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, 2005

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	**77-0405505**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. employer identification no.)**
3553 North First Street, San Jose, CA	**95134**
(Address of principal executive offices)	**(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, 2005, the Registrant had outstanding 54,173,791 shares of Common Stock.

NETIQ CORPORATION

INDEX TO QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED March 31, 2005

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

NetIQ CORPORATION

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

	March 31, 2005 (Unaudited)	June 30, 2004 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 66,213	$ 57,841
Short-term investments	219,907	229,781
Accounts receivable, net	26,578	31,081
Prepaid expenses and other	5,321	5,269
Current assets of discontinued operations	6,050	—
Total current assets	324,069	323,972
Property and equipment, net	42,750	49,706
Other intangible assets, net	20,859	39,040
Other assets	1,132	2,489
Long-term investments	3,714	4,614
Goodwill	96,051	124,081
Non-current assets of discontinued operations	35,717	—
Total assets	$ 524,292	$ 543,902
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 7,813	$ 8,278
Accrued compensation and related benefits	12,317	14,374
Other liabilities	10,988	11,812
Deferred revenue, current portion	52,240	61,174
Restructuring liability, current portion	8	929
Current liabilities of discontinued operations	18,019	—
Total current liabilities	101,385	96,567
Deferred revenue, net of current portion	2,351	5,442
Restructuring liability, net of current portion	—	393
Non-current liabilities of discontinued operations	456	—
Total liabilities	104,192	102,402
Stockholders' equity:		
Common stock-$0.001 par value; 250,000,000 shares authorized, 53,854,037 issued and outstanding at March 31, 2005; 55,216,057 issued and outstanding at June 30, 2004	2,888,415	2,905,610
Deferred employee stock-based compensation	(2,085)	(313)
Accumulated deficit	(2,464,760)	(2,462,825)
Accumulated other comprehensive loss	(1,470)	(972)
Total stockholders' equity	420,100	441,500
Total liabilities and stockholders' equity	$ 524,292	$ 543,902

(1) Derived from audited consolidated financial statements.

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2005	2004	2005	2004
Software license revenue	$24,745	$ 31,735	$ 86,113	$ 91,200
Service revenue	26,353	23,693	77,000	69,106
Total revenue	51,098	55,428	163,113	160,306
Cost of software license revenue	1,128	2,465	3,611	7,817
Cost of service revenue	6,776	5,742	19,932	16,370
Amortization of purchased technology	2,953	1,998	8,860	5,609
Total cost of revenue	10,857	10,205	32,403	29,796
Gross profit	40,241	45,223	130,710	130,510
Operating expenses:				
Sales and marketing	26,089	27,954	77,921	79,177
Research and development	12,159	14,446	38,522	41,288
General and administration	7,430	6,577	21,689	20,064
Amortization of other intangible assets	2,147	2,122	6,406	6,366
Employee stock-based compensation	384	68	881	247
Restructuring charge (credit)	—	—	19	(504)
Impairment of goodwill	—	—	—	134,255
Total operating expenses	48,209	51,167	145,438	280,893
Loss from operations	(7,968)	(5,944)	(14,728)	(150,383)
Other income (expenses):				
Interest income	1,582	1,186	4,126	3,953
Gain on sale of long-term investment	—	—	4,100	—
Impairment of long-term investment	—	—	—	(4,100)
Gain on sale of technology	2,893	—	2,893	—
Other income (expenses), net	(163)	430	394	(175)
Total other income (expenses)	4,312	1,616	11,513	(322)
Loss before income taxes	(3,656)	(4,328)	(3,215)	(150,705)
Income tax expense (benefit)	(426)	1,010	1,120	2,707
Loss from continuing operations	(3,230)	(5,338)	(4,335)	(153,412)
Income (loss) from discontinued operations (net of taxes of $55, $(60), $166, $143), respectively	167	(5,269)	2,399	(31,056)
Net loss	$ (3,063)	$(10,607)	$ (1,936)	$(184,468)
Other comprehensive income (loss), net of income taxes:				
Foreign currency translation adjustment	50	(252)	32	278
Unrealized loss on short-term investments	(434)	(16)	(530)	(336)
Comprehensive loss	$ (3,447)	$(10,875)	$ (2,434)	$(184,526)
Basic and diluted earnings (loss) per share:				
Continuing operations	$ (0.06)	$ (0.09)	$ (0.08)	$ (2.70)
Discontinued operations	$ 0.00	$ (0.09)	$ 0.04	$ (0.55)
	$ (0.06)	$ (0.19)	$ (0.04)	$ (3.25)
Shares used to compute basic and diluted earnings (loss) per share	54,162	57,045	54,759	56,739

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

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

	Nine Months Ended March 31, 2005	Nine Months Ended March 31, 2004
Cash flows from operating activities:		
Net loss from continuing operations	$ (4,335)	$(153,412)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Gain (loss) from discontinued operations	2,399	(31,056)
Depreciation and amortization	25,872	42,454
Amortization of employee stock-based compensation	886	257
Loss on sale of investments and property and equipment	196	160
Impairment of goodwill	—	150,842
Gain on sale of long-term investment	(4,100)	—
Gain on sale of technology	(2,893)	—
Impairment of long-term investment	—	4,100
Changes in:		
Accounts receivable	(120)	13,559
Prepaid expenses and other	534	1,435
Accounts payable	150	(557)
Accrued compensation and related benefits	69	(3,230)
Other liabilities	1,011	(853)
Restructuring liability	(844)	(2,253)
Deferred revenue	529	8,363
Net cash provided by operating activities	19,354	29,809
Cash flows from investing activities:		
Purchases of property and equipment, net	(7,414)	(5,774)
Proceeds from sales of property and equipment	42	11
Cash used in acquisitions	(808)	—
Purchases of short-term investments	(97,590)	(170,539)
Proceeds from maturities of short-term investments	102,022	161,909
Proceeds from sale of long-term investment	5,000	—
Proceeds from sales of short-term investments	4,912	9,181
Proceeds from sales of technology, net	2,209	—
Purchase of technology	(300)	(15,402)
Other	108	(73)
Net cash provided by (used in) investing activities	8,181	(20,687)
Cash flows from financing activities:		
Proceeds from sale of common stock	3,671	10,715
Repurchase of common stock	(23,526)	(10,399)
Net cash provided by (used in) financing activities	(19,855)	316
Effect of exchange rate changes on cash	692	319
Net increase in cash and cash equivalents	8,372	9,757
Cash and cash equivalents, beginning of period	57,841	76,095
Cash and cash equivalents, end of period	$ 66,213	$ 85,852
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 47	$ 33
Cash paid for income taxes	$ 737	$ 943

See notes to condensed consolidated financial statements.

NetIQ CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended March 31, 2005 and 2004
(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 Pacific, 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. 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, 2005.

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, 2004.

