UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549

Form 10-Q

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

For the Quarterly Period Ended March 31, 2004

OR

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

For the transition period from to

Commission File Number 000-26757

NetIQ CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**77-0405505** **(I.R.S. employer identification no.)**
3553 North First Street, San Jose, CA **(Address of principal executive offices)**	**95134** **(Zip Code)**

(408) 856-3000
(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 registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

As of April 30, 2004, the Registrant had outstanding 57,039,023 shares of Common Stock.

NETIQ CORPORATION

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FOR THE QUARTER ENDED MARCH 31, 2004

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PART I   FINANCIAL INFORMATION

ITEM 1.   FINANCIAL STATEMENTS

NetIQ CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)

	March 31, 2004 (Unaudited)	June 30, 2003[1]
ASSETS		
Current assets:		
Cash and cash equivalents	$ 85,852	$ 76,095
Short-term investments	235,959	237,281
Accounts receivable, net	28,366	39,016
Prepaid expenses and other	5,938	7,019
Total current assets	356,115	359,411
Property and equipment, net	51,673	58,042
Other intangible assets, net	41,396	56,245
Other assets	1,659	1,797
Long-term investments	1,614	5,714
Goodwill	120,090	272,561
Total assets	$ 572,547	$ 753,770
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 6,884	$ 7,224
Accrued compensation and related benefits	13,818	16,667
Other liabilities	11,952	13,124
Deferred revenue, current portion	63,948	55,632
Restructuring liability, current portion	581	2,302
Total current liabilities	97,183	94,949
Deferred revenue, net of current portion	4,112	3,082
Restructuring liability, net of current portion	—	532
Total liabilities	101,295	98,563
Stockholders' equity:		
Common stock-$0.001 par value; 250,000,000 shares authorized, 56,811,087 issued and outstanding at March 31, 2004; 56,540,908 issued and outstanding at June 30, 2003	2,927,576	2,927,470
Deferred employee stock-based compensation	(396)	(861)
Accumulated deficit	(2,455,913)	(2,271,445)
Accumulated other comprehensive income (loss)	(15)	43
Total stockholders' equity	471,252	655,207
Total liabilities and stockholders' equity	$ 572,547	$ 753,770

(1) Derived from audited consolidated financial statements.

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
		(As revised *)		(As revised *)
Software license revenue	$ 36,059	$50,320	$ 105,096	$ 162,908
Service revenue	30,858	29,845	88,638	74,655
Total revenue	66,917	80,165	193,734	237,563
Cost of software license revenue	2,464	2,546	7,817	7,057
Cost of service revenue	8,186	7,801	23,653	21,468
Amortization of purchased technology (*)	5,907	7,110	17,509	18,205
Total cost of revenue	16,557	17,457	48,979	46,730
Gross profit	50,360	62,708	144,755	190,833
Operating expenses:				
Sales and marketing	32,802	36,408	91,695	98,897
Research and development	17,921	19,920	50,910	52,879
General and administration	6,623	6,864	20,109	17,711
Amortization of other intangible assets	4,216	5,771	12,742	13,560
Employee stock-based compensation	71	258	257	664
Restructuring charge (credit)	—	—	(504)	5,280
Impairment of goodwill	—	—	150,842	—
Write-off of acquired in-process research and development	—	—	—	1,396
Total operating expenses	61,633	69,221	326,051	190,387
Income (loss) from operations	(11,273)	(6,513)	(181,296)	446
Other income (expenses):				
Interest income	1,186	1,960	3,953	9,203
Other income (expenses), net	430	373	(175)	875
Impairment of long-term investment	—	(745)	(4,100)	(745)
Total other income (expenses), net	1,616	1,588	(322)	9,333
Income (loss) before income taxes and cumulative effect of change in accounting principle	(9,657)	(4,925)	(181,618)	9,779
Income tax expense (benefit)	950	(1,770)	2,850	4,500
Income (loss) before cumulative effect of change in accounting principle	(10,607)	(3,155)	(184,468)	5,279
Cumulative effect of change in accounting principle, net of income taxes	—	—	—	(579,338)
Net loss	$(10,607)	$ (3,155)	$(184,468)	$(574,059)
Other comprehensive loss, net of income taxes:				
Foreign currency translation adjustment	(252)	(275)	278	(318)
Unrealized loss on short-term investments	(16)	(385)	(336)	(786)
Comprehensive loss	$(10,875)	$ (3,815)	$(184,526)	$(575,163)
Basic earnings per share:				
Income (loss) before cumulative effect of change in accounting principle	$ (0.19)	$ (0.06)	$ (3.25)	$ 0.10
Cumulative effect of change in accounting principle	—	—	—	(11.05)
Net loss per share	$ (0.19)	$ (0.06)	$ (3.25)	$ (10.95)
Diluted earnings per share:				
Income (loss) before cumulative effect of change in accounting principle	$ (0.19)	$ (0.06)	$ (3.25)	$ 0.10
Cumulative effect of change in accounting principle	—	—	—	(10.80)
Net loss per share	$ (0.19)	$ (0.06)	$ (3.25)	$ (10.70)
Shares used to compute basic earnings per share	57,045	55,063	56,739	52,408
Shares used to compute diluted earnings per share	57,045	55,063	56,739	53,667

(*) See Note 5 to Condensed Consolidated Financial Statements.

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended March 31, 2004	Nine Months Ended March 31, 2003
Cash flows from operating activities:		
Net loss	$(184,468)	$(574,059)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	42,454	41,755
Amortization of employee stock-based compensation	257	664
Loss on sale of investments and property and equipment	160	527
Impairment of goodwill	150,842	—
Impairment of long-term investment	4,100	—
Impairment of long-term investment affiliate	—	745
Tax benefit from disqualifying dispositions	—	3,022
Equity interest in loss of unconsolidated investee	—	343
Write-off of acquired in-process research and development	—	1,396
Cumulative effect of change in accounting principle		579,338
Changes in:		
Accounts receivable	13,559	11,276
Prepaid expenses and other	1,435	(2,868)
Accounts payable	(557)	316
Accrued compensation and related benefits	(3,230)	(1,269)
Other liabilities	(853)	(12,126)
Restructuring liability	(2,253)	3,300
Deferred revenue	8,363	440
Net cash provided by operating activities	29,809	52,800
Cash flows from investing activities:		
Purchases of property and equipment	(5,774)	(12,707)
Proceeds from sales of property and equipment	11	16
Cash used in acquisitions, net of cash acquired	—	(202,800)
Purchase of technology	(15,402)	—
Purchases of short-term investments	(170,539)	(130,623)
Proceeds from maturities of short-term investments	161,909	219,568
Proceeds from sales of short-term investments	9,181	108,611
Purchase of long-term investment	—	(5,000)
Other	(73)	476
Net cash used in investing activities	(20,687)	(22,459)
Cash flows from financing activities:		
Repurchase of common stock	(10,399)	—
Proceeds from sale of common stock	10,715	6,564
Net cash provided by financing activities	316	6,564
Effect of exchange rate changes on cash	319	(7)
Net increase in cash and cash equivalents	9,757	36,898
Cash and cash equivalents, beginning of period	76,095	64,032
Cash and cash equivalents, end of period	$ 85,852	$ 100,930
Noncash investing activities:		
Issuance of common stock and options in business combination	$ —	$ 37,663
Issuance of treasury stock in business combination	$ —	$ 53,528
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 33	$ 34
Cash paid for income taxes	$ 943	$ 1,045

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended March 31, 2004 and 2003
(Unaudited)

1. Basis of Presentation

Interim Financial Information—The accompanying financial statements include the accounts of NetIQ Corporation and its subsidiaries. We have subsidiaries in Canada, Europe, Asia, and South America.

These interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the rules and regulations of the Securities and Exchange Commission for interim financial statements. In the opinion of management, the condensed consolidated financial statements include all adjustments (consisting only of normal recurring accruals) that management considers necessary for a fair presentation of our financial position, operating results and cash flows for the interim periods presented. All intercompany accounts and transactions have been eliminated in consolidation. The unaudited financial information furnished herein reflects all adjustments, consisting only of normal recurring adjustments, that in our opinion are necessary to fairly state our consolidated financial position, the results of operations, and cash flows for the periods presented. Operating results and cash flows for interim periods are not necessarily indicative of results to be expected for the entire fiscal year ending June 30, 2004.

These interim financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2003.

Reclassifications—Certain amounts previously reported have been reclassified to conform to the current year presentation, including amounts presented in the statement of cash flows for the nine month period ended March 31, 2003 related to purchases, sales, and maturities of short-term investments.

2. Stock Based Compensation Plans

We account for stock-based compensation for our employee stock plans using the intrinsic value method presented in Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Unvested options assumed in acquisitions are accounted for in accordance with the provisions of Financial Accounting Standards Board Interpretation No. 44 (FIN 44), *Accounting for Certain Transactions Involving Stock Compensation—an Interpretation of APB Opinion No. 25,* and the related deferred employee stock-based compensation is amortized ratably over the vesting periods.

Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, requires the disclosure of pro forma earnings as if we had adopted the SFAS No. 123 fair value method since our inception. The fair value of stock-based awards to employees is calculated using the Black-Scholes option pricing model, even though this model was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which differ significantly from the terms and characteristics of our stock option awards. The Black-Scholes model also requires the use of subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values.

The weighted-average fair value of stock-based compensation to our employees is based on the single option valuation approach. Forfeitures are recognized as they occur, and it is assumed no dividends will be declared. The weighted-average fair value calculations are based on the following assumptions:

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
Estimated life (in years)	4.3	4.0	4.0 - 4.3	4.0
Risk-free interest rate	2.6%	2.5%	2.6 - 2.9%	2.5 - 3.3%
Volatility	58%	70%	58 - 70%	70 - 75%

For pro forma purposes, the estimated fair value of stock-based compensation awards to employees is amortized using the straight-line method over the vesting period of the options. Our pro forma results are as follows (in thousands, except per share amounts):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
Reported net loss	$(10,607)	$ (3,155)	$(184,468)	$(574,059)
Employee stock-based compensation included in reported net loss	71	258	257	664
Employee stock-based compensation determined under the fair value method for all awards, net of income taxes	(13,962)	(21,341)	(46,669)	(55,575)
Pro forma net loss	$(24,498)	$(24,238)	$(230,880)	$(628,970)
Basic loss per share:				
As reported	$ (0.19)	$ (0.06)	$ (3.25)	$ (10.95)
Pro forma	$ (0.43)	$ (0.44)	$ (4.07)	$ (12.00)
Diluted loss per share:				
As reported	$ (0.19)	$ (0.06)	$ (3.25)	$ (10.70)
Pro forma	$ (0.43)	$ (0.44)	$ (4.07)	$ (11.72)

3. Change in Accounting Principle

We adopted SFAS No. 142, *Goodwill and Other Intangible Assets,* on July 1, 2002. SFAS No. 142 requires that companies stop amortizing goodwill and certain intangible assets with an indefinite useful life. Instead, it requires that goodwill and intangible assets deemed to have an indefinite useful life be reviewed for impairment upon adoption of SFAS No. 142, and at least annually thereafter. Under SFAS No. 142, goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value.

