$497 and \$364.

5. Business Segment and Geographic Information

We operate in one industry segment, the development and sale of computer software programs and related services. Revenue from transactions with United States government agencies was approximately 44% and 43% of total revenue for the three months ended December 31, 2005 and

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2004, respectively. Revenue from transactions with United States government agencies was approximately 46% and 47% of total revenue for the nine months ended December 31, 2005 and 2004, respectively. Substantially all assets were held in the United States at December 31 and March 31, 2005. Revenue by geographic area and as a percentage of total revenue is as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|-------------------------|------------------------------------|------------------|-----------------------------------|------------------|
| | 2005 | 2004 | 2005 | 2004 |
| | (dollars in thousands) | | | |
| Geographic Area: | | | | |
| United States | \$ 16,056 | \$ 12,737 | \$ 43,471 | \$ 38,421 |
| International | 4,042 | 3,326 | 11,368 | 8,643 |
| Total revenue | \$ 20,098 | \$ 16,063 | \$ 54,839 | \$ 47,064 |
| Geographic Area: | | | | |
| United States | 79.9% | 79.3% | 79.3% | 81.6% |
| International | 20.1 | 20.7 | 20.7 | 18.4 |
| Total revenue | 100.0% | 100.0% | 100.0% | 100.0% |

Table of Contents**6. Comprehensive Income**

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|---|------------------------------------|--------------|-----------------------------------|-----------------|
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands) | | | |
| Net income | \$ 1,166 | \$ 169 | \$ 1,152 | \$ 2,703 |
| Foreign currency translation adjustments | (137) | (165) | (379) | (166) |
| Unrealized gain (loss) on marketable securities | | 9 | 44 | 73 |
| Total comprehensive income | \$ 1,029 | \$ 13 | \$ 817 | \$ 2,610 |

7. Commitments and Contingencies

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the United States District Court for the Eastern District of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. To date, no injunctive relief has been granted and the court has scheduled the matter for a jury trial beginning on April 11, 2006; however, the parties have asked the court to reschedule the start of the trial to October 20, 2006 or later. The court has not ruled on the request for a later trial date. We cannot predict the outcome of the claims, nor can we reasonably estimate a range of possible loss, if any, that may arise. OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation.

On February 6, 2006, OPNET filed a lawsuit against Compuware Corporation in Montgomery County, Maryland, Circuit Court, seeking damages and injunctive relief for Compuware's misappropriation and misuse of OPNET's trade secrets, confidential and proprietary information and unfair competition. To date, the lawsuit has not been served on Compuware.

The Internal Revenue Service, or IRS, is examining our federal corporate income tax returns for fiscal years ended March 31, 2002 and 2003. While the outcome of the IRS examination is not final at this time, we have reached a preliminary agreement with respect to the amount of tax deficiencies asserted that relate to research and development tax credits that we claimed on our tax returns for fiscal years ended March 31, 2002 and 2003. Based on the preliminary agreement we have reached with the IRS regarding the amount of tax deficiencies asserted that relate to research and development tax credits, we estimate that the aggregate amount of the research and development tax credits that will be disallowed on our tax returns for fiscal years ended March 31, 2002 and 2003 will be approximately \$350. As a result, our December 31, 2004 tax return reflected the reversal of approximately \$350 of previously claimed research and development tax credits. The IRS also asserted that there are tax deficiencies related to the timing of revenue reported on our tax returns for fiscal years ended March 31, 2002 and 2003. The tax deficiencies asserted by the IRS related to timing of revenue are associated with contract milestone billings that the IRS asserts should have been included in taxable income on our tax returns for the fiscal year ended March 31, 2002, but were instead included in taxable income on our tax returns for the fiscal year ended March 31, 2003. We do not believe any tax deficiencies related to the timing of revenue will be material to the financial statements.

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

8. Treasury Stock

On January 31, 2005, we announced that our Board of Directors had authorized the repurchase of up to 1,000,000 shares of our common stock from time to time on the open market or in privately negotiated transactions. This stock repurchase program does not have a specified termination date. Any repurchased shares will be available for use in connection with our stock plans or other corporate purposes. We expended \$1,961 to purchase 214,438 shares during the three months ended December 31, 2005, at an average price of \$9.14. We expended \$3,055 to purchase 349,838 shares during the nine months ended December 31, 2005, at an average price of \$8.73. As of December 31, 2005, we have repurchased 349,838 shares of common stock under this program.

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

The following discussion and analysis relate to our financial condition and results of operations for the three and nine months ended December 31, 2005 and 2004, respectively, and should be read in conjunction with our condensed consolidated financial statements and the related notes included elsewhere in this report. You should also read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended March 31, 2005, filed with the SEC. This discussion and analysis contains forward-looking statements that involve risks, uncertainties, and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth under Certain Factors That May Affect Future Results and elsewhere in this Quarterly Report on Form 10-Q.

Overview

OPNET Technologies, Inc. is a provider of management software for networks and applications. Our solutions address: application performance management, network configuration management, capacity planning, and network research and development. Our customers include corporate enterprises, government and defense agencies, network service providers, and network equipment manufacturers. Our solutions are designed to help our customers make better use of resources, reduce operational problems and improve competitiveness.