2. Discontinued Operations

On March 26, 2005, we entered into a definitive agreement to sell our WebTrends web analytics business to WebTrends Inc. (formerly Spider Holding Inc.), an affiliate of Francisco Partners, L.P., a technology-focused private equity investment firm. The transaction closed on April 30, 2005 and we received $93.4 million in gross proceeds resulting in a net pretax gain of approximately $64.6 million, which we will record in the quarter ending June 30, 2005. In addition, the employment of approximately 237 of our employees was assumed by WebTrends Inc as of April 30, 2005. As a result of this transaction, we have presented historical NetIQ financial statements to exclude the following:

Discontinued operations income statement detail
(In thousands)

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2005	2004	2005	2004
Software license revenue	$ 3,758	$ 4,323	$12,240	$ 13,896
Service revenue	7,924	7,165	22,677	19,532
Total revenue	11,682	11,488	34,917	33,428
Cost of software license revenue	80	—	112	—
Cost of service revenue	1,900	2,443	6,073	7,283
Amortization of purchased technology	141	3,908	425	11,900
Total cost of revenue	2,121	6,351	6,610	19,183
Gross profit	9,561	5,137	28,307	14,245
Operating expenses:				
Sales and marketing	5,836	4,848	16,079	12,519
Research and development	2,882	3,475	8,680	9,621
General and administration	544	46	844	46
Amortization of other intangible assets	43	2,094	128	6,376
Employee stock-based compensation	2	3	6	9
Restructuring charge	32	—	5	—
Impairment of goodwill	—	—	—	16,587
Total operating expenses	9,339	10,466	25,742	45,158
Income taxes	(55)	60	(166)	(143)
Income (loss) from discontinued operations	$ 167	$ (5,269)	$ 2,399	$(31,056)

Discontinued operations balance sheet detail
(In thousands)

	March 31, 2005 (Unaudited)
ASSETS	
Accounts receivable, net	$ 5,353
Prepaid expenses and other	697
Current assets of discontinued operations	$ 6,050
Property and equipment, net	$ 4,186
Other intangibles	2,663
Other assets	30
Goodwill	28,838
Non-current assets of discontinued operations	$35,717
LIABILITIES	
Accounts payable	$ 767
Accrued compensation and related benefits	2,331
Other liabilities	1,492
Deferred revenue current portion	13,154
Restructuring liability, current portion	275
Current liabilities of discontinued operations	$18,019
Deferred revenue, net of current portion	$ 261
Restructuring liability, net of current portion	195
Non-current liabilities of discontinued operations	$ 456

3. Recently Issued Accounting Pronouncement

On December 16, 2004, the FASB issued Statement No. 123 (revised 2004) ("SFAS No. 123(R)"), *Share-Based Payment*. SFAS No. 123(R) will require us to measure the cost of all employee stock-based compensation awards based on the fair value of those awards on the grant date and to record that cost as compensation expense over the period during which the employee is required to perform service in exchange for the award (generally one to four years). Excess tax benefits, as defined by SFAS 123(R), will be recognized as an addition to paid-in capital. SFAS No. 123(R) will be effective with our fiscal quarter beginning July 1, 2005. The company is currently evaluating the impact that the adoption of SFAS No. 123(R) will have on its results of operations, but it is expected to have a material impact on our consolidated results of operations.

4. Stock Based Compensation Plans

We account for stock-based compensation for our employee stock plans in accordance with provisions of 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.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Nine Months Ended March 31, 2005 and 2004
(Unaudited)

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,	
	2005	2004	2005	2004
Estimated life (in years)	4.2	4.3	2.5-4.3	4.0-4.3
Risk-free interest rate	3.8%	2.6%	3.2-3.8%	2.6-2.9%
Volatility	63%	58%	63-66%	58-70%

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,	
	2005	2004	2005	2004
Reported net income (loss):				
Continuing operations	$ (3,203)	$ (5,338)	$ (4,335)	$(153,412)
Discontinued operations	167	(5,269)	2,399	(31,056)
Employee stock-based compensation included in reported net loss:				
Continuing operations	382	68	875	248
Discontinued operations	2	3	6	9
Employee stock-based compensation determined under the fair value method for all awards, net of income taxes	(11,477)	(13,962)	(38,336)	(46,669)
Pro forma net loss	$(14,129)	$(24,498)	$(39,391)	$(230,880)
Basic and diluted earnings (loss) per share:				
As reported	$ (0.06)	$ (0.19)	$ (0.04)	$ (3.25)
Pro forma	$ (0.26)	$ (0.43)	$ (0.72)	$ (4.07)

5. 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, 2005 are as follows (in thousands):

	Uncollectible Accounts	Sales Returns
Balances, June 30, 2004	$ 671	$ 863
Continuing operations		
Increase (decrease) in allowance	(119)	560
Recoveries and (write-offs), net	103	(498)
Discontinued operations		
Increase (decrease) in allowance	30	105
Recoveries and (write-offs), net	8	(92)
Reclass to discontinued operations	(142)	(126)
Continuing operations balances, March 31, 2005	$ 551	$ 812

6. Other Intangible Assets

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

	Carrying Amount	Accumulated Amortization	Net
	March 31, 2005		
Purchased technology	$49,154	$34,459	$14,695
Customer contracts	24,829	19,102	5,727
Customer lists	16,465	16,465	—
Publishing rights	1,262	971	291
Tradenames	1,894	1,748	146
Total	$93,604	$72,745	$20,859

The above table reflects intangible assets related to continuing operations and does not include a net book value of $2.7 million of intangible assets which have been classified as discontinued operations as of March 31, 2005.

	Carrying Amount	Accumulated Amortization	Net
	June 30, 2004		
Purchased technology	$ 99,636	$ 73,968	$25,668
Customer contracts	24,829	12,895	11,934
Customer lists	43,078	42,686	392
Publishing rights	1,262	656	606
Tradenames	3,190	2,750	440
Total	$171,995	$132,955	$39,040

Estimated future amortization of other intangible assets as of March 31, 2005 is as follows (in thousands):

Fiscal year ending June 30,	Purchased Technology*	Other Intangible Assets
2005 (remaining 3 months)	$ 2,980	$2,122
2006	8,216	3,751
2007	3,758	—
2008	32	—
2009	—	—
Total	$14,986	$5,873

* Includes publishing rights

7. Long-term Investments

During the three months ended December 31, 2004, @Stake, Inc., a company in which we held a long-term investment, was acquired by a third party. Under the terms of the acquisition agreement, we received a $5.0 million payment resulting in a $4.1 million gain, which has been included in other income for the nine months ended March 31, 2005.

8. Goodwill

The following summarizes the change in goodwill during the nine months ended March 31, 2005:

	Goodwill
Balance at June 30, 2004	$124,081
Cash payments in accordance with earn out from 2004 acquisition	808
Classified as discontinued operations	(28,838)
Balance at March 31, 2005	$ 96,051

9. Other Liabilities

Other liabilities consist of (in thousands):

	March 31, 2005	June 30, 2004
Accrued sales and marketing costs	$ 3,364	$ 4,120
Sales tax payable	875	933
Facility reserve	—	379
Other	6,749	6,380
Other liabilities	$10,988	$11,812

At June 30, 2004 our facility reserve represented the expected future costs under a lease agreement for unoccupied office space in Portland, Oregon, which expires in December 2006. This reserve is included in discontinued operations at March 31, 2005.

10. Restructuring Liability

Fiscal 2004 restructuring

During the three months ended June 30, 2004 we recorded a restructuring charge of $2.5 million related to restructuring of our information technology group and operations and continued cost reduction efforts.

Pursuant to the restructuring plan, we notified 86 employees that their employment would be terminated. As of March 31, 2005, 83 of these employees had left our employment and 3 employees had their termination rescinded. As of March 31, 2005, $1.7 million had been paid as termination benefits and related costs pursuant to the restructuring.