Upon adoption of SFAS No. 142, we recorded a non-cash transitional impairment charge of $579.3 million to reduce the carrying value of goodwill from previous acquisitions. The charge is reflected as the cumulative effect of a change in accounting principle in the accompanying condensed consolidated statements of operations and comprehensive loss. In calculating the impairment charge, the fair values of the reporting units were estimated using the discounted cash flow method supplemented by the market approach. See also Note 6 to Condensed Consolidated Financial Statements.

4. Allowance for Uncollectible Accounts and Sales Returns

Accounts receivable are presented net of allowance for uncollectible accounts and sales returns. Changes in the allowance for uncollectible accounts and sales returns during the nine months ended March 31, 2004 are as follows (in thousands):

	Uncollectible Accounts	Sales Returns
Balances, June 30, 2003	$ 944	$1,101
Increase (decrease) in allowance	(131)	679
Write-offs, net of recoveries	(65)	(918)
Balances, March 31, 2004	$ 748	$ 862

5. Other Intangible Assets

Other intangible assets consist of the following (in thousands):

	Carrying Amount	Accumulated Amortization	Net
	March 31, 2004		
Purchased technology	$ 98,480	$ 72,153	$26,327
Customer contracts	24,829	10,825	14,004
Customer lists	42,651	42,651	—
Publishing rights	1,262	553	709
Tradenames	3,047	2,691	356
Patents	1,487	1,487	—
Total	$171,756	$130,360	$41,396
	June 30, 2003		
Purchased technology	$ 83,078	$ 54,962	$28,116
Customer contracts	24,829	4,618	20,211
Customer lists	42,651	36,840	5,811
Publishing rights	1,262	235	1,027
Tradenames	3,047	2,246	801
Patents	1,487	1,208	279
Total	$156,354	$100,109	$56,245

Estimated future amortization of other intangible assets as of March 31, 2004 is as follows (in thousands):

Fiscal year ending June 30,	Purchased Technology*	Other Intangible Assets
2004 (remaining 3 months)	$ 3,089	$ 2,122
2005	12,174	8,487
2006	8,115	3,751
2007	3,658	—
Total	$27,036	$14,360

* Includes publishing rights

During fiscal 2003, we reclassified the amortization of purchased technology from operating expenses to cost of revenue, with no consequent effect on total revenue, net loss, or earnings per share. The effect of the reclassification on the fiscal 2003 statement of operations is as follows (in thousands):

	Three Months Ended March 31, 2003		Nine Months Ended March 31, 2003	
	As previously reported	As revised	As previously reported	As revised
Amortization of purchased technology	$ —	$ 7,110	$ —	$ 18,205
Total cost of revenue	$10,347	$17,457	$ 28,525	$ 46,730
Gross profit	$69,818	$62,708	$209,038	$190,833
Amortization of other intangible assets	$12,881	$ 5,771	$ 31,765	$ 13,560
Total operating expenses	$76,331	$69,221	$208,592	$190,387

6. Goodwill

The changes in goodwill during the nine months ended March 31, 2004 resulted from an impairment charge based on our interim review of goodwill and changes to purchase price allocation for acquired assets.

Revenue during the three months ended September 30, 2003 was significantly lower than we had anticipated. Accordingly, as of September 30, 2003 we reduced our forecasted revenues, operating results and cash flows. This significant change in estimated future results required an interim review of goodwill for impairment. The review resulted in a non-cash impairment charge of $150.8 million recorded in the three months ended September 30, 2003 consistent with the overall decline in our market capitalization.

In calculating the impairment charge, we estimated the fair values of the reporting units using the discounted cash flow method supplemented by the market approach.

7. Other Liabilities

Other liabilities consist of (in thousands):

	March 31, 2004	June 30, 2003
Accrued sales and marketing costs	$ 4,462	$ 7,547
Sales tax payable	981	879
Facility reserve	412	753
Other	6,097	3,945
Other liabilities	$11,952	$13,124

At March 31, 2004 and June 30, 2003 our facility reserve represented the expected future costs under a lease agreement for unoccupied office space in Portland, Oregon, which expires in December 2006.

8. Restructuring Liability

During the three months ended December 31, 2002 we recorded a restructuring charge of $5.3 million related to employment redundancies resulting from our acquisition of PentaSafe and resizing of the combined businesses.

Pursuant to the restructuring plan, we terminated the employment of 52 employees. All of these employees had left our employment as of September 30, 2003 with the exception of one employee whose termination was rescinded. The unused balance of $116,000 was credited to the restructuring charge in the statement of operations during the three months ended September 30, 2003 eliminating the remaining liability related to employee severance.

As part of the restructuring plan, we determined that we no longer required certain office space in Houston, Texas and Portland, Oregon, and we established an accrual of $4.2 million for facilities consolidation. In July 2003, we subleased a portion of the vacated premises resulting in a $250,000 reduction in the accrual during the three months ended September 30, 2003. In November 2003, we settled part of our lease obligation for a facility for less than the amount then unpaid, which resulted in a $138,000 reduction in the accrual during the three months ended December 31, 2003. The amounts accrued for facilities consolidations at March 31, 2004 represent the total remaining liability under the leases, net of estimated sub-lease income.

The following summarizes the restructuring activity (in thousands):

	Employee Severance and Other Related Benefits	Facilities Consolidations	Total
Restructuring charge (quarter ended December 31, 2002)	$1,060	$4,220	$ 5,280
Cash payments	(944)	(690)	(1,634)
Reclassification	—	56	56
Write-off of leasehold improvements	—	(868)	(868)
Restructuring liability at June 30, 2003	116	2,718	2,834
Cash payments, net of sub-lease income	—	(563)	(563)
Changes to assumed sublease income	—	(217)	(217)
Adjustment to restructuring charge	(116)	(250)	(366)
Restructuring liability at September 30, 2003	—	1,688	1,688
Cash payments, net of sub-lease income	—	(663)	(663)
Adjustment to restructuring charge	—	(138)	(138)
Restructuring liability at December 31, 2003	—	887	887
Cash payments, net of sub-lease income	—	(306)	(306)
Restructuring liability at March 31, 2004	$ —	$ 581	$ 581

9. Earnings Per Share

The following is a reconciliation of the shares used to compute basic and diluted earnings per share (in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
Weighted average common shares outstanding	57,045	55,590	56,987	52,732
Weighted average common shares outstanding subject to repurchase	—	(527)	(248)	(324)
Shares used to compute basic earnings per share	57,045	55,063	56,739	52,408
Weighted average common shares outstanding	57,045	55,590	56,987	52,732
Weighted average common shares outstanding subject to repurchase	—	(527)	(248)	—
Common equivalent shares related to outstanding options and warrants	—	—	—	935
Shares used to compute diluted earnings per share	57,045	55,063	56,739	53,667

During the three and nine months ended March 31, 2004 we had securities outstanding which could potentially dilute earnings per share. However, we excluded these securities from the computation of diluted earnings per share because the effect of including them would have been antidilutive. Such outstanding securities consist of the following (in thousands):

	Three Months	Nine Months
	Ended March 31, 2004	
Outstanding options	15,795	15,795
Common shares outstanding subject to repurchase	—	248
Total	15,795	16,043

10. Indemnification and Contingencies

Indemnification—We enter into standard indemnification agreements with many of our customers and certain other business partners in the ordinary course of business. These agreements include provisions for indemnifying the customer against any claim brought by a third-party to the extent any such claim alleges that a NetIQ product infringes a patent, copyright or trademark, misappropriates a trade secret, or violates any other proprietary rights of that third-party. It is not possible to estimate the maximum potential amount of future payments we could be required to make under these indemnification agreements. To date, we have not incurred significant costs to defend lawsuits or settle claims related to indemnification agreements. We have not recorded any liabilities for these indemnification agreements at March 31, 2004 or June 30, 2003.

At our discretion and in the ordinary course of business, we perform and subcontract the performance of certain services. Accordingly, we enter into standard indemnification agreements with our customers to indemnify them for damage caused by our employees and subcontractors. It is not possible to estimate the maximum potential amount of future payments we could be required to make under these indemnification agreements. We maintain insurance policies that may enable us to recover a portion of any such claim. We have not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. We have not recorded any liabilities for these indemnification agreements at March 31, 2004 or June 30, 2003.

As permitted under Delaware law, we have agreements indemnifying our executive officers, directors and some other employees for certain events and occurrences while the officer, director and employee is, or was, serving at our request in such capacity. The maximum potential amount of future payments we could be required to make under these indemnification agreements is not estimable. We maintain directors and officers liability insurance designed to enable us to recover a portion of any future amounts paid. We have not recorded any liabilities for these indemnification agreements at March 31, 2004 or June 30, 2003.

Contingencies—In January 2003 BMC Software, Inc. (BMC) filed suit against us in the U.S. District Court for the Southern District of Texas (Court) for patent and trademark infringement. In August 2003 the Court stayed the litigation, pending arbitration. In September 2003 BMC submitted to the American Arbitration Association a statement of claim against us seeking a declaratory judgment that its claims are not subject to arbitration and alleging that it believes that at least AppManager and Operations Manager, a product we presently do not offer and which is licensed to Microsoft, infringe a BMC patent. In October 2003 we submitted our initial answer, denying the claims of infringement asserted by BMC. In November 2003 we filed an amended answer and counterclaim alleging that BMC infringes a valid patent that we own. BMC has denied the allegations in our counterclaim. Each party seeks injunctive relief, compensatory and treble damages, interest, and attorneys' fees with respect to its claims.

We may also be a potential defendant in lawsuits and claims arising in the ordinary course of business. While the outcomes of such claims, lawsuits, or other proceedings cannot be predicted with certainty, management expects that such liability, to the extent not reimbursed by insurance or otherwise, will not have a material adverse effect on our financial condition or results of operations.

11. Major Customer

At March 31, 2004 no single customer represented 10% or more of our accounts receivable. At June 30, 2003 one customer represented 14% of our accounts receivable.