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

Our revenue is derived from three primary sources: (1) new software licenses, (2) software license updates and technical support, and (3) professional services, which include consulting and training services. New software license revenue represents all fees earned from granting customers licenses to use our software, and exclude revenue derived from software license updates, which are included in software license updates and technical support revenue. Our software master license agreement provides our customers with the right to use our software either perpetually (perpetual licenses) or during a defined term, generally for 2 to 4 years (term licenses). For the nine months ended December 31, 2005, approximately 98% of software license revenue was generated by the sale of perpetual software licenses. Substantially all of our software license arrangements include both perpetual licenses and software license updates and technical support. Software license updates and technical support revenue represents fees associated with the sale of unspecified license updates and technical support under our maintenance agreements. We offer professional services, under both time and material and fixed-price agreements, primarily to facilitate the adoption of our technology.

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

The key strategies of our business plan include increasing sales to existing customers, increasing deal size by selling modules and introducing new products, improving our sales and marketing execution, establishing alliances to extend our market reach and increasing our international presence. We have focused our sales, marketing, and other efforts on corporate enterprise and United States Government opportunities, and to a much lesser extent, service provider and network equipment manufacturer opportunities. Our focus and strategies are designed to increase revenue and profitability. Because of the uncertainty surrounding the amount and timing of revenue growth, we expect to closely manage the

increases in our total expenses as we implement these strategies.

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In March 2005, we entered into a multi-year worldwide distribution agreement with Cisco Systems. Under the terms of the agreement, Cisco began distributing a broad range of our software products. We will also collaborate with Cisco's Network Management Technology Group to develop new network management solutions. Cisco began sales of our products in the second half of calendar 2005. We expect to begin generating revenue from the Cisco Systems agreement during the fourth quarter of fiscal year 2006.

In November 2005, we entered into a global sales and marketing agreement with Computer Associates. Under the terms of the agreement, Computer Associates began marketing our systems performance and capacity modeling technologies. Computer Associates began sales of our products in the third quarter of fiscal 2006, and we began generating revenue from the Computer Associates agreement during the third quarter of fiscal 2006.

Acquisition

On October 6, 2004, we completed the acquisition of Altaworks for a total purchase price of \$3,431. As a result of the merger, we acquired all the assets and liabilities of Altaworks. We paid the purchase price in cash from working capital. As a result of the acquisition, we acquired two commercially available software products that provide advanced correlation and analysis technologies to our product portfolio for end-to-end application performance analysis and, with the addition of Altaworks' employees, have greater engineering depth and technical expertise.

This acquisition was accounted for as a purchase; consequently, operations of the acquired business will be included in our financial statements prospectively from the date of acquisition.

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

During the three months ended December 31, 2005, or Q3 2006, as compared to the three months ended September 30, 2005, or Q2 2006, we generated growth in revenue, gross profit, income from operations and diluted income per common share. During the three months ended December 31, 2005, we generated record revenue across all three revenue categories: new software licenses, software license updates and technical support and professional services, achieved record gross profit and ended the quarter with record deferred revenues of \$16,842.

The following table summarizes information on certain key metrics:

| | Three Months Ended | | Amount Change | Percentage Change |
|---|------------------------------|-------------------------------|--------------------------|------------------------------|
| | December 31, 2005 | September 30, 2005 | | |
| (dollars in thousands, except per share data) | | | | |
| Operations Data: | | | | |
| Total revenue | \$ 20,098 | \$ 18,264 | \$ 1,834 | 10.0% |
| Total cost of sales | \$ 4,532 | \$ 4,217 | \$ 315 | 7.5% |
| Gross profit | \$ 15,566 | \$ 14,047 | \$ 1,519 | 10.8% |

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| | | | | |
|--|-----------|-----------|----------|----------|
| Gross profit as a percentage of total revenue (gross margin) | 77.5% | 76.9% | | |
| Total operating expenses | \$ 15,247 | \$ 14,026 | \$ 1,221 | 8.7% |
| Income from operations | \$ 319 | \$ 21 | \$ 298 | 1,419.0% |
| Income from operations as a percentage of total revenue (operating margin) | 1.6% | 0.1% | | |
| Net income | \$ 1,166 | \$ 440 | \$ 726 | 165.0% |
| Diluted net income per common share | \$ 0.06 | \$ 0.02 | \$ 0.04 | 200.0% |
| Total employees (period end) | 412 | 412 | | 0.0% |
| Total average employees | 411 | 409 | 2 | 0.5% |
| Total consultants (period end) | 91 | 92 | (1) | (1.1%) |
| Total quota-carrying sales persons (period end) | 58 | 55 | 3 | 5.5% |
| Financial Condition and Liquidity Data: | | | | |
| Cash, cash equivalents, and marketable securities (period end) | \$ 82,991 | \$ 79,785 | \$ 3,206 | 4.0% |
| Cash flows provided (used in) by operating activities | \$ 4,492 | \$ (781) | \$ 5,273 | 675.2% |
| Total deferred revenue (period end) | \$ 16,842 | \$ 15,257 | \$ 1,585 | 10.4% |

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The increase in total revenue in Q3 2006 from Q2 2006 was primarily attributable to an increase of approximately 15.5% in professional services revenue and an increase of approximately 11.2% in new software license revenue. Revenue from professional services provided to United States government customers accounted for the most significant sequential increase in professional services revenue. Sales to corporate enterprise customers accounted for the most significant sequential increase in new software license revenue. We continue to execute and monitor plans to improve sales training and mentoring programs and grow our direct sales force. These continued efforts are designed to maximize overall sales execution and provide management with feedback necessary to evaluate the effectiveness of such programs.