As part of the restructuring plan, we determined that we no longer required certain office space in Portland, Oregon, and established an accrual of $764,000 for fair value of the facilities consolidation. The amounts accrued for facilities consolidation at March 31, 2005 represent the total remaining liability under the lease, net of estimated sub-lease income and are included in discontinued operations.

We lease approximately 12,000 square feet of office space in Manukau, New Zealand under a lease expiring April of 2005. The space was vacated in July of 2004 and a subsequent adjustment of $92,000 was made to the restructuring liability to reflect the estimated remaining obligation under this lease.

The following summarizes the 2004 restructuring plan activity (in thousands):

	Employee Severance and Other Related Benefits	Facilities Consolidation	Total
Restructuring charge (Quarter ended June 30, 2004)	$ 1,738	$ 764	$ 2,502
Cash payments	(1,377)	(78)	(1,455)
Restructuring liability at June 30, 2004	361	686	1,047
Cash payments	(231)	(97)	(328)
Adjustments to restructuring, net	(73)	92	19
Restructuring liability at September 30, 2004	57	681	738
Cash payments	(57)	(96)	(153)
Adjustments to restructuring, net	—	(27)	(27)
Restructuring liability at December 31, 2004	—	558	558
Cash payments	—	(112)	(112)
Adjustments to restructuring, net	—	32	32
Classified as discontinued operations	—	(470)	(470)
Restructuring liability at March 31, 2005	$ —	$ 8	$ 8

Fiscal 2003 restructuring

Payments made during the nine months ended March 31, 2005 represent the final payments due under the Houston lease obligation, net of sublease income.

The following summarizes the 2003 restructuring plan activity (in thousands):

	Employee Severance and Other Related Benefits	Facilities Consolidation	Total
Restructuring liability at June 30, 2004	$—	$ 275	$ 275
Cash payments, net of sub-lease income	—	(275)	(275)
Restructuring liability at September 30, 2004	$—	$ —	$ —

11. 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,	
	2005	2004	2005	2004
Weighted average common shares outstanding	54,349	57,045	54,874	56,987
Weighted average common shares outstanding subject to repurchase	(187)	—	(115)	(248)
Shares used to compute basic and diluted loss per share	54,162	57,045	54,759	56,739

During the three and nine months ended March 31, 2005 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 outstanding options to purchase 17,160,305 common shares.

12. 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, 2005 or June 30, 2004.

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, 2005 or June 30, 2004.

As permitted under Delaware law, we have agreements indemnifying our executive officers, directors and some other employees from liabilities incurred 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, 2005 or June 30, 2004.

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 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 our former Operations Manager product, the underlying technology of 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 in the arbitration proceeding alleging that BMC infringes a valid patent that we own. BMC has denied the allegations in our counterclaim. In April 2005, BMC amended its statement of claim to assert that one or more of our products infringes an additional patent owned by BMC. We intend to deny the allegations in the amended claim. Each party seeks injunctive relief, compensatory and treble damages, interest, and attorneys' fees with respect to its claims. Currently, discovery is in the very early stages.

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.

13. Major Customer

At March 31, 2005 and at June 30, 2004, no single customer represented 10% of our accounts receivable.

In addition no single customer accounted for more than 10% of our revenue during the three and nine months ended March 31, 2005 or 2004.

14. Subsequent Events

On April 30, 2005, we completed the sale of our web analytics business to WebTrends Inc. (formerly Spider Holding Inc.), a Delaware corporation and affiliate of Francisco Partners, L.P. ("Francisco Partners"), pursuant to an Asset Purchase Agreement dated March 26, 2005 between the Company and various of its subsidiaries and WebTrends Inc. Francisco Partners is a technology-focused private equity investment firm.

As consideration for the sale, we received $93.4 million in cash (the "Purchase Price"). The Purchase Price is subject to adjustment based upon a net working capital calculation as of the closing date, as determined within sixty days of the closing date by the parties. Any such adjustment in the Purchase Price will be paid in cash by us or by WebTrends Inc., as the case may be, within five days following the date of determination.

On May 3, 2005 our Board of Directors approved a program to repurchase and cancel up to $200 million of the Company's outstanding stock in open market purchases or in private transactions. This replaces the previous program which was approved in September 2004.

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

The following Management's Discussion and Analysis should be read in conjunction with our consolidated financial statements and notes thereto.

Our systems and security management software solutions enable organizations to assure the performance, availability and security of the services delivered by their information technology (IT) infrastructures. While we initially focused on developing and marketing software to manage applications running on the Microsoft Windows operating system, we have expanded our core business to include cross-platform systems and security management solutions covering four product areas—Performance and Availability Management, Security Management, Configuration and Vulnerability Management, and Operational Change Control, the last of which is currently composed of software to test, migrate, and administer Microsoft Windows and Active Directory environments. We also develop and market software to test and manage voice over internet protocol (VoIP) deployments as part of our Performance and Availability Management offerings.

In the three months ending March 2005, we publicly unveiled our Knowledge-Based Service Assurance product strategy (KBSA). The key elements to this strategy are the five product areas outlined above delivered across four IT disciplines—Operational Integrity, Service Management, Policy Compliance, and Risk Management. Also central to our KBSA strategy is deep integration among the five product areas to enable cross-product analyses, the sharing of important technology components, and use of a common reporting engine and user interface to facilitate cross-product and cross-user-group value delivery.

Delivering upon the full promise of the KBSA product vision will require several years of focused product development. As such, concurrent with the launch of our KBSA product strategy, we are more tightly focusing our product investments into areas consistent with that strategy and are making efforts to exit business areas that do not support that strategy.

As part of these focusing efforts, on March 26, 2005, we entered into a definitive agreement to sell our WebTrends web analytics business to WebTrends Inc. (formerly Spider Holding Inc.), an affiliate of Francisco Partners, L.P., a technology-focused private equity investment firm. The transaction closed on April 30, 2005 and we received $93.4 million in gross proceeds, resulting in a pretax net gain of approximately $64.6 million, which will be recorded in the quarter ending June 30, 2005. In addition, the employment of approximately 237 of our employees was assumed by WebTrends Inc. as of April 30, 2005. Accordingly, the historical financial statements of NetIQ have been retroactively adjusted to account for WebTrends as discontinued operations in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* The discontinued operations data reflect the historical results of operations for all periods presented and the current assets and liabilities of WebTrends as of March 31, 2005.

We believe our sale of WebTrends enhances our long-term strategic direction and provides us greater opportunity to accelerate innovation in our core business and increase shareholder value. We intend to continue to evaluate our options across other non-core product areas within NetIQ as we increase our focus on executing our KBSA product strategy.

Special Considerations in Reviewing Fiscal 2005 and Fiscal 2004 Results

Our financial results for the nine months ended March 31, 2005 and 2004 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, pursuant to which 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 nine months ended December 31, 2003. All marketing funds received by us from Microsoft had been exhausted as of December 31, 2004.

Over the last three years we have invested in the development and acquisition of new products to replace the anticipated decline in revenue 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 in the future 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 lack of any expenses associated with the revenue from Microsoft. As a result, our overall gross margin percentages 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.

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. No such impairment charge was recorded for the nine months ended March 31, 2005.