No single customer accounted for more than 10% of revenue during the three and nine months ended March 31, 2004. Microsoft Corporation accounted for 13% and 23% of total revenue during the three and nine months ended March 31, 2003.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations, intentions, strategies, and expected operating results and financial condition. Forward-looking statements also include statements regarding events, conditions and financial trends that may affect our future plans of operations, business strategy, results of operations and financial position. All forward-looking statements included in this document are based on information available to us on the date hereof and we assume no obligation to update any such forward-looking statements. Investors are cautioned that any forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties and actual results may differ materially from those included within the forward-looking statements as a result of various factors. These forward-looking statements are made in reliance upon the safe harbor provision of The Private Securities Litigation Reform Act of 1995. Factors that could cause or contribute to such differences include, but are not limited to, those described in "Management's Discussion and Analysis of Financial Condition and Results of Operations", under the heading "Factors That May Affect Future Operating Results" and elsewhere in this Quarterly Report on Form 10-Q.

Overview

We are a leading provider of cross-platform systems and security management software, and web analytics software and services.

Our systems and security management offerings enable organizations to analyze, optimize and assure the performance, availability, security, and utilization of their IT infrastructures. Historically focused on Microsoft Windows applications management, we have become a leading provider of cross-platform solutions by introducing products for non-Windows-based computing environments and by expanding the breadth and functionality of our offerings. Our products now include systems and security management functionality for UNIX and Linux environments, which addresses our customers' growing need to manage and secure heterogeneous environments, and we now offer software to test, migrate, administer, monitor, secure and analyze complex, distributed computing systems. As a result, many organizations currently are able to manage and secure most of their applications, servers and operating systems using our products.

Our web analytics offerings are available as a software-based solution or hosted service, and enable organizations to track, report and analyze website traffic and usage. This functionality is designed to help our customers convert more website visitors into customers and to improve the returns that they generate on their investments in their websites.

Special Considerations in Reviewing Fiscal 2004 and Fiscal 2003 Results

Our financial results for the three and nine months ended March 31, 2004 and 2003 were affected by certain significant events that should be considered in comparing these periods.

In August 2003, we received the final $5.0 million license payment in accordance with our license agreement with Microsoft whereby Microsoft received a perpetual, non-exclusive license to our Operations Manager technology and source code. We received a total of $175.0 million in license fees from Microsoft starting in November 2000 and ending in August 2003. Under the terms of the agreement, Microsoft also paid us an additional $5.0 million per year to market joint solutions of the parties, which served to reduce our sales and marketing expenses when such expenses were incurred. The last marketing payment under this agreement was received during the three months ended September 30, 2003. Of the total marketing funds received approximately $700,000 had not been spent as of March 31, 2004.

Over the last three years we have invested in the development and acquisition of new products to replace the declining revenues from Microsoft and to otherwise grow our business. However, we have not yet been able to fully replace the Microsoft revenue stream with revenue from new products and services. Our ability to do so will depend on a variety of factors, including general economic conditions, spending in the IT sector, competition and market acceptance of our new products. In addition, during the term of the agreement with Microsoft, our operating results benefited from the relatively low cost of revenue and operating expenses associated with the revenue from Microsoft. Our overall gross margins and operating margins have declined as the Microsoft revenue has been phased out, and we do not expect to achieve the same relatively low costs of revenue and operating expenses with respect to any replacement revenue we earn in future periods.

Our mix of license revenue and service revenue has shifted significantly in recent periods, with a much greater percentage of our revenue attributable to service revenue. The change in the mix is attributable in part to the end of revenue under the license agreement with Microsoft and to our increased base of maintenance customers. Although we have achieved greater efficiencies and lowered our costs with respect to provision of services, the higher cost associated with service revenue, as compared to cost of license revenue, has caused our overall gross margins to decline.

In December 2002 we acquired PentaSafe Security Technologies, Inc. and Marshal Software Ltd. for aggregate acquisition costs of $207.7 million in cash and $56.3 million in stock and warrants. The results of operations of the acquired companies have been included in our results of operations since the respective dates of acquisition.

Due to a revenue shortfall in the quarter ended September 30, 2003, we performed an impairment analysis on the fair value of goodwill. We determined that the shortfall related primarily to our acquired and internally developed security products and that future revenue would not meet the forecast then in effect. Accordingly, we recorded a goodwill impairment charge of $150.8 million in September 2003.

We purchased 644,208 shares of our common stock during the three months ended March 31, 2004 for $8.3 million pursuant to a repurchase program approved by our board of directors in October 2003. The program, authorized by our board of directors, authorizes the repurchase of up to 5% of our outstanding common stock in open market transactions over a one-year period. To date 816,426 shares of our common stock have been repurchased under the program for $10.4 million.

Comparison of Three and Nine Months Ended March 31, 2004 and 2003

Total Revenue. Total revenue and period-over-period changes are as follows (dollars in thousands):

	Three Months Ended March 31,		Percentage	Nine Months Ended March 31,		Percentage
	2004	2003	Change	2004	2003	Change
Software license revenue	$36,059	$40,320	(11)%	$100,096	$107,908	(7)%
Software license revenue under Microsoft agreement	—	10,000	(100)%	5,000	55,000	(91)%
Total software license revenue	36,059	50,320	(28)%	105,096	162,908	(35)%
Service revenue	30,858	29,845	3 %	88,638	74,655	19 %
Total revenue	$66,917	$80,165	(17)%	$193,734	$237,563	(18)%

Total revenue decreased by $13.2 million or 17% and $43.8 million or 18% during the three and nine months ended March 31, 2004, compared with the three and nine months ended March 31, 2003, respectively. Software license revenue represented 54% of total revenue for the three and nine months ended March 31, 2004 and 63% and 69% of total revenue for the three and nine months ended March 31, 2003, with service revenue representing the balance. During the three months ending June 30, 2004, we expect the mix of license and service revenue to remain consistent with the three and nine months ended March 31, 2004.

Pursuant to the schedule of payments set forth in the agreement with Microsoft, software license revenue from Microsoft has sequentially declined, with the final $5.0 million payment made in August 2003.

Software License Revenue. Total software license revenue decreased by 28% and 35% during the three and nine months ended March 31, 2004 compared with the three and nine months ended March 31, 2003, primarily due to a $10.0 million and $50.0 million decrease in revenue under the Microsoft agreement during the three and nine month periods ended March 31, 2004 compared to prior year periods. Excluding revenue from Microsoft, software license revenue decreased by 11% and 7% during the three and nine month periods ended March 31, 2004 respectively. We believe the decrease in non-Microsoft license revenue was substantially due to sales productivity issues and challenging business conditions exacerbated by the effects of prior integration activities related to acquisitions.

Service Revenue. Service revenue consists of revenue from the sale of maintenance service agreements, consulting services and training services, as well as the sale of hosted web analytics services. Service revenue increased by $1.0 million or 3% and $14 million or 19% during the three and nine months ended March 31, 2004 compared with the three and nine months ended March 31, 2003. The increase was primarily due to maintenance fees associated with new software licenses, renewals by our existing customers, and increases in revenue from our hosted web analytics service.

Total Cost of Revenue. Total cost of revenue and period-over-period changes are as follows (dollars in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
Cost of software license revenue	$ 2,464	$ 2,546	$ 7,817	$ 7,057
As percentage of license revenue	7%	5%	7%	4
Cost of service revenue	8,186	7,801	23,653	21,468
As percentage of service revenue	27%	26%	27%	29
Amortization of purchased technology	5,907	7,110	17,509	18,205
Total cost of revenue	$16,557	$17,457	$48,979	$46,730
As percentage of total revenue	25%	22%	25%	20

Total cost of revenue decreased by $0.9 million during the three months ended March 31, 2004 and increased $2.2 million during the nine months ended March 31 2004 when compared with the three and nine months ended March 31, 2003.

Cost of Software License Revenue. Cost of software license revenue includes personnel costs and costs associated with software packaging, documentation such as user manuals and CDs, and production, as well as shipping, royalties and commissions paid to third parties. Cost of software license revenue as a percentage of related license revenue increased from 5% and 4% during the three and nine months ended March 31, 2003 to 7% during each of the three and nine months ended March 31, 2004. The percentage increase primarily was due to increases in royalty expense and the decline in revenue from Microsoft, which did not have any costs associated with it. We expect cost of software license revenue during the remainder of fiscal 2004 to decrease as a percentage of software license revenue as we acquired technology in March 2004, which was previously licensed under an OEM agreement requiring us to make fixed quarterly royalty payments, and the amortization of the purchased technology, which is expected to be slightly less than the previous royalty payments, will be included in amortization of purchased technology.

Cost of Service Revenue. Cost of service revenue consists primarily of personnel costs and expenses incurred in providing telephonic support, on-site consulting services, training services, and costs associated with our hosted service. Cost of service revenue as a percentage of related service revenue decreased from 29% during nine months ended March 31, 2003 to 27% during the nine months ended March 31, 2004, primarily due to greater efficiencies in providing technical support services and a majority of our customers renewing their maintenance agreements. For the three months ended March 31, 2004 compared to the three months ended March 31, 2003 cost of service revenue was relatively consistent as a percentage of related service revenue. We expect our cost of service revenue during the three months ending June 30, 2004 to be higher due to one time costs associated with streamlining efforts, but flat on a dollar basis excluding the cost associated with streamlining efforts when compared with the three months ended March 31, 2004.

Amortization of Purchased Technology. Purchased technology consists of developed software capitalized in our acquisitions and is amortized using the straight-line method over the estimated useful life, generally three years. Amortization decreased from $7.1 million and $18.2 million during the three and nine months ended March 31, 2003 to $5.9 million and $17.5 million during the three and nine months ended March 31, 2004. The decrease in the amortization is due to amounts capitalized in prior acquisitions becoming fully amortized. We expect to amortize approximately $3.3 million of purchased technology during the three months ending June 30, 2004, absent further acquisitions or impairments.

Operating Expenses

Sales and Marketing. Our sales and marketing expenses consist primarily of personnel costs, including salaries and employee commissions, and expenses relating to travel, advertising, public relations, seminars, marketing programs, trade shows, lead generation activities and proportionately allocated facilities and information technology costs.

Sales and marketing expenses and period-over-period changes are as follows (dollars in thousands):

	Three Months Ended March 31,		**Nine Months Ended March 31,**	
	2004	**2003**	**2004**	**2003**
Sales and marketing expenses	$32,802	$36,408	$91,695	$98,897
Percentage change from comparable prior period	(10)%		(7)%	
As a percentage of total revenue	49 %	45%	47 %	42%
Headcount at March 31	511	594	511	594

Sales and marketing expenses decreased by $3.6 million or 10% and $7.2 million or 7% during the three and nine months ended March 31, 2004 compared with the corresponding periods a year earlier. The decrease in absolute dollars resulted principally from our lower revenue during the current periods, resulting in the payment of lower commissions and bonuses, combined with our implementation of cost savings measures and reduction in the number of sales and marketing personnel. Sales and marketing as a percentage of revenue increased from 45% and 42% during the three and nine months ended March 31, 2003 to 49% and 47% during the three and nine months ended March 31, 2004, respectively, principally as a result of the decline in Microsoft revenue in the current periods, as minimal sales and marketing effort was required to receive this revenue. During the three months ending June 30, 2004, we expect sales and marketing expenses to stay relatively flat in absolute dollars.