Our international revenue increased 4.8% to \$4,042 for Q3 2006, from \$3,857 for Q2 2006. International revenue comprised 20.1% and 21.1% of total revenue for Q3 2006 and Q2 2006, respectively. The increase in international revenue in Q3 2006 from Q2 2006 was primarily attributable to an increase in sales to corporate enterprise customers. We expect revenue from sales outside the United States to continue to account for a significant portion of our total revenue in the future but fluctuate from period to period. We believe that continued growth and profitability will require further expansion of our sales, marketing and customer service functions in international markets.

Our gross margin for Q3 2006 increased to 77.5% from 76.9% for Q2 2006. The increase in our gross margin was primarily due to an increase in new license revenue of \$852 for Q3 2006 from Q2 2006.

As a software company, we believe that our business model has the potential to generate operating margins of 20% or more. Our operating margin increased to 1.6% during Q3 2006 from 0.1% during Q2 2006. The improvement in operating margin during Q3 2006 as compared to Q2 2006 was primarily the result of an increase in new license revenue of \$852, which was partially offset by increases in legal expenses and sales commissions. During fiscal 2006 we expect our operating margin to continue to be adversely impacted by legal expenses, as we expect to incur significant legal expenses during the remainder of fiscal 2006 related to the lawsuit filed by Compuware Corporation in September of 2004 (see Note 7 of our consolidated financial statements for additional information).

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

Total Revenue. Despite indications that the overall economy and IT industry are improving, we continue to see cautious capital spending by our current and potential customers. We currently expect future growth opportunities in revenue to come primarily from sales to enterprise IT organizations and the United States government. We expect revenue from sales to service providers and network equipment manufacturers to fluctuate from quarter to quarter with the potential for periods of declining license revenue. Our ability to increase professional services revenue will depend upon our ability to maintain several large consulting contracts with the United States government and to attract and retain additional qualified consultants, including those with security clearances. As a result of these factors, we believe that we may experience fluctuations in quarterly revenue.

International Revenue. Our international sales are impacted by the mix of direct and indirect sales channels and our focus on increasing sales to corporate enterprises. We believe that these factors impact the timing of sales orders as well as our ability to forecast future revenue. As a result, we expect our international sales to fluctuate from quarter to quarter both in absolute dollars and as a percentage of total revenue.

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

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Research and Development Expenses. We believe that a significant level of research and development investment will be required to maintain our competitive position, broaden our product lines and support channel initiatives, as well as enhance the features and functionality of our current products. We anticipate hiring additional engineers, and we expect to incur additional research and development expenses in connection with such new hires. In addition, the Altaworks acquisition we completed in October of 2004 will continue to result in higher research and development expenses. We expect that the absolute dollar amount of these expenditures will continue to grow but could generally decrease as a percentage of total revenue in future periods. Our ability to decrease these expenses, as a percentage of revenue, will depend upon increases in our revenue growth, among other factors.

Sales and Marketing Expenses. We depend upon our direct sales model to generate revenue and believe that increasing the size of our quota-carrying sales team is essential for long-term growth. We plan to add additional quota carrying sales persons during fiscal 2006 and fiscal 2007 to pursue our growth strategies. We anticipate that we will continue to commit substantial resources to sales and marketing in the future and that sales and marketing expenses may increase both in absolute dollars and as a percentage of total revenue in future periods.

General and Administrative Expense. We expect the dollar amount of general and administrative expenses to increase as we continue to expand our operations. During fiscal 2006 as compared to fiscal 2005, we expect expenses associated with Sarbanes-Oxley to significantly decrease, but we expect to incur significant increased legal expenses related to the lawsuit filed by Compuware Corporation in September of 2004 (see Note 7 to our consolidated financial statements for additional information).

Operating Margin. Since a significant portion of our software license arrangements close in the latter part of each quarter, we may not be able to adjust our cost structure in the short-term to respond to lower than expected revenue, which would adversely impact our operating margin and earnings. Our operating margin increased to 1.6% for Q3 2006 from 0.1% for Q2 2006 due primarily to an increase in new license revenue, which was partially offset by increased legal expenses and sales commissions. We remain committed to our long-term growth strategies and do not believe that adjustments to our cost structure are necessary at this time, but we intend to closely manage expenses.

Table of Contents**Results of Operations**

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

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|--|------------------------------------|--------------|-----------------------------------|--------------|
| | 2005 | 2004 | 2005 | 2004 |
| Revenue: | | | | |
| New software licenses | 42.0% | 48.5% | 41.3% | 45.8% |
| Software license updates and technical support | 30.8 | 31.1 | 32.7 | 31.1 |
| Professional services | 27.2 | 20.4 | 26.0 | 23.1 |
| Total revenue | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of revenue: | | | | |
| New software licenses | 0.9 | 1.3 | 1.0 | 1.2 |
| Software license updates and technical support | 3.2 | 3.7 | 3.5 | 3.7 |
| Professional services | 17.4 | 14.7 | 18.2 | 15.1 |
| Amortization of acquired technology | 1.0 | 1.2 | 1.0 | 1.0 |
| Total cost of revenue | 22.5 | 20.9 | 23.7 | 21.0 |
| Gross profit | 77.5 | 79.1 | 76.3 | 79.0 |
| Operating expenses: | | | | |
| Research and development | 23.0 | 23.6 | 25.2 | 23.1 |
| Sales and marketing | 33.9 | 36.5 | 34.6 | 35.2 |
| General and administrative | 19.0 | 15.4 | 18.0 | 12.4 |
| Total operating expenses | 75.9 | 75.5 | 77.8 | 70.7 |
| Income (loss) from operations | 1.6 | 3.6 | (1.5) | 8.3 |
| Interest and other income, net | 3.7 | 2.1 | 3.4 | 1.6 |
| Income before provision for income taxes | 5.3 | 5.7 | 1.9 | 9.9 |
| Provision for income taxes | (0.5) | 4.6 | (0.2) | 4.2 |
| Net income | 5.8% | 1.1% | 2.1% | 5.7% |