Periodically our Board of Directors authorizes plans to repurchase shares of our outstanding common stock. A summary of the stock repurchase plans and the activity in each plan follows:

	September 2004 Program	October 2003 Program
Program size	**Up to $50 million of outstanding stock**	**Up to 5% of outstanding stock**
Shares purchased to date	2,004,742	816,426
Cash used to date	$23,500,000	$10,400,000
Amount remaining in program	$26,500,000	Complete

In January 2005, Ixia finalized its exercise of an option to purchase our remaining assets and assume the liabilities associated with the Chariot product line. Under the terms of our agreement with Ixia, we received a net cash payment of $2.2 million in consideration for the transfer of those assets and assumption of the liabilities. The transaction resulted in a gain of $2.9 million, which is reflected in other income for the three and nine months ended March 31, 2005.

Comparison of Three and Nine Months Ended March 31, 2005 and 2004

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

	Three Months Ended March 31,		Percentage Change	Nine Months Ended March 31,		Percentage Change
	2005	2004		2005	2004	
Software license revenue	$24,745	$31,735	(22)%	$ 86,113	$ 86,200	(0)%
Software license revenue under Microsoft agreement	—	—	N/A %	—	5,000	(100)%
Total software license revenue	24,745	31,735	(22)%	86,113	91,200	(6)%
Service revenue	26,353	23,693	11 %	77,000	69,106	11 %
Total revenue	$51,098	$55,428	(8)%	$163,113	$160,306	2 %

	Revenue as % of Total Revenue			
	Three Months ended March 31,		Nine Months ended March 31,	
	2005	2004	2005	2004
Software license revenue	48%	57%	53%	54%
Software license revenue under Microsoft agreement	N/A	N/A	N/A	3%
Total software license revenue	48%	57%	53%	57%
Service revenue	52%	43%	47%	43%
Total revenue	100%	100%	100%	100%

Total revenue decreased by $4.3 million or 8% and increased by $2.8 million or 2% during the three and nine months ended March 31, 2005, compared with the three and nine months ended March 31, 2004. Software license revenue represented 48% and 53% of total revenue for the three and nine months ended March 31, 2005 and 57% of total revenue for the three and nine months ended March 31, 2004, with service revenue representing the balance.

Pursuant to the schedule of payments set forth in the agreement with Microsoft, the final $5.0 million license payment was received from Microsoft in August 2003.

Software License Revenue. Total software license revenue decreased by $7.0 million or 22% and by $5.1 million or 6% during the three and nine months ended March 31, 2005 compared with the three and nine months ended March 31, 2004. Excluding revenue from Microsoft, software license revenue remained flat during the nine month period ended March 31, 2005 when compared with the same period during the prior year. The decrease in license revenue in the most recent quarter compared with the same quarter of last year was substantially a result of the termination of the Ixia revenue and lower sales of both our core and non-core products.

Service Revenue. Service revenue consists of revenue from the sale of maintenance service agreements, consulting services and training services. Service revenue increased by $2.7 million or 11% and by $7.9 million or 11% during the three and nine months ended March 31, 2005 compared with the three and nine months ended March 31, 2004. The increase was primarily due to maintenance renewals by our existing customers and fees associated with new software licenses.

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,	
	2005	**2004**	**2005**	**2004**
Cost of software license revenue	$ 1,128	$ 2,465	$ 3,611	$ 7,817
As percentage of license revenue	5%	8%	4%	9%
Cost of service revenue	6,776	5,742	19,932	16,370
As percentage of service revenue	26%	24%	26%	24%
Amortization of purchased technology	2,953	1,998	8,860	5,609
Total cost of revenue	$10,857	$10,205	$32,403	$29,796
As percentage of total revenue	21%	18%	20%	19%

Total cost of revenue increased by 6% or $652,000 and by 9% or $2.6 million during the three and nine months ended March 31, 2005 when compared with the three and nine months ended March 31, 2004.

Cost of Software License Revenue. Cost of software license revenue includes royalties paid to third parties, personnel and other costs associated with software packaging, documentation such as user manuals and CDs, and production, as well as shipping. Cost of software license revenue as a percentage of related license revenue decreased from 8% and 9% during the three and nine months ended March 31, 2004 to 5% and 4% during the three and nine months ended March 31, 2005. The percentage decrease was primarily due to a decrease in royalty expense as result of our acquisition, in March 2004, of certain technology previously subject to quarterly royalty payments. Such costs were previously included in the cost of software and from the purchase date forward the amortization of the purchase price has been recorded as amortization of purchased technology. We expect our cost of software license revenue to remain relatively constant in absolute dollars during the three months ending June 30, 2005 compared with the three months ended March 31, 2005.

Cost of Service Revenue. Cost of service revenue consists primarily of personnel costs and expenses incurred in providing telephonic support, on-site consulting services and training services. Cost of service revenue as a percentage of related service revenue was relatively constant as a percentage of related service revenue for the three and nine months ending March 31, 2005 and March 31, 2004. We expect our cost of service revenue, in absolute dollars, to remain relatively constant during the three months ending June 30, 2005 compared with the three months ended March 31, 2005.

Amortization of Purchased Technology. Purchased technology consists of developed software capitalized in our acquisitions or purchased separately, and is amortized using the straight-line method over the estimated useful life of the software, generally three years. Amortization increased from $2.0 million and $5.6 million during the three and nine months ended March 31, 2004 to $3.0 million and $8.9 million during the three and nine months ended March 31, 2005. The increase in the amortization from the comparable periods in the prior fiscal year was due to the increase in other intangible assets from our acquisitions in March 2004 of certain technology previously subject to quarterly royalty payments. We expect to amortize approximately $3.0 million of purchased technology during the three months ending June 30, 2005, absent further acquisitions, impairments or divestitures.

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, net of payments received from Microsoft for marketing promotions.

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,	
	2005	2004	2005	2004
Sales and marketing expenses	$26,089	$27,954	$77,921	$79,177
Percentage change from comparable prior period	(7)%		(2)%	
As a percentage of total revenue	51 %	50%	48 %	49%
Headcount at March 31	398	424	398	424

Sales and marketing expenses decreased by $1.9 million or 7% and by $1.3 million or 2% during the three and nine months ended March 31, 2005 compared with the corresponding period a year earlier. The decrease in absolute dollars for the three and nine months ending March 31, 2005 compared to the three and nine months ended March 31, 2004 is principally a result of lower overall head count and the payment of lower incentive compensation amounts. Sales and marketing as a percentage of revenue increased from 50% and 49% during the three and nine months ended March 31, 2004 to 51% and 48% during the three and nine months ended March 31, 2005. During the three months ending June 30 2005, we expect sales and marketing expenses to increase slightly 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 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,	
	2005	2004	2005	2004
Research and development	$12,159	$14,446	$38,522	$41,288
Percentage change from comparable period	(16)%		(7)%	
As a percentage of total revenue	24 %	26%	24 %	26%
Headcount at March 31	298	351	298	351

Research and development expenses decreased by $2.3 million or 16% and by $2.8 million or 7% during the three and nine months ended March 31, 2005 compared with the three and nine months ended March 31, 2004. This decrease in absolute dollars resulted principally from lower overall headcount. We anticipate research and development spending to remain relatively flat during the three months ending June 30, 2005 compared to the three months ended March 31, 2005.