Research and Development. Our research and development expenses consist primarily of salaries and other personnel-related costs, consulting fees, depreciation and proportionately allocated facilities and information technology costs. To date, we have expensed all research and development costs as incurred in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, as technological feasibility is established at the same time our software development process is completed.

Research and development expenses and period-over-period changes are as follows (dollars in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
Research and development	$17,921	$19,920	$50,910	$52,879
Percentage change from comparable period	(10)%		(4)%	
As a percentage of total revenue	27 %	25%	26 %	22%
Headcount at March 31	432	506	432	506

Research and development expenses decreased by $2.0 million or 10% and $2.0 million or 4% during the three months and nine months ended March 31, 2004 compared with the three and nine months ended March 31, 2003. This decrease in absolute dollars resulted principally from lower overall headcount and payment of lower bonuses partially offset by the effect of annual base salary increases that took place in November. We anticipate research and development spending to increase slightly during the three months ending June 30, 2004, primarily due to one time costs associated with streamlining efforts.

General and Administrative. Our general and administrative expenses consist primarily of personnel costs for finance and administration, as well as directors and officers insurance, director's compensation, compliance with the Sarbanes-Oxley legislation, professional services expenses, such as legal and accounting fees, and proportionately allocated facilities and information technology costs.

General and administrative expense and period-over-period changes are as follows (dollars in thousands):

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2004	2003	2004	2003
General and administrative	$6,623	$6,864	$20,109	$17,711
Percentage change from comparable period	(4)%		14%	
As a percentage of total revenue	10 %	9%	10%	7%
Headcount at March 31	191	189	191	189

General and administrative expenses decreased by $241,000 or 4% during the three months ended March 31, 2004 and increased $2.4 million or 14% during the nine months ended March 31, 2004 compared with the three and nine months ended March 31, 2003. The increase in absolute dollars in the nine month period was primarily due to increased professional fees and additional costs associated with Sarbanes-Oxley legislation compliance. We anticipate general and administrative costs to increase slightly during the three months ending June 30, 2004.

Amortization of Other Intangible Assets. Amortization of other intangible assets includes amortization of customer contracts, customer lists, patents, and tradename intangibles capitalized in our acquisitions. Amortization decreased from $5.7 million and $13.6 million during the three and nine months ended March 31, 2003 to $4.2 million and $12.7 million during the three and nine months ended March 31, 2004. The decrease occurred because other previously capitalized acquisition related intangibles had been fully amortized by June 2003. During the three months ending March 31, 2004 we expect to amortize approximately $2.2 million of other intangible assets, absent further acquisitions or impairments.

Employee Stock-Based Compensation. Deferred employee stock-based compensation represents the intrinsic value of unvested options assumed in acquisitions and the charges associated with the grant of options at less than fair market value. The deferred amount is being amortized over the vesting periods of the assumed and granted options, generally four years. During the three and nine months ended March 31, 2004, we recognized employee stock-based compensation expense of $71,000 and $257,000 as compared with $258,000 and $664,000 during the three and nine months ended March 31, 2003. The decrease was due to the reduced number of options vesting in the current quarter. During the three months ending June 30, 2004 we expect to amortize approximately $82,000 of deferred employee stock-based compensation, absent further acquisitions.

Restructuring Charge (Credit). During the three months ended December 31, 2002, we recorded a restructuring charge of $5.3 million related to a plan to terminate the employment of certain employees and to vacate certain of our facilities in connection with our acquisition of PentaSafe**.** During the nine months ending March 31, 2004 we sublet certain facilities, settled a portion of our lease obligation for less than the amount then unpaid, and completed our workforce reduction plan below estimated costs, resulting in a reduction of the recorded liability by $504,000 during the period. The change during the three month period ended March 31, 2004 related to expected facilities payments, net of sub-lease income.

Impairment of Goodwill. We adopted SFAS No. 142, *Goodwill and Other Intangible Assets*, on July 1, 2002 and accordingly stopped amortizing goodwill on that date. Upon adoption of SFAS No. 142, we recorded a one-time, non-cash transitional impairment charge of $579.3 million to reduce the carrying value of our goodwill from previous acquisitions. The charge is reflected as the cumulative effect of a change in accounting principle in the accompanying consolidated statements of operations. There was no income tax effect resulting from the change in accounting principle.

Revenue for the three months ended September 30, 2003 was significantly lower than we anticipated. Because a significant portion of our revenues historically has been generated during the last month of each fiscal quarter, the actual drop-off in revenues compared with plan was not evident until the end of the quarter. Accordingly, as of September 30, 2003 we reduced our forecasted future operating profits and cash flows. This significant change in estimated future results required us to perform an interim review of goodwill for impairment, as prescribed by SFAS No. 142. This resulted in a non-cash impairment charge of $150.8 million during the three months ended September 30, 2003 consistent with the overall decline in our market capitalization. There were no changes in goodwill during the three months ended March 31, 2004.

Write-off of Acquired In-Process Research and Development. During the three months ended December 31, 2002 we expensed $1.4 million relating to in-process technology acquired from PentaSafe. These costs were charged to operations as the technologies had not reached technological feasibility and did not have alternative future uses at the date of acquisition. No such charges were recorded during the nine months ended March 31, 2004.

Total Other Income (Expenses), Net. Total net other income (expenses), is primarily composed of interest income on our cash, cash equivalents and short-term investments, foreign exchange losses, and impairment of long-term investment. Interest income during the three and nine months ended March 31, 2004 was $1.2 million and $4.0 million compared with $2.0 million and $9.2 million during the three and nine months ended March 31, 2003. The decline in the interest income was due to our use of cash in acquisitions during the three months ended December 31, 2002 as well as a continued decline in the yield on our investments. During the three and nine months ended March 31, 2004 we recorded other income of $430,000 and expense of $175,000, respectively, consisting primarily of foreign exchange gains and losses on U.S. dollars held in subsidiaries with non-U.S. Dollar local functional currencies. During the three months ended September 30, 2003 we recorded a $4.1 million charge related to an impairment of a long-term investment based on management's assessment that the decline in value was other than temporary. No such charge was recorded in any of the other periods presented.

Income Taxes. We recorded income tax expense of $950,000 and $2.9 million during the three and nine months ended March 31, 2004 compared with tax benefit of $1.8 million and tax expense of $4.5 million during the three and nine months ended March 31, 2003. Tax expense is booked based on the estimated tax obligation for the entire year and includes foreign income tax, state franchise tax and federal alternative minimum tax.

Liquidity and Capital Resources

At March 31, 2004, we held $85.9 million in cash and cash equivalents and $236.0 million in short-term investments, for a total of $321.9 million compared with $313.4 million as of June 30, 2003, an increase of $8.5 million principally resulting from operation of our business and exercise of stock options partially offset by the purchase of technology, property and equipment and repurchase of our common stock.

Our operating activities, adjusted for non-cash charges, resulted in net cash inflows of $29.8 million and $52.8 million during the nine months ended March 31, 2004 and 2003, respectively. During the nine months ended March 31, 2004, primary non-cash charges were impairment of goodwill of $150.8 million, depreciation and amortization of $42.5 million, and impairment of long-term investments of $4.1 million. During the nine months ended March 31, 2003, the primary non-cash charges were the cumulative effect of change in accounting principle of $579.3 million and depreciation and amortization of $41.8 million. In addition, decreases in assets and increases in liabilities provided cash during the nine months ended March 31, 2004 as compared with a use of cash related to increases in assets and decreases in liabilities, net of acquired assets and liabilities, during the nine months ended March 31, 2003.

Our investing activities resulted in net cash outflows of $20.7 million and $22.5 million during the nine months ended March 31, 2004 and 2003, respectively. During the nine months ended March 31, 2004 and 2003, primary uses of cash from investing activities were acquisitions of property and equipment of $5.8 million and $12.7 million, respectively, principally for computer hardware and software, purchases of short-term investments of $170.5 million and $130.6 million, respectively and the acquisition of technology for $15.4 million in March 2004. Cash outflows also included a long-term investment of $5.0 million during the nine months ended March 31, 2003 in securities of a privately held security consulting company. The principal sources of cash during the nine months ended March 31, 2004 were maturities and sales of short-term investments of $161.9 million and $9.2 million, respectively. Proceeds from the maturities and sale of short-term investments of $219.6 million and $108.6 million, respectively provided cash during the nine months ended March 31, 2003.

During the nine months ended March 31, 2004 financing activities used $10.4 million in cash for purchase of common stock. Financing activities generated cash of $10.7 million and $6.6 million during the nine months ended March 31, 2004 and 2003, respectively, from the proceeds of the exercise of stock options.

As of March 31, 2004, we had no significant debt other than operating leases.

Long-term Obligations

The following summarizes our obligations as of March 31, 2004 and the effect we expect such obligations to have on our liquidity and cash flows in future periods (in thousands, including lease payments accrued as part of our goodwill, facility reserve, and restructuring liability):

	Fiscal Year Ending June 30					
	2004[1]	2005	2006	2007	2008	Thereafter
Operating lease payments	$1,839	$5,657	$2,431	$1,341	$661	$239

(1) Represents remaining three months of fiscal year

Assuming there is no significant change in our business, we believe that our cash and cash equivalent balances, short-term investments, and cash flows generated by operations will be sufficient to satisfy our anticipated cash needs for working capital and capital expenditures for at least the next 12 months.

From time to time, in the ordinary course of business, we may evaluate potential acquisitions of businesses, products or technologies. A portion of our cash may be used to acquire or invest in complementary businesses or products or to obtain the right to use third party technologies. In addition, in making such acquisitions or investments we may assume obligations and or liabilities that may require us to make payments or otherwise use cash in the future.

Critical Accounting Policies and Estimates

The accompanying discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. We believe there are several accounting policies that are critical to understanding our consolidated financial statements, as these policies affect the reported amounts of revenue and expenses and involve management's judgment regarding significant estimates. The critical accounting policies and estimates are described below.

Revenue Recognition

We primarily generate revenue from licensing software and providing services. We recognize revenue in accordance with accounting principles generally accepted in the United States of America, as set forth in American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition*, and AICPA SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*, and Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition*, and other related pronouncements. In accordance with these statements, we recognize revenue upon meeting each of the following criteria:

- Existence of persuasive evidence of an arrangement. Persuasive evidence generally is a purchase order, license agreement or other contract.
- Delivery of product and authorization keys. Delivery has occurred when the customer is given online access to the software and the authorization keys needed to activate the software are made available to the customer. Alternatively, revenue may be recognized when the physical media kit containing the software is shipped.
- Fee is fixed or determinable. A fee is deemed to be fixed or determinable when it is not subject to subsequent refund or adjustment.
- Collection is deemed probable.
- Vendor-specific objective evidence exists to allocate fees to the undelivered elements of the arrangement.