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

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| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------|-------------------|------|
| | December 31, | | December 31, | |
| | 2005 | 2004 | 2005 | 2004 |
| Cost of Revenue: | | | | |
| New software licenses | 2.2% | 2.6% | 2.4% | 2.7% |
| Software license updates and technical support | 10.3 | 11.9 | 10.8 | 11.9 |
| Professional services | 64.4 | 72.3 | 69.8 | 65.6 |

Revenue

New Software License Revenue. New software license revenue was \$8,436 and \$7,793 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 8.3%. For the three months ended December 31, 2005, as compared to the same period in fiscal 2005, the increase in license revenue was primarily due to increased sales to service providers, and to a lesser extent, increased sales to corporate enterprise customers. New software license revenue was \$22,646 and \$21,578 for the nine months ended December 31,

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2005 and 2004, respectively, representing an increase of 4.9%. For the nine months ended December 31, 2005, as compared to the same period in fiscal 2005, the increase in license revenue was primarily due to increased sales to service providers.

Software License Updates and Technical Support Revenue. Software license updates and technical support revenue was \$6,198 and \$4,998 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 24.0%. Software license updates and technical support revenue was \$17,922 and \$14,617 for the nine months ended December 31, 2005 and 2004, respectively, representing an increase of 22.6%. 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 technical support revenue for the three and nine months ended December 31, 2005, as compared to the same period in fiscal 2005, reflect increases in the overall customer-installed base.

Professional Services Revenue.

The components of professional services for the three and nine months ended December 31, 2005 and 2004 were as follows:

| | Three Months Ended December 31, | | Nine Months Ended December 31, | |
|-------------------------------|------------------------------------|----------|-----------------------------------|-----------|
| | 2005 | 2004 | 2005 | 2004 |
| | (in thousands) | | | |
| Consulting services revenue | \$ 5,124 | \$ 2,985 | \$ 13,302 | \$ 9,797 |
| Training and other | 340 | 287 | 969 | 1,072 |
| Professional services revenue | \$ 5,464 | \$ 3,272 | \$ 14,271 | \$ 10,869 |

Professional services revenue was \$5,464 and \$3,272 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 67.0%. Consulting services revenue comprised 93.8% and 91.2% of professional services revenue for the three months ended December 31, 2005 and 2004, respectively. Professional services revenue was \$14,271 and \$10,869 for the nine months ended December 31, 2005 and 2004, respectively, representing an increase of 31.3%. Consulting services revenue comprised 93.2% and 90.1% of professional services revenue for the nine months ended December 31, 2005 and 2004, respectively. The increase in total professional services revenue for the three and nine month periods ended December 31, 2005 as compared to the same periods in the prior fiscal year was primarily due to an increase in services provided to United States government customers and to a lesser extent services provided to service providers.

In January 2003, we were awarded a consulting contract with the United States Department of Defense that contributed approximately \$3,096 and \$3,296 of consulting revenue for fiscal 2004 and fiscal 2003, respectively. The funding under this contract for calendar year 2003 was \$3,147. Under the first of four possible contract extensions, the funding under this contract for 2004 was \$3,520.

In January 2005, we were awarded the contract option for calendar year 2005 in the amount of \$2,604. The option contributed approximately \$1,746 of consulting revenue for the nine months ended December 31, 2005 and \$657 of consulting revenue for fiscal 2005. The option years for calendar years 2006 and 2007 under this contract may be exercised by the United States Department of Defense at its discretion. Our future

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results of operations could be adversely affected if any of the remaining options are not exercised or the contract otherwise does not receive additional funding.

International Revenue

Our international revenue was \$4,042 and \$3,326 for the three months ended December 31, 2005 and 2004, respectively. Our international revenue decreased as a percentage of total revenue to 20.1% for the three months ended December 31, 2005 from 20.7% for the same period in fiscal 2005. Our international revenue was \$11,368

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and \$8,643 for the nine months ended December 31, 2005 and 2004, respectively. Our international revenue increased as a percentage of total revenue to 20.7% for the nine months ended December 31, 2005 from 18.4% for the same period in fiscal 2005. Our international revenue is primarily generated in Europe and Japan. Historically, a significant portion of our international business has come from service providers and network equipment manufacturers. We have focused our efforts on increasing sales to corporate enterprises. International revenue from corporate enterprises comprised the largest percentage of international revenue for the three and nine months ended December 31, 2005 and 2004.

Cost of Revenue

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

Cost of New Software License Revenue. Cost of software license revenue was \$184 and \$202 for the three months ended December 31, 2005 and 2004, respectively. Gross margin on software license revenue increased to 97.8% for the three months ended December 31, 2005 from 97.4% for the same period in fiscal 2005. Cost of software license revenue was \$546 and \$578 for the nine months ended December 31, 2005 and 2004, respectively. Gross margin on software licenses revenue increased to 97.6% for the nine months ended December 31, 2005 from 97.4% for the same period in fiscal 2005. The cost of new software license revenue is primarily comprised of royalty payments required for certain of our software license sales. Consequently, the proportion of licenses sold that require royalty payments impacts the gross margin.