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 fees, 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,	
	2005	2004	2005	2004
General and administrative	$7,430	$6,577	$21,689	$20,064
Percentage change from comparable period	13%		8%	
As a percentage of total revenue	15%	12%	13%	13%
Headcount at March 31	182	191	182	191

General and administrative expenses increased by $853,000 or 13% and by $1.6 million or 8% during the three and nine months ended March 31, 2005 compared with the three and nine months ended March 31, 2004. The increase in absolute dollars in the three and nine month periods was primarily due to increased salaries and related payroll taxes, an increase in payments for outside services, primarily associated with our Sarbanes-Oxley 404 compliance activities ("SOX") and increased legal fees related to dispute resolution matters and the sale of our WebTrends web analytics business. We anticipate general and administrative costs to increase slightly during the three months ending June 30, 2005 compared with the three months ended March 31, 2005 due to the costs of SOX and dispute resolution matters, which should be partially offset by expense reduction actions we are taking to reduce general and administrative expenses following the completion of the divestiture of our WebTrends business unit.

Amortization of Other Intangible Assets. Amortization of other intangible assets includes amortization of capitalized values relating to customer contracts, customer lists, patents, and trade name intangibles from our acquisitions. Other intangible assets are amortized using the straight-line method over their estimated useful life, generally three years. Amortization remained unchanged at $2.1 million and $6.4 million during the three and nine months ended March 31, 2005 and during the three and nine months ended March 31, 2004. During the three months ending June 30, 2005 we expect to amortize approximately $2.2 million of other intangible assets, absent further acquisitions, impairments or divestitures.

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 restricted stock and options at less than fair market value. The deferred amount is being amortized over the vesting periods of the restricted stock grant and the assumed and granted options, generally one to four years. During the three and nine months ended March 31, 2005, we recognized employee stock-based compensation expense of $384,000 and $881,000 compared with $68,000 and $247,000 during the three and nine months ended March 31, 2004. The increase was due to restricted stock grants made during the nine months ended March 31, 2005. During the three months ending June 30, 2005 we expect to amortize approximately $525,000 of deferred employee stock-based compensation, absent further acquisitions, restricted stock grants or grants at less than fair market value.

Restructuring Charge. During the three months ended June 30, 2004, we recorded a restructuring charge of $2.5 million related to a plan to terminate the employment of certain employees and to vacate certain of our facilities related to restructuring our information technology group and operations and continued cost reduction efforts**.** During the first quarter of fiscal year 2005 we included the costs associated with the lease for our New Zealand facility in the restructuring charge which was partially offset by a reduction in employee related costs resulting in an increase in the liability.

Total Other Income (Expenses). Total other income (expenses) is primarily composed of interest income on our cash, cash equivalents and short-term investments, foreign exchange gains and losses, and gains on and impairment of long-term investment. Interest income during the three and nine months ended March 31, 2005 was $1.6 million and $4.1 million compared with $1.2 million and $4.0 million during the three and nine months ended March 31, 2004.

During the three and nine months ended March 31, 2005 we recorded other income of $2.9 million related to Ixia's exercise of its option to purchase our remaining assets associated with the Chariot products. Under the terms of the agreement we received net cash of $2.2 million in consideration of our transfer of the remaining chariot assets and liabilities to Ixia, which resulted in a gain of $2.9 million.

During the nine months ended March 31, 2004, we recorded a $4.1 million charge related to an impairment of a long-term investment based on management's assessment that there was a decline in the value of that long-term investment that was other than temporary. Subsequently, during the nine months ended March 31, 2005 the company in which we held the long-term investment was acquired. Under the terms of the acquisition agreement, we received a payment of $5 million for our interest, resulting in a $4.1 million gain which has been recorded in other income.

Income Taxes. We recorded a credit to income tax of $426,000, resulting from lower quarterly revenue than forecasted and an expense of $1.1 million during the three and nine months ended March 31, 2005 compared with income tax expense of $1.0 million and $2.7 million during the three and nine months ended March 31, 2004. 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, 2005, we held $66.2 million in cash and cash equivalents and $219.9 million in short-term investments, for a total of $286.1 million compared with $287.6 million as of June 30, 2004, a decrease of $1.5 million. The primary reasons for the decrease during the nine month period were the repurchase of shares of our common stock pursuant to our stock repurchase program for a total purchase price of $23.5 million, capital expenditures of $7.4 million, and payments of $808,000 as an earn out pursuant to the terms of a prior acquisition. These decreases were partially offset by cash generated from operations of $19.4 million, $5.0 million from an acquisition of a company in which we held a long-term investment, the sale of common stock under our stock option plans for $3.7 million and the receipt of $2.2 million in net cash for our remaining interest in the Chariot products.

Our operating activities resulted in net cash inflows of $19.4 million and $29.8 million during the nine months ended March 31, 2005 and 2004, respectively. During the nine months ended March 31, 2005, the primary non-cash charges were depreciation and amortization of $25.9 million, the $4.1 million gain resulting from the acquisition of a company in which we held a long-term investment, the $2.9 million gain resulting from the sale of technology and the amortization of employee stock based compensation of $886,000. During the nine months ended March 31, 2004, the primary non-cash charges were the impairment of goodwill of $150.8 million, depreciation and amortization of $42.5 million and impairment of long-term investment of $4.1 million. In addition, changes in assets and liabilities provided cash of $1.3 million and $16.5 million during the nine months ended March 31, 2005 and 2004.

Our investment activities resulted in net cash inflows of $8.2 million for the nine month period ended March 31, 2005 and a net cash outflow of $20.7 million for the nine month period ended March 31, 2004. During the nine months ended March 31, 2005 and 2004, primary uses of cash from investing activities were acquisitions of property and equipment of $7.4 million and $5.8 million, respectively, principally for computer hardware and software, the purchases of short-term investments of $97.6 million and $170.5 million, respectively and the purchases of technology of $300,000 and $15.4 million, respectively. The principal sources of cash during the nine months ended March 31, 2005 and 2004 were maturities and sales of short-term investments of $106.9 million and $171.1 million, respectively. In addition, for the nine months ended March 31, 2005 the sale of a long-term investment generated cash of $5.0 million, the sale of technology generated net cash of $2.2 million and $808,000 was paid as an earn out pursuant to the terms of a prior acquisition.

During the nine months ended March 31, 2005 and 2004 financing activities used $23.5 million and $10.4 million in cash, respectively for the purchase of common stock pursuant to our stock repurchase programs. Financing activities generated cash of $3.7 million and $10.7 million during the nine months ended March 31, 2005 and 2004, respectively, from proceeds from the sale of common stock under our stock option and employee stock purchase plans.

As of March 31, 2005, we had no significant debt.

Long-term Obligations

The following summarizes our long-term obligations for continuing operations as of March 31, 2005 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):

	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
Operating leases	$26,869	$4,240	$10,128	$5,013	$7,488
Future minimum royalty payments	3,000	900	2,100	—	—
Total long-term obligations and commitments	$29,869	$5,140	$12,228	$5,013	$7,488

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 from 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 complementary technologies. In addition, we may use cash to repurchase additional shares under Board authorized share repurchase programs.

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 related 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.
- 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. 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 may either be recognized ratably over the term of the service or deferred and recognized when one of the following occur: 1) fair value can be established for all undelivered elements or 2) when all elements are delivered and all other revenue recognition criteria are met.