We recognize software revenue using the residual method. Under the residual method revenue is recognized if vendor-specific objective evidence of fair value (VSOE) exists for all of the undelivered elements in an arrangement and all other revenue recognition criteria are met. VSOE is based on the price generally charged when the element is sold separately. Alternatively, if the element is not sold separately, VSOE is based on the price established by authorized management. In situations where vendor-specific objective evidence of fair value for an undelivered element does not exist, the entire amount of revenue from the arrangement is deferred and recognized when fair value can be established for all undelivered elements or when all elements are delivered and all other revenue recognition criteria are met.

Service revenue includes maintenance revenue, usage and subscription-based revenue from our hosted services offerings and revenue from consulting and training services.

We defer license revenue until all of the criteria noted above are met. We defer maintenance revenue and recognize it ratably over the maintenance term, typically one year. We defer advance payments for hosted services and recognize such revenue as earned. We defer consulting and training revenues and recognize them as those services are performed.

We generally recognize revenue from sales made through distributors, resellers, and original equipment manufacturers at the time these partners report that they have sold the software or, alternatively, when we drop-ship the product to the end-user, in each case after all revenue recognition criteria have been met. We recognize revenue from sales made to international master distributors of web analytics products when sold to the master distributor once all revenue recognition criteria have been met. Additionally, we monitor master distributor inventory levels, accounts receivable aging, and the distributor credit history and current credit rating in order to determine that collection is probable. We also maintain an allowance for potential sales returns.

When licenses and services are sold together, we recognize license fees upon shipment, provided that (1) the above criteria have been met, (2) payment of the license fee is not dependent upon the performance of the services, and (3) the services do not provide significant customization of the software and are not essential to the functionality of the software for which a license was sold. For arrangements that do not meet the above criteria, we defer revenue recognition until all of the criteria are met.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. We base our estimates and judgments on historical experience and on various assumptions that we believe are reasonable under current circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustments therefore actual results could differ from our current estimates. Significant estimates made in the accompanying financial statements are:

- Allowance for Uncollectible Accounts—We provide an allowance for uncollectible accounts receivable based on our assessment of the collectibility of specific customer accounts and an analysis of the remaining accounts receivable. Changes in the allowance are included as a component of general and administrative expense on the income statement. The allowance for uncollectible accounts was $748,000 at March 31, 2004. If actual collections differ significantly from our estimates, we may experience a decrease or increase in our general and administrative expenses.
- Allowance for Sales Returns—We provide an allowance for sales returns based on historical trends in product returns. Revenue is recognized net of the provision for sales returns. The allowance for sales returns was $862,000 at March 31, 2004. If actual returns differ significantly from our estimates, it may result in a decrease or increase in future revenue.
- Other Intangible Assets—We record intangible assets when we acquire companies. The cost of the acquisition is allocated to the assets and liabilities acquired, including identifiable intangible assets, with the remaining amount being classified as goodwill. Certain identifiable intangible assets such as purchased technology and customer lists are amortized over time, while in-process research and development is recorded as a charge on the date of acquisition and goodwill is capitalized, subject to periodic review for impairment. Accordingly, the allocation of the acquisition cost to identifiable intangible assets has a significant impact on our future operating results. The allocation process requires extensive use of estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets. Should conditions be different than management's current assessment, material write-downs of the fair value of intangible assets may be required. We periodically review the estimated remaining useful lives of our other intangible assets. A reduction in the estimate of remaining useful life could result in accelerated amortization expense or a write-down in future periods. As such, any future write-downs of these assets would adversely affect our gross and operating margins.

- Goodwill—Under current accounting guidelines adopted on July 1, 2002 we periodically assess goodwill for impairment. Accordingly, goodwill recorded in business combinations may significantly affect our future operating results to the extent impaired, but the magnitude and timing of any such impairment is uncertain. When we conduct our annual evaluation of goodwill, as of April 30, or if in the interim impairment indicators are identified with respect to goodwill, the fair value of goodwill is re-assessed using valuation techniques that require significant management judgment. Should conditions be different than management's last assessment, significant write-downs of goodwill may be required. Goodwill as of March 31, 2004 is $120.1 million, and any future write-downs of goodwill will adversely affect our operating margin.

- Facility Reserve—As of December 31, 2001 we determined that one of our facilities in Portland, Oregon would never be occupied and that sublease opportunities were limited. We reserved our obligations through the remaining term of the lease based principally on management's assessment of market conditions, the time required to sublease, our experience with subleasing, and the remaining lease term. In July 2003, we sublet a portion of the space but receipt of the future sub-lease income is not assured. At March 31, 2004 we had an accrual of $412,000 for expected future costs. If actual future costs, net of any sub-lease income, differ from our estimates, we could experience an increase or decrease in our operating expenses that may affect future operating results.

- Restructuring Liability—In connection with our acquisition of PentaSafe we resized our business and accrued a restructuring liability associated with costs of employee terminations, vacating facilities and write-off of assets that will no longer be used in operations, based on management estimates. The restructuring charge recorded in December 2002 was $5.3 million. The total remaining liability of $581,000 at March 31, 2004 relates to vacated facilities. If actual future payments, net of any sub-lease income, differ from our estimates, we may experience an increase or decrease in our restructuring charge, and a significant increase could adversely affect future operating results.

- Provision for Income Taxes—The provision for income taxes includes taxes currently payable and changes in deferred tax assets and liabilities. We record deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement carrying amounts and the tax basis of assets and liabilities. If we do not generate sufficient taxable income, the realization of deferred tax assets could be impaired resulting in additional income tax expense. As a result, we record a valuation allowance to reduce net deferred tax assets to amounts that are more likely than not to be recognized. Deferred tax assets are principally the result of the tax benefit of disqualifying dispositions of stock options, which will be credited to equity when realized. We have established a valuation allowance to fully reserve these deferred tax assets due to the uncertainty regarding their realization.

Employee Stock Options

Our stock option program is a broad-based, long-term retention program that is intended to attract and retain talented employees and align stockholder and employee interests. We consider our option program critical to our operation and productivity and most of our employees participate in our option program. During the nine months ended March 31, 2004, 77% of the options granted went to employees other than our five most highly compensated executive officers. Options granted under the plans expire no later than 10 years from the grant date and generally vest within four years. We also have an employee stock purchase plan under which employees are entitled to purchase a limited number of shares at 85% of fair market value. See Note 10 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended June 30, 2003 for additional information regarding our stock option plans.

We have assumed certain option plans in connection with our acquisitions. Generally, these options were granted under terms similar to the terms of our stock option plans at prices adjusted to reflect the relative exchange ratio in each acquisition.

The following information is presented to reflect the activity, including grants to our highly compensated executive officers (listed officers), and status of our outstanding options to enhance our disclosure of our stock option program and potential stockholder dilution.

Options granted to employees, including officers and non-employee directors, and dilutive effect of options granted are summarized as follows:

	Nine Months Ended March 31, 2004	Year Ended June 30, 2003	Year Ended June 30, 2002
Total options granted	6,378,253	2,124,750[1]	5,611,027[2]
Less options cancelled	(2,417,961)	(5,821,744)[3]	(1,659,123)
Net options (cancelled) granted	3,960,292	(3,696,994)	3,951,904
Net (cancellations) grants as a percentage of outstanding shares[4]	7.0%	(6.8)%	7.4%
Grants to top five listed officers[5] as a percentage of total options granted	22.5%	15.3%	31.9%
Grants to top five listed officers as a percentage of outstanding shares[4]	2.5%	0.6%	3.4%
Cumulative options held by top five listed officers as a percentage of total options outstanding[6]	22.4%	19.4%	17.6%

(1) Excludes 3,848,214 options assumed in connection with acquisition and 2,848,145 options regranted as part of our 2003 tender offer.

(2) Excludes 1,304,606 options regranted as part of our 2001 tender offer.

(3) Excludes 2,848,145 options cancelled and regranted in our 2003 tender offer.

(4) Outstanding shares at the beginning of each fiscal year.

(5) "Listed Officers" are those defined for proxy statements as our Chief Executive Officer (CEO) and each of the four other most highly compensated executive officers during the respective fiscal years. Listed Officers for the six months ended March 31, 2004 are defined as our CEO and each of the four most highly compensated executives, during fiscal 2003 taking into consideration changes in executive officers since June 30, 2003.

(6) Outstanding options at the end of each period.

Summary of stock option activity under our plans is as follows:

	Shares Available for Options	Options Outstanding Shares	Options Outstanding Weighted-Average Exercise Price
Outstanding, June 30, 2002	1,659,509	13,638,049	$31.36
Granted	(2,124,750)	2,124,750	$16.31
Options regranted under tender offer	(2,848,145)	2,848,145	$16.00
Options assumed in acquisitions	—	3,848,214	$11.80
Exercised	—	(1,174,385)	$ 5.45
Options tendered by employees	5,276,953	(5,276,953)	$34.85
Cancelled	3,392,936	(3,392,936)	$27.95
Expired	(2,175,940)	—	—
Additional shares reserved	2,529,235	—	—
Outstanding, June 30, 2003	5,709,798	12,614,884	$21.26
Granted	(6,378,253)	6,378,253	$13.72
Exercised	—	(780,392)	$ 9.86
Cancelled	2,417,961	(2,417,961)	$20.89
Expired	(789,266)	—	—
Additional shares reserved	2,600,000	—	—
Outstanding, March 31, 2004	3,560,240	15,794,784	$18.84

Summary of outstanding in-the-money and out-of-the-money options as of March 31, 2004 is as follows:

	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
In-the-Money	1,464,438	$ 9.52	5,337,411	$13.34	6,801,849	$12.51
Out-of-the-Money[(1)]	5,169,383	$26.30	3,823,552	$19.99	8,992,935	$23.62
Total Options Outstanding	6,633,821	$22.60	9,160,963	$16.11	15,794,784	$18.84

(1) Out-of-the-money options have an exercise price equal to or above the closing price of $13.99 at March 31, 2004.