Cost of Software License Updates and Technical Support Revenue. Cost of software license updates and technical support revenue was \$639 and \$597 for the three months ended December 31, 2005 and 2004, respectively. Gross margin on software license updates and technical support revenue increased to 89.7% for the three months ended December 31, 2005 from 88.1% for the same period in fiscal 2005. Cost of software license updates and technical support revenue was \$1,932 and \$1,734 for the nine months ended December 31, 2005 and 2004, respectively. Gross margin on software license updates and technical support revenue increased to 89.2% for the nine months ended December 31, 2005 from 88.2% for the same period in fiscal 2005. The cost of software license updates and technical support revenue is primarily impacted by the cost of labor associated with providing technical support. The change in the cost of software license updates and technical support revenue for the three months ended December 31, 2005 as compared to the same period in fiscal 2005 was not significant.

Cost of Professional Services Revenue. Cost of professional services revenue was \$3,517 and \$2,367 for the three months ended December 31, 2005 and 2004, respectively. Gross margin on professional services revenue increased to 35.6% for the three months ended December 31, 2005 from 27.7% for the same period in fiscal 2005. Cost of professional services revenue was \$9,961 and \$7,128 for the nine months ended December 31, 2005 and 2004, respectively. Gross margin on professional services revenue decreased to 30.2% for the nine months ended December 31, 2005 from 34.5% for the same period in fiscal 2005. The increases in cost of professional services revenue and the resulting lower gross margin was primarily due to an increase in our consulting staff to meet demand for our services and the time necessary to train and assign new consulting staff to billable projects.

Operating Expenses

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Research and Development. Research and development expenses were \$4,608 and \$3,780 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 21.9%. Research and

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development expenses were \$13,796 and \$10,836 for the nine months ended December 31, 2005 and 2004, respectively, representing an increase of 27.3%. The increases were primarily due to higher personnel costs as a result of the Altaworks acquisition and increased staffing levels required for developing new products as well as sustaining and upgrading existing products.

Sales and Marketing. Sales and marketing expenses were \$6,813 and \$5,867 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 16.1%. Sales and marketing expenses were \$18,989 and \$16,568 for the nine months ended December 31, 2005 and 2004, respectively, representing an increase of 14.6%. The increases for the three and nine months ended December 31, 2005 as compared to the same periods in fiscal 2005 were primarily due to increased commission expense related to increased sales and increases in our sales and marketing staff to pursue our business plan.

General and Administrative. General and administrative expenses were \$3,826 and \$2,475 for the three months ended December 31, 2005 and 2004, respectively, representing an increase of 54.6%. General and administrative expenses were \$9,867 and \$5,865 for the nine months ended December 31, 2005 and 2004, respectively, representing an increase of 68.2%. The increase in general and administrative expenses for the three months ended December 31, 2005 as compared to the same period in fiscal 2005 was primarily due to incurring approximately \$1,484 in legal expenses related to the lawsuit filed by Compuware Corporation. The increase in general and administrative expenses for the nine months ended December 31, 2005 as compared to the same period in fiscal 2005 was primarily due to incurring approximately \$2,924 in legal expenses related to the lawsuit filed by Compuware Corporation, and to a lesser extent, professional services costs associated with Sarbanes Oxley compliance efforts. See Note 7 to our consolidated financial statements for additional information regarding the lawsuit filed by Compuware Corporation.

Interest and Other Income, net. Interest and other income, net, was \$746 and \$326 for the three months ended December 31, 2005 and 2004, respectively. Interest and other income, net, was \$1,873 and \$787 for the nine months ended December 31, 2005 and 2004, respectively. The increases were primarily due to an increase in interest income earned on our cash and cash equivalents and marketable securities. The increase in interest income was primarily the result of an increase in interest rates for the three and nine months ended December 31, 2005 as compared to the same periods in fiscal 2005.

Provision for Income Taxes. Our effective tax rates were negative 9.5% and positive 81.4% for the three months ended December 31, 2005 and 2004, respectively. Our effective tax rates were negative 10.1% and positive 43% for the nine months ended December 31, 2005 and 2004, respectively. The decrease in the company's effective tax rates for the three and nine month periods ended December 31, 2005, as compared to the same periods in fiscal 2005, was the result of adjusting previously projected foreign tax credits and projected research and development tax credits to the actual amount of the credits computed on the Company's fiscal 2005 tax return, which was completed and filed during the third quarter of fiscal 2006. The decrease in the effective rate for the three and nine months ended December 31, 2005 was also the result of adjusting similar projections for the current year. The decrease was also the result of an estimated tax deficiency of \$350,000 related to an IRS examination of research and development tax credits claimed on our corporate tax returns for fiscal 2002 and 2003 that was accrued in Q3 of fiscal 2005. See Contingencies disclosed below for additional information related to the IRS examination. The effective tax rate differs from the statutory tax rate and varies from period to period due principally to the amount of income before taxes from various tax jurisdictions and the amount of tax credits available to us in each period from incremental research expenditures.

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

Liquidity and Capital Resources

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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

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approximately \$54,114, net of underwriting discounts and offering expenses payable by us. As of December 31, 2005, we had cash, cash equivalents and marketable securities totaling \$82,991.

Cash provided by operating activities was \$4,492 for the nine months ended December 31, 2005. Cash provided by operating activities was \$2,472 for the nine months ended December 31, 2004. Cash provided by operating activities is primarily derived from net income, as adjusted for non-cash items such as depreciation and amortization expense, tax benefits from exercise of employee stock options, and changes in operating assets and liabilities. The increase in cash provided by operating activities for the nine months ended December 31, 2005 as compared to the same period in fiscal 2005 was primarily attributable to an increase in accounts payable and accrued liabilities.