Service revenue includes maintenance revenue 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 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 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 $551,000 at March 31, 2005. 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 $812,000 at March 31, 2005. 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 or technology. 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 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—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, 2005 is $96.1 million. Any future write-downs of goodwill will adversely affect our operating margin.
- Restructuring Liabilities and Facility Reserves—We regularly evaluate the utilization of our facilities and when future use of a specific facility is no longer required and the facility is no longer occupied, we record a charge for the remaining costs, net of any sublease or other recoveries anticipated. In connection with significant acquisitions and from time to time in an effort to better respond to customer needs, to reduce operating costs or to facilitate better collaboration between organizations, we also restructure our operating activities and organizations, eliminating redundancies in personnel and facilities. Establishing reserves for unoccupied facilities typically is more dependent on the exercise of judgment than a reserve for personnel termination, as sublease rental income or other recoveries are more difficult to estimate than severance benefits or salary continuation payments. At March 31, 2005 we had $8,000 reserved for unoccupied facilities.
- 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 the result of the tax benefit of disqualifying dispositions of stock options, temporary timing differences, tax credits and acquired net operating losses which will be credited to equity or to tax expense, respectively, 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, 2005, 83% of the shares subject to options granted were 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. Since August 2002, employee options granted were for a term of not more than seven 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, 2004 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 ratios in the acquisition.

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

	Nine Months Ended March 31, 2005	Year Ended June 30, 2004	Year Ended June 30, 2003
Total options granted	3,979,571	6,774,998	2,124,750[1]
Less options cancelled	(1,963,928)	(3,259,892)	(5,821,744)[2]
Net options (cancelled) granted	2,015,643	3,515,106	(3,696,994)
Net (cancellations) grants as a percentage of outstanding shares [3]	3.7%	6.2%	(6.8)%
Grants to top five listed officers [4] as a percentage of total options granted	16.6%	21.2%	15.3%
Grants to top five listed officers as a percentage of outstanding shares [3]	1.2%	2.5%	0.6%
Cumulative options held by top five listed officers as a percentage of total options outstanding [5]	23.4%	22.5%	19.4%

(1) Excludes 3,848,214 options assumed in connection with an acquisition and 2,848,145 options regranted as part of our 2003 tender offer.
(2) Excludes 2,848,145 options regranted as part of our 2003 tender offer.
(3) Outstanding shares at the beginning of each fiscal year.
(4) "Listed Officers" are our Chief Executive Officer (CEO) and each of the four other most highly compensated executive officers as of June 30, 2004 that are still employed by us.
(5) 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, 2003	5,709,798	12,614,884	$21.26
Granted	(6,774,998)	6,774,998	$13.69
Exercised	—	(888,285)	$ 9.98
Cancelled	3,259,892	(3,259,892)	$19.85
Expired	(854,912)	—	—
Additional shares reserved	2,600,000	—	—
Outstanding, June 30, 2004	3,939,780	15,241,705	$18.86
Granted—Stock Options	(3,979,571)	3,979,571	$ 9.63
Granted—Restricted Stock	(250,000)	—	—
Exercised	—	(97,043)	$ 6.23
Cancelled	1,963,928	(1,963,928)	$18.38
Expired	(164,854)		—
Additional shares reserved	2,600,000	—	—
Outstanding, March 31, 2005	4,109,283	17,160,305	$16.84

Summary of outstanding in-the-money and out-of-the-money options as of March 31, 2005 is as follows:

	Exercisable		Unexercisable		Total	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
In-the-Money	785,799	$ 7.14	3,291,425	$ 9.19	4,077,224	$ 8.80
Out-of-the-Money [(1)]	8,129,430	$21.89	4,953,651	$15.17	13,083,081	$19.35
Total Options Outstanding	8,915,229	$20.59	8,245,076	$12.79	17,160,305	$16.84

(1) Out-of-the-money options have an exercise price equal to or above the closing price of $11.43 on March 31, 2005.

Options granted to top five listed officers during the nine months ended March 31, 2005 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)	375,000	9.42%	$8.95 - $12.00	8/06/2011 - 2/07/2012	$1,643,668	$3,830,445
Mark P. Marron	75,000	1.88%	$ 8.95	8/06/2011	$ 273,266	$ 636,826
Marc Andrews	75,000	1.88%	$ 8.95	8/06/2011	$ 273,266	$ 636,826
Betsy E. Bayha	60,000	1.51%	$ 8.95	8/06/2011	$ 218,613	$ 509,461
Gregory L. Drew	75,000	1.88%	$ 8.95	8/06/2011	$ 273,266	$ 636,826
Total	660,000	16.6%				

(1) Based on a total of 3,979,571 options granted to employees during the nine months ending March 31, 2005.

Option exercises during the three months ended March 31, 2005 and remaining option holdings for top five listed officers as of March 31, 2005 are as follows:

Name	Shares Acquired on Exercise	Value Realized	Number of Securities Underlying Unexercised Options at March 31, 2005		Value of Unexercised In-the-Money Options at March 31, 2005 [(1)]	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Charles M. Boesenberg (CEO)	—	$—	2,018,948	856,252	$ —	$372,000
Mark P. Marron	—	$—	190,824	184,376	$ —	$186,000
Marc Andrews	—	$—	90,910	209,290	$ —	$186,000
Betsy E. Bayha	—	$—	91,865	135,001	$ —	$148,800
Gregory L. Drew	—	$—	110,825	134,375	$25,781	$197,719

(1) Option values based on stock price of $11.43 at March 31, 2005.

The following table summarizes common stock subject to future issuance under our equity compensation plans as of March 31, 2005:

	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)]	12,697,686	$17.03	3,183,918[(3)]
Plans not approved by stockholders [(4)]	3,317,907	$17.82	925,365
Total	16,015,593		4,109,283

(1) Does not include an aggregate of 1,144,712 shares of common stock to be issued upon exercise of options assumed in connection with our acquisitions.

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

(3) Does not include 2,650,091 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.

Success in our markets requires rapid innovation and response to market changes, and we may be unable to remain competitive.

The markets for our systems and security management software solutions are characterized by rapid technological innovation, with frequent product introductions and enhancements. To maintain our competitive position, we must continue to develop new products and services, and to enhance the features, functionality and performance of our existing products and services. The development of new products and services, and the enhancement of existing products and services, require significant investment and planning, and entail significant risk of technical failure. If we are unable to successfully and timely innovate in response to the offerings of our competitors and the requirements of our customers, our products and services may become obsolete, our ability to compete may be impaired, and our operating results may suffer.

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 markets for our systems and security management software solutions are intensely competitive, and we expect competition to increase in the future. There are few substantial barriers to entry at the low end to prevent new entrants to those markets. Moreover, many of our competitors and potential competitors have substantially greater financial and other resources than we have or may enjoy other competitive advantages. As a consequence, these competitors may have greater name and brand recognition, develop more advanced technology, deliver more compelling solutions, bring solutions to market more rapidly, 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:

- providers of network and systems management products, such as BMC Software, Inc., Computer Associates International, Inc., Hewlett-Packard Company, International Business Machines Corporation and Microsoft Corporation;
- providers of security management solutions, such as ArcSight, netForensics, Computer Associates International, Inc., International Business Machines Corporation, Internet Security Systems, Inc., Cisco Systems Inc., and Symantec Corporation;
- providers of vulnerability and configuration management solutions, such as BindView Corporation, Symantec Corporation, Computer Associates International, Inc., Internet Security Systems, Configuresoft, Inc., and McAfee, Inc.;
- providers of intrusion detection and intrusion prevention solutions, such as Symantec Corporation, Internet Security Systems, Cisco Systems, Inc. and McAfee Inc.;

- providers of Windows and Active Directory administration products, such as BindView Corporation and Quest Software, Inc.;
- providers of VoIP management solutions such as Cisco Systems, Inc., Integrated Research Ltd., and Computer Associates International, Inc.
- providers of content security solutions, such as Clearswift Limited, Postini Corporation, SurfControl plc, Symantec Corporation, Trend Micro, Inc., Tumbleweed Communications Corp., and Websense, Inc.; and
- customers' internal information technology departments that develop or integrate systems management, security management, or Windows Active Directory administration products for their particular needs.