Options granted to top five listed officers during the nine months ended March 31, 2004 are as follows:

Name	Number of Securities Underlying Option Granted	Percentage of Total Options Granted to Employees [(1)]	Exercise Price Per Share	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term 5%	10%
Charles M. Boesenberg (CEO)	1,000,200	15.7%	$13.95 - 14.08	9/8/2010[(2)]	$5,715,114	$13,318,554
Marc Andrews	150,200	2.4%	$13.95 - 14.18	1/6/2011[(3)]	$ 861,999	$ 2,008,730
Mark P. Marron	125,200	2.0%	$13.95	9/8/2010[(2)]	$ 710,652	$ 1,656,029
James A. Barth	80,200	1.3%	$13.95	9/8/2010[(2)]	$ 455,095	$ 1,060,472
Holly Files	80,200	1.3%	$13.95	9/8/2010[(2)]	$ 455,095	$ 1,060,472
Total	1,436,000	22.5%				

(1) Based on a total of 6,378,253 options granted to employees during the nine months ended March 31, 2004.

(2) 200 options expiring by September 8, 2008.

(3) 200 options expiring by September 8, 2008 and 50,000 options expiring by September 8, 2010.

Option exercises during the nine months ended March 31, 2004 and remaining option holdings for top five listed officers as of March 31, 2004 are as follows:

Name	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options at March 31, 2004		Value of Unexercised In-the-Money Options at March 31, 2004[1]	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Charles M. Boesenberg (CEO)	—	$—	1,243,948	1,256,252	$ 5,338	$7,995
Marc Andrews	—	$—	28,411	196,789	$ —	$2,000
Mark P. Marron	—	$—	100,199	200,001	$ 8	$5,000
James A. Barth	—	$—	242,977	115,000	$288,315	$3,200
Holly Files	—	$—	36,762	118,438	$ 8	$3,200

(1) Option values based on stock price of $13.99 at March 31, 2004.

The following table summarizes common stock subject to future issuance under our equity compensation plans as of March 31, 2004:

	Stock to be issued upon exercise of outstanding options[1]	Weighted-average exercise price	Stock remaining available for future issuance under equity compensation plans
Plans approved by stockholders[2]	10,507,174	$20.07	3,094,527[3]
Plans not approved by stockholders[4]	3,907,517	$17.86	465,713
Total	14,414,691		3,560,240

(1) Does not include an aggregate of 1,380,093 shares of common stock to be issued upon exercise of options assumed in connection with our acquisitions. No additional awards will be granted under these plans.

(2) Includes the 1995 Stock Plan and the 1999 Employee Stock Purchase Plan (Purchase Plan).

(3) Does not include 2,476,421 shares of common stock reserved for issuance pursuant to the Purchase Plan.

(4) Includes the 2002 Stock Plan, the Amended and Restated 1998 Stock Incentive Compensation Plan, including the Approved UK Sub Plan, and the Mission Critical Software, Inc. 1997 Stock Plan.

Factors That May Affect Future Operating Results

In addition to the other information contained in this Quarterly Report on Form 10-Q, the following risk factors should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem less significant also may impair our business operations. The occurrence of any of the following risks could materially and adversely affect our business, financial condition and operating results.

We may not be able to achieve or sustain the revenue growth rates we have previously experienced.

We have not sustained the sequential quarterly revenue growth we experienced through the quarters ended December 31, 2002, which was attributable in substantial part to license payments made to us under our September 2000 agreement with Microsoft to license our Operations Manager technology. The agreement provided for a total license of $175.0 million to be paid in installments over roughly a three year period. The size of the installment payments made under the agreement decreased starting in the second quarter of fiscal 2003 and the final payment was made by Microsoft in August 2003. To date we have not fully replaced this revenue with revenue from our existing business.

To increase our revenue we must continue to enhance our existing products and services and develop new products, services and multiple-product solutions to address the increasingly sophisticated and varied needs of our existing and prospective customers. The development of new products, services, solutions, and enhancement of existing products and services, entail significant technical and business risks and require substantial lead-time and significant investments in product development and sales. The market for some of our products is in the early stage of development, and we are recent entrants to other markets and face competition from established competitors. Demand and market acceptance for recently introduced products and new market entrants are subject to high levels of uncertainty and risk. Furthermore, new products can quickly render obsolete products that were formerly in high demand, which may include products that currently provide us with significant revenue.

We expect our revenue to fluctuate for a number of reasons, and therefore it is difficult to predict our future operating results.

Our revenue and operating results have varied substantially from quarter to quarter in the past and are likely to vary significantly in the future. These fluctuations are due to a number of factors, many of which are outside of our control, including:

- general economic conditions and the discretionary nature of our customers' purchasing practices, IT budgets and budget cycles;
- the timing of new product introductions or enhancements by us, our competitors and our platform vendors, which may result in purchase deferrals by our customers in anticipation of new products;
- competitive conditions in our industry, including new products, product announcements and special pricing offered by our competitors;
- our ability to introduce new products and enhancements and the timing of their release;
- our ability to complete specific sales transactions in a given quarter or fiscal year;
- fluctuation in the number and size of orders in a quarter;
- our ability to recognize revenues from the fees we charge to our customers; and
- unexpected expenses relating to past or future acquisitions and managing our growth.

We have experienced seasonality in our license bookings, with the second and fourth quarter of our fiscal year typically having the largest volume in new license bookings. We believe that this seasonality results from the budgeting, procurement and work cycles of our customers, and from the structure of our direct sales incentive and compensation program. We expect this seasonality to continue in the future.

In addition, the effect of quarterly fluctuations relative to our expectations is increased by the fact that a significant portion of our revenues has historically been generated during the last month of each fiscal quarter, with a substantial portion of sales occurring in the last week and on the last day of the fiscal quarter. Our reliance on a large portion of revenue occurring at the end of the quarter results in uncertainty relating to quarterly revenues, and our forecasts may not be achieved, either because expected sales do not occur or because they occur at lower prices or on terms that are less favorable to us. We may not learn of shortfalls in revenue or earnings until late in a particular quarter, leaving us unable to proportionately reduce operating expenses for that quarter. These factors increase the chances that our results could diverge from the expectations of investors and securities analysts.

Given the above factors, we believe that quarter-to-quarter financial comparisons may not necessarily be meaningful, and should not be relied upon as single indicators of our future operating results and performance.

Our Stock Price is Volatile

The market price of our common stock has been volatile and we expect that our stock price will continue to fluctuate. The value of an investment in our stock could decline due to the impact of a number of factors upon the market price of our common stock, including: growth rate expectations for the technology sector generally; variations in our actual and anticipated operating results and revenues; changes in our earnings estimates by securities analysts; and our failure to meet securities analysts' performance expectations.

Our investments in products and companies, including through internal development and acquisition, present many risks, and we may not realize the financial and strategic goals that were contemplated at the time of the investment.

We have made substantial investments in developing and acquiring new products, services and technologies, and have made investments in and acquisitions of other companies. We intend to continue to make investments in products, services and technologies, and may in the future acquire or make investments in companies we perceive to be complementary or to have synergies with our business. The risks we may encounter in connection with such investments include:

- the investment may not further our business strategy, we may pay more than the investment proves to be worth, the technology may not be feasible or may fail to be popular with customers, or economic conditions may change, all of which may diminish the value of the investment to us;
- we may fail to anticipate new technology development, customer requirements or industry standards, or may be unable to develop or purchase new products, services and technologies that adequately address these developments, requirements or standards in a timely manner;
- we may have difficulty integrating the investment with our business, marketing and sales strategies;
- we may have difficulty integrating any acquired technologies, operations or personnel, into our existing business and product lines; and
- our ongoing business may be disrupted by transition or integration issues arising from the investment.

The failure of our investments to produce anticipated benefits may also adversely affect our operating results, as a consequence of amortization of purchased technology and other intangible assets, other acquisition or investment related charges, and impairment charges associated with goodwill. During fiscal 2002 and 2001, we amortized $751.8 million and $535.8 million of goodwill related to our acquisitions and in accordance with SFAS No. 142 had no goodwill amortization in fiscal 2003. We may be required to record charges for impairment if a product or technology is discontinued, if we pay more than an investment is worth, or if an investment subsequently declines in value. Upon adoption of SFAS No. 142, on July 1, 2002, we recorded an impairment charge of $579.3 million and have subsequently recorded impairment charges of $330.5 million on April 30, 2003, and $150.8 million on September 30, 2003. These impairment charges are attributable to our revised forecasts for future operating profits and cash flows from our investments, and reflect the decline in our market capitalization. If in future periods we discontinue additional products, or determine that our remaining goodwill from acquisitions has become further impaired or that our investments have further declined in value, we will be required to record additional charges.

The consideration paid in connection with an investment or acquisition also affects our immediate operating results and financial condition. To the extent we issue shares of stock or other rights to purchase stock, such as options, the stock holdings of existing stockholders will be diluted and earnings per share may decrease. To the extent we pay cash for future investments or acquisitions our cash reserves will be further reduced.

We expect to face increasing competition in the future, which could result in loss of market share, decreased prices, reduced gross margins and diminished profits.

The market for systems and security management software solutions and our web analytics software solutions is intensely competitive, and we expect competition to increase in the future. While there are few substantial barriers to entry at the low end, we expect to see increasing consolidation in the software industry, including among our competitors, which could increase the resources available to our competitors and the scope of their product offerings. Our competitors and potential competitors may have more name and brand recognition, develop more advanced technology, undertake more extensive sales and marketing campaigns, adopt more aggressive pricing policies and sales terms, and be able to leverage more extensive financial, customer and partner resources.

Our principal competitors, include:

- customers' internal information technology departments that develop or integrate systems management, security management, or web analytics tools for their particular needs;

- providers of network and systems management framework products, such as Computer Associates International, Inc., Hewlett-Packard Company, and International Business Machines Corporation;

- providers of performance and availability management solutions, such as Microsoft Corporation, BMC Software, Inc., Concord Communications, Inc., and Veritas Software Corporation;

- vendors of computers, operating systems, or networking hardware, such as Microsoft Corporation, Sun Microsystems, Inc., Cisco Systems, and others that bundle systems or security management solutions with their products;

- application vendors who bundle management solutions with their products, such as Oracle Corporation and SAP AG;

- providers of security management solutions, such as BindView Corporation, Computer Associates International, Inc., International Business Machines Corporation, Internet Security Systems, Inc., Network Associates Technology, Inc., Symantec Corporation, netForensics Inc., ArcSight, and Intellitactics;

- providers of administration products, such as BindView Corporation and Quest Software, Inc.;

- providers of content security solutions, such as Clearswift Limited, Tumbleweed Communications Corp., Trend Micro, Inc., Postini Corporation, Brightmail, Inc., SurfControl plc, and Websense, Inc.;

- providers of web analytics solutions, such as Coremetrics, Inc., Omniture Inc., WebSideStory, Inc., DoubleClick Inc., Sane Solutions, LLC, RedSheriff, Fireclick, Inc., International Business Machines Corporation, Datanautics, Inc., and SPSS Inc.;

- providers of online marketing reporting tools and services, such as Go Toast, LLC, aQuantive, Inc., DoubleClick Inc., and OneStat.com;

- web management service providers and vendors, such as consulting firms, web design firms, Internet audit firms, site management vendors, Internet service providers and independent software vendors.