Net cash provided by investing activities was \$17,572 for the nine months ended December 31, 2005, and net cash used in investing activities was \$1,880 for the nine months ended December 31, 2004. Investing activities include the purchase, sale or maturity of marketable securities, expenditures for property and equipment, and acquisitions of businesses and technologies. For the nine months ended December 31, 2005, funds were used to purchase marketable securities of \$22,922, and to purchase property and equipment of \$918. Proceeds from the sale/maturity of investments were \$41,412 for the nine months ended December 31, 2005. For the nine months ended December 31, 2004, funds were used to acquire Altaworks of \$3,431, purchase marketable securities of \$40,759, and purchase property and equipment of \$810. Proceeds from the sale/maturity of investments were \$43,120 for the nine months ended December 31, 2004.

Net cash used in financing activities was \$2,433 for the nine months ended December 31, 2005 and net cash provided by financing activities was \$851 for the nine months ended December 31, 2004. We used cash of \$3,055 to acquire 349,838 shares of treasury stock during the nine months ended December 31, 2005. Cash provided by financing activities generally reflects the proceeds received from the exercise of stock options and the sale of common stock under our 2000 Employee Stock Purchase Plan.

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

The following table summarizes our contractual arrangements at December 31, 2005, and the timing and effect that such commitments are expected to have on our liquidity and cash flow in future periods. In addition, the table summarizes the timing of principal payments on long-term debt obligations as reported on our consolidated balance sheet as of December 31, 2005.

| <u>Contractual Obligations</u> | <u>Payments Due by Period</u> | | | | |
|---|-------------------------------|--------------------|-----------------|-----------------|------------------|
| | <u>Total</u> | <u>Less Than 1</u> | | | <u>More than</u> |
| | | <u>Year</u> | <u>1</u> | <u>3 Years</u> | <u>3</u> |
| Facilities Operating Lease Obligations | \$ 15,856 | \$ 3,240 | \$ 6,470 | \$ 5,899 | \$ 247 |
| Long-term Debt Obligations (including interest) | 143 | 48 | 95 | | |
| Total | \$ 15,999 | \$ 3,288 | \$ 6,565 | \$ 5,899 | \$ 247 |

As of December 31, 2005, we have no material capital lease obligations, either individually or in the aggregate.

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

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

Contingencies

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the United States District Court for the Eastern District of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. To date, no injunctive relief has been granted and the court has scheduled the matter for a jury trial beginning on April 11, 2006; however, the parties have asked the court to reschedule the start of the trial to October 20, 2006 or later. The court has not ruled on the request for a later trial date. We cannot predict the outcome of the claims, nor can we reasonably estimate a range of possible loss, if any, that may arise. OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation.

On February 6, 2006, OPNET filed a lawsuit against Compuware Corporation in Montgomery County, Maryland, Circuit Court, seeking damages and injunctive relief for Compuware's misappropriation and misuse of OPNET's trade secrets, confidential and proprietary information and unfair competition. To date, the lawsuit has not been served on Compuware.

The Internal Revenue Service, or IRS, is examining our federal corporate income tax returns for fiscal years ended March 31, 2002 and 2003. While the outcome of the IRS examination is not final at this time, we have reached a preliminary agreement with respect to the amount of tax deficiencies asserted that relate to research and development tax credits that we claimed on our tax returns for fiscal years ended March 31, 2002 and 2003. Based on the preliminary agreement we have reached with the IRS regarding the amount of tax deficiencies asserted that relate to research and development tax credits, we estimate that the aggregate amount of the research and development tax credits that will be disallowed on our tax returns for fiscal years ended March 31, 2002 and 2003 will be approximately \$350. As a result, our December 31, 2004 tax return reflects the reversal of approximately \$350 of previously claimed research and development tax credits. The IRS also asserted that there are tax deficiencies related to the timing of revenue reported on our tax returns for fiscal years ended March 31, 2002 and 2003. The tax deficiencies asserted by the IRS related to timing of revenue are associated with contract milestone billings that the IRS asserts should have been included in taxable income on our tax returns for the fiscal year ended March 31, 2002, but were instead included in taxable income on our tax returns for the fiscal year ended March 31, 2003. We do not believe any tax deficiencies related to the timing of revenue will be material to the financial statements.

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

Certain Factors That May Affect Future Results

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

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

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

the timing of large orders;

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changes in the proportion of software arrangements requiring contract accounting;

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

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

the cost and time required to develop new software products;

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

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

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

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

the timing and size of potential acquisitions by us.

We expect to make significant expenditures in all areas of our business, particularly sales and marketing operations, in order to promote future growth. Because the expenses associated with these activities are relatively fixed in the short term, we may be unable to adjust spending quickly enough to offset any unexpected shortfall in revenue growth or any decrease in revenue levels. In addition, our revenue in any quarter depends 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 revenue than we expect, we probably will not be able to reduce our operating expenses quickly in response. Therefore, any significant shortfall in revenue or delay of customer orders could have an immediate adverse effect on our operating results in that quarter.

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

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

We derive all of our revenue 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 revenue, which could ultimately lead to our becoming unprofitable. The market for intelligent network management software solutions is in an early stage of development. Therefore, we cannot accurately assess the size of the market and may be unable to identify an effective distribution strategy, the competitive environment that will develop, and the appropriate features and prices for products to address the market. If we are to be successful, our current and potential customers must recognize the value of intelligent network management software solutions,

decide to invest in the management of their networks, and, in particular, adopt and continue to use our software solutions.