Due to the competitive nature of our markets, we have experienced increasing pressure on product and service pricing, and we may be required to continue to lower our prices to remain competitive. Our failure to effectively compete with our competitors, on the basis of price, technology, available solution sets or otherwise, could lead to our inability to achieve forecasted revenue and adversely affect our operating results.

The trend towards consolidation in the software industry could impede our ability to compete effectively.

The software industry has experienced increasing consolidation, as software firms seek to offer broader arrays of products and product functionality, to integrate hardware and software solutions, and to achieve greater economies of scale. The firms resulting from these consolidations may have greater resources, more compelling product offerings and greater pricing flexibility than our existing competitors, making it more difficult for us to compete effectively, including on the basis of price, sales and marketing programs, technology, and available solution sets. In addition, the industry trend towards consolidation may impact customers' perceptions of the viability of smaller or even medium sized software firms and consequently customers' willingness to purchase from such firms.

The trend towards product integration and bundling could impede our ability to compete effectively.

We have seen increasing integration and bundling of software products in the systems and security market into solution sets or bundles, and expect integration and bundling to be an important competitive factor in the future. We anticipate that competitors may bundle their products with products similar to ours, or incorporate functionality into their existing products that could render certain of our products unmarketable or obsolete. 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. For instance, if Microsoft were to incorporate Microsoft Operations Manager with its Windows operating system, the demand for our AppManager product could be affected. Customer perception of this pattern could also adversely affect or delay sales of our products. If we are unable to sufficiently differentiate our products from the integrated or bundled products of our competitors, such as by price or enhanced functionality or performance, we may see a decrease in demand for those products.

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

Our revenue and operating results have varied in the past and are likely to vary significantly from period to period 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 programs offered by our competitors;
- changes in our pricing policies or those of 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;
- changes in the mix of products or services sold in a quarter;
- fluctuation in the number and size of orders in a quarter;
- unanticipated operating expense; and
- our ability to recognize revenues from the fees we charge to our customers.

We base our operating expenses on our expectations regarding future revenue. However, a significant portion of our revenue historically has 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. Since we may not learn of shortfalls in anticipated revenue until late in a particular quarter, we may be unable to proportionately reduce operating expenses for that quarter. As a consequence, our operating results may fail to meet the expectations of our investors or securities analysts, and the market price of our stock could decline.

Our license bookings historically have been seasonal, 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.

Given the above factors, we believe that sequential revenue comparisons are not necessarily meaningful, and should not be relied upon as indicative of our future performance.

If we are unable to sufficiently align our expenses with revenue we will be unable to achieve an acceptable operating profit.

The market price of our stock is, in part, dependent on our ability to achieve a level of operating profit that meets the expectations of investors and securities analysts. Since our inception, we have incurred significant net losses. During fiscal 2004, 2003 and 2002, we reported GAAP net losses from continuing and discontinued operations of $191.4 million, $908.7 million and $730.5 million, respectively. During the first nine months of fiscal 2005 we reported a GAAP net loss from continuing and discontinued operations of $1.9 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 2005. To the extent our operating expenses exceed our expectations or we do not accurately forecast our operating results, our earnings may be harmed, which may in turn adversely affect our stock price.

We continue to adopt a number of measures to better align our expenses with anticipated revenue, including various reductions in headcount, closure of facilities and reorganization of our business including the divestiture of the Web analytics business to better address our strategic business initiative. In addition, we have taken steps to improve the efficiency of our sales force. However, while these measures have contributed to improved operating profitability during certain recent periods, we have not been wholly successful in achieving an operating profit commensurate with that of many of our peers, and we continue to focus on reduction of our operating expenses, as well as seeking to grow revenue. The organizational and operational changes that we believe are necessary to achieve an acceptable operating profit may disrupt our business or negatively impact customer service and satisfaction, and consequently our ability to grow our revenue. Such changes also may not result in the intended operational improvements and cost reductions, and may adversely affect our business, results of operations and financial condition.

If we are unable to timely complete our assessment of internal controls over financial reporting, our stock price may be adversely affected.

Under Section 404 of the Sarbanes-Oxley Act of 2002, our management is required to complete an assessment of the effectiveness of our internal controls for financial reporting and to assert that such controls are effective. In addition, our independent auditors must issue opinions on the adequacy of management's assessment and on the effectiveness of our controls over financial reporting. These activities must be completed prior to our filing with the SEC of our annual report on Form 10-K for our fiscal year ending June 30, 2005.

We have undertaken a variety of activities to prepare for compliance with the requirements of Section 404. We believe that such activities will enable our management to perform the assessment and provide the required assertion and consequently our auditors will be able to provide the required opinions concurrent with their report on our financial statements. However, we can give no assurance that such activities will be completed in a timely manner and on a successful basis. If our management is unable to make the required assertion or if our auditors are unable to issue the required opinions, this may reflect negatively on our internal controls over financial reporting and adversely affect the price of our stock.

Changes in financial accounting standards or practices, including those that require us to recognize employee stock options as a compensation expense, could substantially and adversely our financial results.

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 financial 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. On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (R), *Share-Based Payment*. Statement 123(R) requires that, commencing July 1, 2005, we recognize compensation expense in an amount equal to the fair value of share-based payments, such as stock options and restricted stock, granted to employees. This is expected to have a material impact on our consolidated results of operations.

We expect that our implementation of the change proposed by FASB Statement 123(R) will result in a reduction of our operating income or an increase in our 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.

We may not be successful in executing our product strategies and our customers may not accept our product strategies.

Our Knowledge-Based Service Assurance strategy requires us to develop new product capabilities, to integrate our new and existing products with each other, and to develop new common components that will be used by multiple products. We may not be successful in developing these new capabilities within the timeframe required for market acceptance. We may also overestimate the aggregate demand for these new capabilities and over-invest in their development. Competitors may market products with these capabilities prior to us, and we may encounter technical difficulties with developing these capabilities as envisioned. Moreover, customers may not accept our newly introduced products and may be reluctant to purchase products from us if they do not accept our overall product strategy and vision. Our business and operating results could materially suffer unless we are able to respond quickly and effectively to these developments.

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, any of which may diminish the value of the investment to us;
- we may fail to anticipate new technological developments, 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 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.

Our failure to realize the anticipated benefits or synergies of our investments may adversely affect our operating results, consolidated financial position, cash flows and stock price. Our earnings may be adversely affected by amortization of purchased technology and other intangible assets, other acquisition or investment related charges, and impairment charges associated with goodwill. As well, we may be required to record charges for impairment if a product or technology is later discontinued, if we pay more than an investment is worth, or if an investment subsequently declines in value. In the past we have taken significant impairment charges as a consequence of revised forecasts for future operating profits and cash flows from our investments and the decline in our market capitalization. We will be required to record additional charges if in future periods we discontinue additional products, or determine that our remaining goodwill has become further impaired or that our investments have further declined in value.