We also expect future product consolidation to be an important competitive factor, and that competitors may bundle their products with products similar to ours, or incorporate functionality into existing products that could render certain of our products unmarketable or obsolete. For instance, Microsoft is a competitor for certain of our products and has an established business practice of adding functionality to new versions of Windows in ways that can impair the success of formerly complementary products. Customer perception of this pattern could also adversely affect or delay sales of our products.

In addition, our ability to sell our products depends, in part, on the compatibility of our products with other third-party products, such as operating systems and messaging, Internet and database applications. Some of these third-party software developers may change their products so that they compete with our products or are no longer compatible with our products. In particular, our business continues to be largely focused on the Microsoft Windows environment and Microsoft has typically provided to us pre-release notification of feature enhancements to its products and necessary development tools and information. If Microsoft stops this practice, we may be unable to coordinate our product offerings with Microsoft or to otherwise capitalize on new Microsoft product releases and feature enhancements.

Our inability to rapidly respond to changes in our revenue and to adopt appropriate expense controls may result in operating losses or a shortfall in operating profits.

As a consequence of our acquisitions and in response to the changing business environment, during fiscal 2003 we adopted a number of measures to better align our expenses with anticipated revenues, including various reductions in force and the closure of certain facilities. In addition, on July 1, 2003, we re-aligned our sales force from a territory orientation to a named account orientation to better focus on our existing customer base, and we realigned our products into solution sets. The focus on specific customers and product solution sets, together with our recent implementation of a value-based sales approach, was intended to enable us to meet customer needs more quickly and achieve more cost-effective sales operations. However, these measures have not been wholly successful. We believe that the disruption caused by our sales realignment, among other factors, resulted in our failure to meet our revenue target for the three months ended September 30, 2003.

We base our operating expenses on our expectations regarding future revenues. However, because most of our revenue is generated at the end of the quarter, we may not learn of shortfalls in revenue or earnings until late in a particular quarter, leaving us unable to proportionately reduce operating expenses for that quarter. As a consequence, we may experience an operating loss, a shortfall in our operating profit or earnings or otherwise fail to meet public market expectations.

In April 2003, we announced a reduction in force designed to reduce operating costs by combining our systems and security business units and streamlining our organizational structure. As a result, we terminated the employment of 108 employees, including four senior executives, substantially all of whom left our employment by June 30, 2003.

To the extent we engage in these and other organizational or operational changes in the future, we may incur additional costs and expenses and suffer lost revenue. These measures, and any future steps we may adopt, may result in distraction of management, operational disruption or negative impact on customer service and satisfaction. Similarly, other organizational or operational changes in the future may not result in the intended operational improvements and cost reductions, and may adversely affect our business and financial condition.

We have a history of losses and may experience losses in the future.

Since our inception, we have incurred significant net losses. During fiscal 2003, 2002 and 2001, we reported net losses of $908.7 million, $730.5 million and $523.8 million, respectively. During the first three quarters of fiscal 2004 we reported a net loss of $184.5 million. These losses principally resulted from amortization and impairment of goodwill, amortization of purchased technology and other intangible assets, and other acquisition related charges.

We expect to incur a net loss in fiscal 2004. To the extent we have any unexpected expenses or do not achieve our revenue targets, it could increase our net loss, which may in turn adversely affect our stock price.

Errors in our products could result in significant costs to us and could impair our ability to sell our products.

Because our software products are complex, they may contain errors, or "bugs," that could be detected at any point in a product's life cycle. These errors could materially and adversely affect our business reputation, result in significant costs to us, and impair our ability to sell our products in the future. The costs incurred in correcting any product errors may be substantial and could decrease our profit margins. While we expect to continually test our products for errors and work with customers through our customer support services organization to identify and correct bugs, errors in our products may be found in the future. Because it is difficult to simulate the highly complex computing environments in which our customers use our products and because of the increasing functionality of our product offerings, testing may be complicated and fail to identify all errors. Moreover, because our products support and interoperate with third-party operating systems and applications, any errors or bugs in that software may result in errors in the performance of our products and may require cooperation from the third-party to resolve.

Detection of any significant errors may result in, among other things, lost or delayed market acceptance and sales of our products, diversion of development resources, injury to our reputation, and increased service and warranty costs. Errors in our software also may result in expensive and time-consuming litigation, and the potential award of substantial damages. While our software license agreements typically contain limitations and disclaimers that purport to limit our liability for damages resulting from errors in our software, there is no assurance that such limitations and disclaimers will be enforced by a court or other tribunal or will otherwise effectively protect us from such claims. This is particularly true with respect to those of our products licensed under "shrink wrap" or "clickwrap" license agreements that are not signed by licensees, but also may apply to negotiated license agreements. We presently carry errors and omissions insurance against such claims, but there is no assurance that such insurance coverage will be adequate to cover any losses as a result of bugs or errors or will be available in the future on commercially reasonable terms.

Our business requires the creation of technology and the effective protection and enforcement of our intellectual property rights in that technology.

Our success is heavily dependent on our ability to create proprietary technology and to protect and enforce our intellectual property rights in that technology, as well as our ability to defend against adverse claims of third parties with respect to our technology and intellectual property. We rely primarily on a combination of patent, copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect our intellectual property rights in our products and services. These laws and procedures provide only limited protection. We presently have 17 issued or allowed patents in the United States, 25 pending patent applications in the United States, 6 issued or allowed foreign patents, and 21 pending patent applications in certain foreign jurisdictions. However, these patents may not provide sufficiently broad protection or they may not be enforceable in actions against alleged infringers. In addition, despite precautions that we take, it may be possible for unauthorized third parties to copy or reverse engineer aspects of our current or future products or to independently develop similar or superior technology or design around the patents we own. Policing unauthorized use and transfer of our software is difficult and software piracy can be expected to be a persistent problem. In licensing our products, other than in enterprise license transactions, we typically rely on "shrink wrap" or "clickwrap" licenses that are not signed by licensees. Such licenses may be unenforceable, in whole or in part, under the laws of certain jurisdictions. In addition, the laws of some foreign countries do not protect our intellectual property rights to as great an extent as do the laws of the United States. It may be necessary to enforce our intellectual property rights through the process of litigation, arbitration or other adversarial proceedings. Such proceedings would be costly and potentially distracting to management, and there is no assurance that we would be successful in such proceeding.

Third parties could assert that our products infringe their intellectual property rights.

Third parties may claim that our current or future products infringe their intellectual property rights, and these claims, whether they have merit or not, could harm our business by increasing our costs, reducing our revenue or by creating customer concerns that result in reduced sales. This is particularly true in the patent area, as an increasing number of U.S. patents covering computer software have been issued during the past few years. Patent owners may claim that one or more of our products infringes a patent held by the claimant. For example, in January 2003, one of our competitors, BMC Software, Inc., initiated a lawsuit alleging that one or more of our products infringed a BMC patent. These claims now have been submitted to arbitration. Although we believe these claims to be without merit, claims such as these could affect our relationships with existing customers and may discourage future customers from purchasing our products. The intensely competitive nature of our industry and the importance of technology to our competitors' businesses may enhance the likelihood of being subject to third-party claims of this nature. Any such claims, even if without merit, could be time consuming, result in potentially significant litigation costs or damages, cause product shipment delays and require us to enter into royalty or licensing agreements. Royalty or license agreements may not be available on commercially favorable terms or at all. Such claims could also force us either to stop selling, incorporating or using products or services that incorporate the challenged intellectual property or to redesign those products or services that incorporate such technology. We expect that software developers will increasingly be subject to infringement claims as the number of products and competitors in the software industry grows, the functionality of products in different industry segments overlaps, and the number of issued software patents increases.

We face challenges in the retention of key management, technical and sales personnel.

We depend on certain key management, technical and sales personnel and on our ability to attract and retain highly qualified personnel. Given recent competitive pressures, we anticipate that our ability to retain key personnel will become more difficult should the economy improve and make more positions available, thus enhancing employee mobility. As well, our ability to attract and retain personnel may be made more difficult by anticipated changes in the accounting treatment of stock-based compensation, which may limit our ability to use broad-based stock option grants as a means to attract and retain qualified personnel.

Our success will depend to a significant extent on our ability to retain the services of our key personnel. We do not have employment contracts for a defined term with our employees, including our key personnel. If we lose the services of one or more of our key personnel, including if one or more of our key employees decided to join a competitor or otherwise compete directly or indirectly with us, this could harm our business and affect our ability to successfully implement our business objectives.

Failure to improve our business processes and infrastructure, and satisfactorily implement new information and fulfillment systems, may adversely affect our business.

Our prior growth, including through acquisitions, as well as recent business and regulatory requirements, has resulted in new and increased responsibilities for our management personnel; a need to upgrade our operational, financial, and management information systems; and the need to develop and implement cost-effective systems, standards, controls, procedures and policies, including documentation of the internal controls procedures required by Section 404 of the Sarbanes Oxley Act of 2002. In particular, we have been required to improve our accounting and financial reporting systems in order to accommodate our growth on a global basis and to meet the requirements of a changing regulatory environment. To meet these challenges we implemented a new customer relationship management system in fiscal 2002, and are continuing the process of modifying and refining it to better meet our needs. We also implemented a new enterprise resource planning system, including an accounting and financial bookkeeping system for tracking and reporting our financial information, during the December 2002 quarter and are in the process of modifying and refining it to better meet our needs. Most recently, we have implemented eServices technology that provides self-service support capabilities to our customers. While we believe that these systems will enable us to operate more efficiently and will enhance our ability to provide timely and accurate reporting, the failure, poor performance or errors of any of these systems, especially during the high-volume end-of-quarter time periods, could impact our ability to sell and deliver our products which could in turn materially and adversely impact our business, including our ability to meet our revenue and expense targets.

We rely on our network and data center infrastructure for internal communications, communications with customers and partners, direct sales of our software products, sales lead generation and direct provision of fee-based services. That infrastructure and our other facilities are vulnerable to damage from human error, physical or electronic security breaches, power loss and other utility failures, fire, earthquake, flood, sabotage, vandalism and similar events. In addition, continued attempts to exploit security vulnerabilities in infrastructure products pose a threat to the stability of our IT infrastructure. Despite precautions, a natural disaster or other incident could result in interruptions in our service or significant damage, and affect our provision of services and fulfillment of product orders, our ability to process product orders and invoices, and our ability otherwise timely conduct our business operations.

Our international sales and operations subject us to additional risks that can adversely affect our operating results.