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

Our software solutions and services are designed to meet the needs of enterprises, United States 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, United States 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 revenue or lower our growth rate.

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The United States 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 United States Department of Defense. The funding under this contract for calendar year 2003 was \$3,147, and there are four successive option years under the contract that may be exercised by the United States Department of Defense at its discretion. In January 2004, the United States Department of Defense exercised the first of four possible contract extensions. The funding under this contract for calendar year 2004 is \$3,520. In January 2005, the United States Department of Defense exercised the second of four possible contract extensions. The funding under this contract for calendar year 2005 is \$2,604. Our results of operations could be adversely affected if any of the remaining options are not exercised, or the contract otherwise does not receive additional funding.

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

A decline in the demand for information technology among our current and prospective customers may result in decreased revenue 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 revenue.

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

We derive a substantial portion of our revenue from sales directly or indirectly to United States government agencies. Transactions with United States government agencies accounted for approximately 46% and 47% of our total revenue for the nine months ended December 31, 2005 and 2004, respectively. Government sales entail a variety of risks including:

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

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

Our products and services are included on a General Services Administration (GSA) schedule. We believe that the GSA schedule facilitates our sales to United States 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.

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

The federal government audits and reviews the performance of federal contractors on contracts, pricing practices, cost structure, and compliance with applicable laws, regulations, and standards. An audit of our work could result in a finding that we overcharged the government, which could result in an adjustment to our previously reported operating results. If a government audit uncovers improper or

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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 United States 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 United States 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 United States government agencies, do not gain widespread market acceptance, our revenue might not increase and could even decline.

We expect to derive a substantial portion of our revenue in the future from sales to enterprises and United States government agencies of version 11.0 of *OPNET IT Guru*, which was released in December 2004, and its associated modules including *Application Characterization Environment*, *ACE Decode Module*, *NetDoctor* and *Flow Analysis*, and *OPNET VNE Server*, which was released in June 2002. Our business depends on customer acceptance of these products and our revenue may not increase, or may even decline, if our target customers do not adopt and expand their use of our products. In addition, sales of our *OPNET Modeler* product, which we have been selling since 1987, have fluctuated from quarter-to-quarter, including periods of declining sales. Sales of our *OPNET Modeler* could decline in the future for a variety of reasons, including market saturation and the financial condition of network equipment manufacturers, and if sales of our newer products do not grow at a rate sufficient to offset the shortfall, our revenue 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 *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 revenue 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

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products for various reasons, including changes in budgets and purchasing priorities. Our prospective customers routinely require education regarding the use and benefit of our products. This may also lead to delays in receiving customers' orders.

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

We sell our products primarily through our direct sales force, and we must expand the size of our sales force to increase revenue. 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 revenue and grow our business could be compromised. Our sales people require a long period of time to become productive, typically three to nine months. The time required to reach productivity, as well as the challenge of attracting, training, and retaining qualified candidates, may make it difficult to meet our sales force growth targets. Further, we may not generate sufficient sales to offset the increased expense resulting from growing our sales force, or we may be unable to manage a larger sales force.

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

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

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

We may be unable to operate our business profitably if we fail to manage our growth. Our growth has sometimes strained, and may in the future continue to strain, our managerial, administrative, operational, and financial resources and controls. We plan to continue to expand our operations and increase the number of our full-time employees. Our ability to manage growth will depend in part on our ability to continue to enhance our operating, financial, and management information systems. Our personnel, systems, and controls may not be adequate to support our growth. In addition, our revenue 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 revenue 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 revenue could fall. Advances in network management technology, software engineering, and simulation technology, or the emergence of new industry standards, could lead to new competitive products that have better performance, more features, or lower prices than our products and could render our products unmarketable.

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

Our existing customers have traditionally generated additional revenue from consulting services, renewed maintenance agreements and purchase of additional software licenses, which represents a majority of our annual

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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 revenue could decrease.

Increases in professional services revenue as a percentage of total revenue could decrease overall margins.

We realize lower margins on professional services revenue than we do on other types of revenue. As a result, if professional services revenue increases as a proportion of total revenue, our gross margins will be lower.

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

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

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

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

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

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

greater difficulty in accounts receivable collection and longer collection periods;

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

potentially adverse tax consequences;

the effects of currency fluctuations; and

political and economic instability.

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

Increasing competition in our market could cause us to lose sales and become unprofitable. We believe that the market for intelligent network management software is likely to become more competitive as it evolves and

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the demand for intelligent network management solutions continues to increase. At least one of our current competitors and many of our potential competitors are larger and have substantially greater financial and technical resources than we do. In addition, it is possible that other vendors as well as some of our customers or distributors will develop and market solutions that compete with our products in the future.

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

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

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

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

diversion of our resources;

injury to our reputation; and

increased support costs.

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

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

Our software products rely on our intellectual property, and any failure to protect our intellectual property could enable our competitors to market products with similar features that may reduce our revenue 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 revenue. 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 revenue. 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.

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

be time-consuming to defend;

result in costly litigation;

divert our management's attention and resources;

cause us to cease or delay product shipments; or

require us to enter into royalty or licensing agreements.

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

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

The Securities and Exchange Commission, American Institute of Certified Public Accountants and various other accounting authoritative bodies continue to issue interpretations and guidance for applying the relevant standards to a wide range of sales contract terms and business arrangements that are prevalent in the software industry. Future interpretations of existing accounting standards or changes in our business practices could result in future changes in our revenue recognition accounting policies that could have a material adverse effect on our results of operations.