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 commensurately reduced.

The development and enhancement of many of our products requires early access to third party technology.

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, which may require that we have access to third party technology to develop and test our products and new versions of our products. Some of these third-party software developers may change their products so that they 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.

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. Alternatively, we might be forced to limit the features available in our current or future software offerings, which could adversely affect our ability to sell our products and services.

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 on a combination of patents, copyrights and trademarks, service marks, trade secrets, confidentiality procedures and contractual provisions (including confidentiality and licensing restrictions) to protect our intellectual property rights in our products and services. These laws and procedures provide only limited protection, and may not provide sufficiently broad protection or be enforceable in actions against alleged infringers. In particular, 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, and some of our license provisions may be unenforceable under the laws of certain jurisdictions. 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.

It occasionally is necessary to enforce or defend our intellectual property rights through the process of litigation, arbitration or other adversarial proceedings. Such proceedings can be costly and potentially distracting to management, and even if successful, can adversely affect our operating results.

Sales of our products may be adversely affected by software piracy.

Policing unauthorized use and transfer of our software is difficult. Although we are unable to quantify the extent of piracy of our software products, certain of our products have been subject to software piracy and our exposure to software piracy is expected to increase as we expand our international operations.

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, even if without merit, could harm our business by increasing our costs, reducing our revenue or by creating customer concern or confusion that results 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, the costs of defense have been significant. 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. The judgments or awards entered with respect to such claims could require 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.

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 that could be detected at any point in a product's life cycle. Moreover, the complexity of our products, and the associated risk of errors, may increase as we pursue our Knowledge-Based Service Assurance strategy, as this strategy involves integrating our various complex independent products with each other into even more complex solutions. These software 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 problems with the performance of our products and may require cooperation from the third-party to resolve.

Detection of 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 provisions designed to limit our liability for damages resulting from errors in our software, there is no assurance that such provisions will be effective in limiting our liability. 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 errors or will be available in the future on commercially reasonable terms.

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

We derive a substantial and increasing amount 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, and sales and support offices in a number of other foreign locations. Our international operations subject us 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, including terrorism and wars;
- seasonal reductions in business activity during the summer months in Europe and certain other regions;
- laws restricting the use and transfer of personally identifiable information about our customers, employees and other individuals;
- reduced protection for intellectual property rights in some countries; and
- increased travel and infrastructure costs associated with multiple international locations.

Any of these risks could harm our international operations and reduce our international sales, adversely affecting our operating results.

Our financial results may be positively or negatively impacted by foreign currency fluctuations.

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 nine months ended March 31, 2005 we recorded a gain of approximately $232,000 consisting primarily of foreign exchange gains and losses on U.S. dollars and other foreign currency receivables held in subsidiaries with local functional currencies. 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.

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;
- financial difficulties that resellers or integrators may experience (and which may lead to payment problems); and
- risk associated with accurately reporting revenue arising from these indirect distribution channels.

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. In addition, 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. The volatility or lack of improvement in our stock price may also affect our ability to attract and retain key personnel, who may expect to realize value from our stock options. In addition, our cash incentive plan is based upon company performance and failure to achieve our established targets may limit the amount or eliminate the payment of cash incentive compensation and further impact our ability to retain key 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, our business and ability to successfully implement our business objectives could be negatively affected.

We continue to make substantial changes in our information systems, which could disrupt our business and adversely affect our operating results.

We are continuously engaged in the process of improving our information systems, including modifying and refining our customer relationship management system and enterprise resource planning system to better meet our needs and to provide the enhanced reporting required by increased competitive pressures and regulatory requirements. Disruption caused by the migration, or the failure, poor performance or errors of any of our systems could impact our ability to sell and deliver our products or could result in our inability to maintain our internal controls to the standards required by applicable law, any of which could in turn materially and adversely impact our business, including our ability to meet our revenue and expense targets. Moreover, notwithstanding our investment in maintenance and upgrades, our enterprise systems may not fully meet our needs in the future. If we determine to replace them, we may write off the remaining value of the associated assets.

Natural disasters and targeted attacks on our networks and data centers may disrupt our business.

We rely on our network and data center infrastructure for internal communications, communications with customers and partners, direct sales of our software products and sales lead generation. 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.

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 those sales and will decrease the revenue attributable to such sales during the reporting period in which the sale is made (although the associated deferred revenue generally will be recognized in subsequent periods). If substantial portions of our license sales are converted to a subscription basis, this could materially affect our revenue during the initial quarters in which the change is implemented.

The price of our stock may fluctuate significantly, which may result in losses for investors.

Our stock price has been volatile and we expect that it will continue to fluctuate in the future. The value of an investment in our stock could decline due to the impact of a number of factors upon our stock price, many of which are outside of our control and are unrelated to our actual operating results. These factors include:

- changes in the market valuations of technology and software companies;
- changes in general economic conditions;
- the effects of war and terrorist attacks;
- actual or anticipated variations in our operating results and revenues;
- announcements of new products, investments or developments by us or our competitors;
- industry and product consolidation;
- changes by securities analysts of their estimates of our earnings or valuation; and
- the failure of our performance to meet the expectations of securities analysts.

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, 2005, 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, 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, 2005, we had no hedging contracts outstanding.

At March 31, 2005 we had $66.2 million in cash and cash equivalents and $219.9 million in short-term investments. Based on our cash, cash equivalents and short-term investments at March 31, 2005 a 10% change in interest rates would change our annual interest income and cash flows by approximately $673,000.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Disclosure Controls and Procedures.* Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

(b) 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 fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We have a disclosure controls committee comprised of key individuals from a variety of disciplines in the 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.

In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, are subject to inherent limitations. These limitations include the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

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 our former operations manager product, the underlying technology of 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 in the arbitration proceeding alleging that BMC infringes a valid patent that we own. BMC has denied the allegations in our counterclaim. In April 2005, BMC amended its statement of claim to assert that one or more of our products infringes an additional patent owned by BMC. We intend to deny the allegations in the amended claim. Each party seeks injunctive relief, compensatory and treble damages, interest, and attorneys' fees with respect to its claims. Currently, discovery is in the very early stages.

ITEM 6. EXHIBITS

(a) Exhibits

Exhibit Number	Description
10.1	Description of the Management Incentive Bonus Program for the second six months of fiscal year 2005 (Incorporated by reference to registrant's current report on Form 8-K filed with the SEC on January 21, 2005)
10.2	Written description of a material definitive agreement concerning the compensation of Charles M. Boesenberg entered into on February 7, 2005 (Incorporated by reference to registrant's current report on Form 8-K filed with the SEC on February 8, 2005)
10.3	Asset Purchase Agreement, dated as of March 26, 2005, between NetIQ Corporation, NetIQ Ireland Limited, NetIQ Limited and Spider Holding Inc. (Incorporated by reference to Exhibit 10.1 to the registrant's current report on Form 8-K filed with the SEC on March 29, 2005)
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

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, 2005.

NETIQ CORPORATON

By: /s/ RICHARD H. VAN HOESEN

Richard H. Van Hoesen
Senior Vice President and Chief Financial Officer