We derive a substantial and increasing portion of our revenues from customers outside the United States and are continuing to expand our international operations. We have support, and administrative services operations in Galway, Ireland, Tokyo, Japan and Staines, United Kingdom, as well as a number of other foreign locations, to provide sales and sales support. We also have a development operation in Auckland, New Zealand, which we are closing in the summer of 2004. Our international operations are subject to a variety of risks, including:

- the overlap of different tax regimes;
- the difficulty of managing and staffing foreign offices;
- differing regulatory and legal requirements and employment schemes, including with respect to separation and redundancies, and our ability to identify and timely comply with such requirements and schemes;
- longer payment cycles and difficulties in collecting accounts receivable;
- fluctuations in currency exchange rates and difficulties in transferring funds from certain countries;
- the need to localize and internationalize our products and licensing programs;
- significant reliance on our distributors and other resellers who do not offer our products exclusively;
- import and export licensing requirements, including export controls on encryption technology;
- political and economic instability in some countries;
- seasonal reductions in business activity during the summer months in Europe and certain other regions;
- reduced protection for intellectual property rights in some countries; and
- increased travel and infrastructure costs associated with multiple international locations.

To date, a substantial portion of our sales have been denominated in U.S. dollars, and we have not used risk management techniques or "hedged" the risks associated with fluctuations in foreign currency exchange rates. In the three and nine months ended March 31, 2004 we recorded a gain of approximately $436,000 and a loss of approximately $132,000, respectively consisting primarily of foreign exchange gains and losses on US dollars and other foreign currency receivables held in subsidiaries with local functional currencies, in particular euros. In the future, if we do not engage in hedging transactions, our results of operations could be subject to further fluctuations resulting in losses or gains from fluctuations in foreign currency exchange rates to the extent our sales are denominated in foreign currencies and the dollar fluctuates in value relative to such currencies.

Our global operations also subject us to laws relating to the use and transfer of personally identifiable information about our customers, employees and other individuals, especially outside of the United States. Violation of these laws, which in many cases apply not only to third-party transfers, but also to transfers of information between our subsidiaries and ourselves, and between and among ourselves, our subsidiaries and our commercial partners, could subject us to significant penalties and negative publicity.

We are increasingly relying on indirect distribution channels to generate revenue.

To further increase our revenues, we have increasingly relied on indirect distribution channels as a means of growing product sales, including with respect to international sales. These relationships, both domestically and internationally, are typically non-exclusive and can be terminated upon short notice. This strategy presents a number of risks and uncertainties including:

- the ability of resellers or integrators to cease marketing or integrating our products with little or no notice;
- the ability of our resellers or integrators to market or use competitive products or services from third parties and to promote such third-party products or services in preference to ours;
- the effectiveness of our resellers and integrators in marketing our products;
- the difficulty in attracting and replacing high quality resellers and integrators;
- the potential of conflicts between our direct and indirect sales channels resulting in lost sales and customer confusion or dissatisfaction; and
- risk associated with accurately reporting revenue.

We have recently experienced several changes in our senior management team.

We have recently undergone significant changes in senior management. On January 7, 2004 we announced the promotion of Marc Andrews to Senior Vice President and General Manager of our Systems and Security Management business unit. On October 28, 2003 we announced the appointment of Gregory L. Drew, Senior Vice President Sales and Marketing, to General Manager of our Web Analytics business unit, replacing Daniel J. Meub, who is retiring. Thomas R. Kemp, Senior Vice President Corporate Strategy and Development, resigned on December 22, 2003, and was replaced by David J. Ehrlich, who was promoted to Senior Vice President Corporate Strategy and Development on January 7, 2004. Steven M. Kahan, Senior Vice President Marketing, resigned on December 12, 2003, and was replaced by Olivier Thierry, who was promoted to Senior Vice President, Worldwide Marketing and Alliances on January 7, 2004. Our success will depend to a certain extent on our ability to assimilate these changes in our leadership team.

We incorporate software licensed from third parties into some of our products and any significant interruption in the availability of these third-party software products or defects in these products could reduce the demand for, or prevent the sale or use of, our products.

Certain of our software products contain components developed and maintained by commercial third-party software vendors or available through the “open source” software community. We also expect that we may incorporate software from commercial third-party vendors and open source software in our future products. Software obtained from commercial third-party vendors is typically made available for a specific term, with no guaranty of renewal. Our business would be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our software to function with alternate third-party software or open source software, or develop these components ourselves, which would result in increased costs and could result in delays in our software shipments. Furthermore, we might be forced to limit the features available in our current or future software offerings. We presently are developing products for use on the Linux platform. The SCO Group (SCO) has filed and threatened to file lawsuits against companies that operate Linux for commercial purposes, alleging that such use of Linux infringes SCO’s intellectual property rights. The threat of such litigation and the cost of the licensing scheme presently proposed by SCO may adversely affect the demand for the Linux platform and, consequently, the sales of our Linux-based products.

Changes in accounting regulations could negatively affect market perception of our results and the way we do business.

The accounting rules applicable to our business have undergone significant changes in recent years, and future changes in accounting regulations and related interpretations and policies, particularly those related to expensing of employee stock options, could cause us to account for our business in ways that may adversely affect our operating results and investor perception of those results. As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, currently we apply Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for our employee stock–based compensation. Under APB No. 25, no compensation expense is recognized for options granted to employees where the exercise price equals the market price of the underlying stock on the date of grant. A change in accounting rules that would require us to change the way we account for such options to include a deferred compensation liability on our balance sheet and to include the deemed expense associated with such options in our statement of operations may if adopted, reduce our operating income or increase operating losses as a result of these non-cash expenses. In such an event, investor perception of our results of operations may be adversely affected and our stock price may fall.

Changes in our market may affect our operating results by changing the manner in which we are required to account for sales.

There have been various changes in the enterprise software market that may affect the manner in which we do business. We currently sell most of our software licenses on a "perpetual" basis, which enables us to recognize the majority of revenue received in connection with the sale promptly upon consummation of the sale. However, certain software vendors are moving towards a subscription-based model in which periodic fees are charged for use of the software. If customers increasingly demand that we sell licenses to our software on a subscription basis, or otherwise charge a periodic fee for its use, it will delay our recognition of revenue for that sale and will decrease the revenues attributable to such sales during the reporting period in which the sale is made (although the deferred revenue will be recognized in subsequent periods). If substantial portions of our license sales are converted to a subscription basis, this could materially affect our revenues during the initial quarters in which the change is implemented.

We have various mechanisms in place that may discourage takeover attempts.

Certain provisions of our certificate of incorporation and bylaws and certain provisions of Delaware law could delay or make difficult a change in control that a stockholder may consider favorable. Our certificate of incorporation allows our Board of Directors to designate and issue one or more series of preferred stock that may have rights preferences and privileges superior to our common stock without any action by our stockholders. Our bylaws limit the ability of a stockholder to call a special meeting. We have a classified Board of Directors, with staggered, three-year terms, that may lengthen the time required to gain control of the Board of Directors. In addition, certain of our officers are parties to a Change of Control Agreement or other agreements with us, that provide for the acceleration of stock option vesting and the payment of certain compensation in the event such officer's employment is terminated within a specified period after a change of control. In addition, our 1995 and 2002 Stock Plans provide for acceleration of stock option vesting in the event an employee's employment is terminated within a specified period after a change of control. Any of these provisions could dissuade a potential acquirer from seeking to acquire control of NetIQ, which in turn could result in our stockholders not being able to participate in premiums that may otherwise have been offered in a potential acquisition.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not use derivative financial instruments in our investment portfolio and have no foreign exchange contracts. Our financial instruments consist of cash and cash equivalents, short-term investments, trade accounts, and accounts payable. We consider investments in highly liquid debt instruments purchased with a remaining maturity of three months or less to be cash equivalents. Our exposure to market risk for changes in interest rates relates primarily to our short-term investments; thus, fluctuations in interest rates would not have a material impact on the fair value of these securities.

Our business is transacted principally in U.S. dollars. During the nine months ended March 31, 2004, 19% of the total amount of our invoices was in currencies other than the U.S. dollar. Accordingly, we are subject to exposure from adverse movements in foreign currency exchange rates. This exposure is primarily related to local currency denominated revenue and operating expenses in Australia, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, New Zealand, Singapore, South Korea, Spain, Sweden, Switzerland, and the United Kingdom. We believe that a natural hedge exists in some local currencies, as local currency denominated revenue offsets some of the local currency denominated operating expenses. We assess the need to utilize financial instruments to hedge currency exposures on an ongoing basis. However, as of March 31, 2004, we had no hedging contracts outstanding.

At March 31, 2004 we had $85.9 million in cash and cash equivalents and $236.0 million in short-term investments. Based on our cash, cash equivalents and short-term investments at March 31, 2004 a 10% change in interest rates would change our annual interest income and cash flows by approximately $486,000.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Disclosure Controls and Procedures*. Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our "disclosure controls and procedures" (as defined in the Securities Exchange Act of 1934 (Exchange Act) Rules 13a-15(e) or 15d-15(e)) as of the end of the period covered by this report, have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

(b) *Changes in Internal Control over Financial Reporting*. There has been no change in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We have a disclosure committee composed of key individuals from a variety of disciplines within our company who are involved in the disclosure and reporting process. The committee meets regularly to ensure the timeliness, accuracy and completeness of the information required to be disclosed in our filings.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In January 2003 BMC Software, Inc. (BMC) filed suit against us in the U.S. District Court for the Southern District of Texas (Court) for patent and trademark infringement. In August 2003 the Court ordered the litigation stayed, pending arbitration. In September 2003 BMC submitted to the American Arbitration Association a statement of claim seeking a declaratory judgment that BMC's claims are not subject to arbitration and alleging that it believes that at least AppManager and Operations Manager, a product we presently do not offer and which is licensed to Microsoft, infringe the BMC patent. In October 2003 we submitted our initial answer, denying the claims of infringement asserted by BMC. In November 2003 we filed an amended answer and counterclaim alleging that BMC infringes a valid patent that we own. BMC has denied the allegations in our counterclaim. Each party seeks injunctive relief, compensatory and treble damages, interest, and attorneys' fees with respect to its claims.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit Number	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302(a) of The Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302(a) of The Sarbanes-Oxley Act of 2002
32	Certification Pursuant to Section 906 of The Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K

1. A current report on From 8-K was filed on February 25, 2004 reflecting shares outstanding as of January 31, 2004
2. A current report on Form 8-K was filed on April 27, 2004 reporting our financial results as of and for the three and nine months ended March 31, 2004 and providing guidance for the three months ending June 30, 2004.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, NetIQ Corporation has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Jose, State of California, on the 6th day of May, 2004.

NetIQ Corporation

By: /s/ James A. Barth

James A. Barth
Senior Vice President and Chief Financial Officer