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

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

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

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

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

the transaction involves contingent payment terms or fees;

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

we are required to accept extended payment terms.

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

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

We completed the NetMaker, WDM NetDesign, and Altaworks acquisition in March 2001, January 2002, and October 2004, respectively. We may continue to acquire or make investments in companies, products or technologies if opportunities arise. Any acquisition could be expensive, disrupt our ongoing business, distract our

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management and employees, and adversely affect our financial results and the market price of our common stock. We may not be able to identify suitable acquisition or investment candidates, and if we do identify suitable candidates, we may not be able to make these acquisitions or investments on commercially acceptable terms or at all. If we make an acquisition, we could have difficulty integrating the acquired technology, employees, or operations. In addition, the key personnel of the acquired company may decide not to work for us.

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

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

At December 31, 2005, we had \$57,423 in cash and cash equivalents and \$25,568 in marketable securities. Based on our cash, cash equivalents, and marketable securities as of December 31, 2005, a 100 basis point increase/decrease in the interest rates would increase/decrease our annual interest income and cash flows by approximately \$830.

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

ITEM 4. CONTROLS AND PROCEDURES

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Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2005. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and

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procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of the Company's disclosure controls and procedures as of December 31, 2005, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

During the three months ended December 31, 2005, there have been no changes to our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1. Legal Proceedings**

On September 27, 2004, OPNET received notice of a lawsuit filed by Compuware Corporation in the United States District Court for the Eastern District of Michigan alleging patent infringement. Compuware Corporation is seeking injunctive relief and unspecified monetary damages. To date, no injunctive relief has been granted and the court has scheduled the matter for a jury trial beginning on April 11, 2006 however; the parties have asked the court to reschedule the start of the trial to October 20, 2006 or later. The court has not ruled on the request for a later trial date. We cannot predict the outcome of the claims, nor can we reasonably estimate a range of possible loss, if any, that may arise. OPNET believes that it has substantial defenses to the allegations, and OPNET intends to vigorously defend against the litigation.

On February 6, 2006, OPNET filed a lawsuit against Compuware Corporation in Montgomery County, Maryland, Circuit Court, seeking damages and injunctive relief for Compuware's misappropriation and misuse of OPNET's trade secrets, confidential and proprietary information and unfair competition. To date, the lawsuit has not been served on Compuware.

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

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

In August 2000, we closed an initial public offering of our common stock. The Registration Statement on Form S-1 (No. 333-32588) was declared effective by the Securities and Exchange Commission on August 1, 2000 and we commenced the offering on that date. After deducting the underwriting discounts and commissions and the offering expenses, the net proceeds from the offering were approximately \$54,114.

Issuer Purchases Of Equity Securities

| <u>Period</u> | <u>Total Number of Shares Purchased</u> | <u>Average Price Paid per Share</u> | <u>Total Number of</u> <u>Shares Purchased as</u> <u>Part of Publicly</u> <u>Announced Plans or</u> <u>Programs (1)</u> | <u>Maximum Number of</u> <u>Shares That May Yet</u> <u>Be Purchased Under</u> <u>the Plans or</u> <u>Programs</u> |
|-----------------------|---|---|---|---|
| | | | | |
| October 1 - 31, 2005 | | | | 864,600 |
| November 1 - 30, 2005 | | \$ 9.00 | 131,160 | 733,440 |
| December 1 - 31, 2005 | | \$ 9.36 | 83,278 | 650,162 |

-
- (1) On January 31, 2005, we announced that our Board of Directors had authorized the repurchase of up to 1,000,000 shares of our common stock from time to time on the open market or in privately negotiated transactions. This stock repurchase program does not have a specified termination date. Any repurchased shares will be available for use in connection with our stock plans or other corporate purposes.

ITEM 6. Exhibits

Exhibits: See Exhibit Index

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SIGNATURE

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

OPNET TECHNOLOGIES, INC.
(Registrant)

Date: February 7, 2006

By: /s/ Mel F. Wesley
Name: Mel F. Wesley
Title: Vice President and Chief Financial Officer

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

| Exhibit Number | Description | Source |
|---------------------------|--|--|
| 2.1 | Agreement and Plan of Merger, dated September 3, 2004, by and among OPNET Technologies, Inc., N Company Acquisition Corp. and Altaworks Corporation | Incorporated by reference from exhibit 2.1 to Current Report on Form 8-K dated October 12, 2004. |
| 3.1 | Third Amended and Restated Certificate of Incorporation of the Registrant | Incorporated by reference from exhibit 3.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588). |
| 3.2 | Amended and Restated By-Laws of the Registrant | Incorporated by reference from exhibit 3.4 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588). |
| 4.1 | Specimen common stock certificate | Incorporated by reference from exhibit 4.1 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588). |
| 4.2 | See Exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and By-Laws of the Registrant defining the rights of holders of common stock of the Registrant | Incorporated by reference from exhibit 4.2 to the Registrant's Registration Statement on Form S-1 (File No. 333-2588). |
| *31.1 | Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended | Exhibit 31.1 to this Quarterly Report on Form 10-Q. |
| *31.2 | Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended | Exhibit 31.2 to this Quarterly Report on Form 10-Q. |
| *32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Exhibit 32.1 to this Quarterly Report on Form 10-Q. |
| *32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | Exhibit 32.2 to this Quarterly Report on Form 10-Q. |

* filed herewith