NETEGRITY INC
Form 10-Q
October 29, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004.

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM __________ TO __________

COMMISSION FILE NUMBER 1-10139

NETEGRITY, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	04-2911320
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

201 JONES ROAD
WALTHAM, MA 02451
(Address of Principal Executive Offices) (Zip Code)

(781) 890-1700
(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 other 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 [X] No [ ]

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

As of October 25, 2004 there were 38,817,961 shares of Common Stock outstanding, exclusive of treasury shares.

QUARTERLY REPORT ON FORM 10-Q
QUARTER ENDED SEPTEMBER 30, 2004

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
Condensed Consolidated Balance Sheets as of September 30, 2004 and December 31, 2003 (unaudi
Condensed Consolidated Statements of Operations for the three months ended September 30, 200
Condensed Consolidated Statements of Operations for the nine months ended September 30, 200
Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 200
Notes to Condensed Consolidated Financial Statements.......................................
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations....
Item 3. Quantitative and Qualitative Disclosures About Market Risk..............................
Item 4. Controls and Procedures..
PART II OTHER INFORMATION..
Item 6. Exhibits...
SIGNATURES...

PART I. - FINANCIAL INFORMATION

NETEGRITY, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	S
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$
Short-term available-for-sale securities	
Accounts receivable--trade, net of allowances of $1,039 at September 30, 2004 and $829 at December 31, 2003	
Prepaid expenses and other current assets	
Restricted cash	
Total Current Assets	
Long-term available-for-sale securities	
Property and equipment, net	
Restricted cash	
Goodwill	
Other intangible assets, net	
Other assets	
Total Assets	$
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable--trade	$
Accrued compensation and benefits	
Other accrued expenses	
Deferred revenue	
Total Current Liabilities	
Commitments and Contingencies	
STOCKHOLDERS' EQUITY:	

Common stock, voting, $.01 par value; 135,000 shares authorized; 38,474 shares issued and 38,436 shares outstanding at September 30, 2004; 37,577 shares issued and 37,539 shares outstanding at December 31, 2003	
Additional paid-in capital	
Accumulated other comprehensive loss	
Accumulated deficit	
Loan to officer	
	-
Less--Treasury stock, at cost: 38 shares	
	-
Total Stockholders' Equity	
	-
Total Liabilities and Stockholders' Equity	$
	=

The accompanying notes are an integral part of the condensed consolidated financial statements.

3

NETEGRITY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	-
	--
Revenues:	
Software licenses	$
Services	
Other	
	-
Total revenues	
	-
Cost of Revenues:	
Cost of software licenses	
Non-cash cost of software licenses	
Cost of services	
Cost of other	
	-
Total cost of revenues	
	-
Gross profit	
Selling, general and administrative expenses	
Research and development expenses	
	-
Income (loss) from operations	
Other income, net	
	-
Income (loss) before provision for income taxes	
Provision for income taxes	
	-

Net income (loss)	$
Net income (loss) per share:	
Basic and diluted	$
Weighted average shares outstanding:	
Basic	
Diluted	

The accompanying notes are an integral part of the condensed consolidated financial statements.

NETEGRITY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE DATA)

Revenues:	
Software licenses	$
Services	
Other	
Total revenues	
Cost of Revenues:	
Cost of software licenses	
Non-cash cost of software licenses	
Cost of services	
Cost of other	
Total cost of revenues	
Gross profit	
Selling, general and administrative expenses	
Research and development expenses	
Income (loss) from operations	
Other income, net	
Income (loss) before provision for income taxes	
Provision for income taxes	
Net income (loss)	$
Net income (loss) per share:	
Basic and diluted	$
Weighted average shares outstanding:	
Basic	
Diluted	

The accompanying notes are an integral part of the condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

OPERATING ACTIVITIES:	
Net income (loss)	$
Adjustments to reconcile net income (loss) to net cash provided by operating activities:	
Depreciation and amortization	
Provision for doubtful accounts	
Non-cash interest expense	
Gain on sale of marketable securities	
Changes in operating assets and liabilities:	
Accounts receivable - trade	
Prepaid expenses and other current assets	
Other assets	
Accounts payable - trade	
Accrued compensation and benefits	
Other accrued expenses	
Deferred revenue	
Net cash provided by operating activities	
INVESTING ACTIVITIES:	
Proceeds from sales of marketable securities	
Proceeds from maturities of marketable securities	
Purchases of marketable securities	
Purchases of property and equipment	
Cash used for acquisition, net of cash acquired	
Restricted cash	
Net cash used for investing activities	
FINANCING ACTIVITIES:	
Proceeds from issuance of common stock under stock plans	
Proceeds from repayment of loan to officer	
Net cash provided by financing activities	
Effect of exchange rate changes on cash and cash equivalents	
Net change in cash and cash equivalents	
Cash and cash equivalents at beginning of period	
Cash and cash equivalents at end of period	$

The accompanying notes are an integral part of the condensed consolidated financial statements.

NETEGRITY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts and operations of Netegrity, Inc. and its wholly owned subsidiaries ("Netegrity", (the "Company", "we" or "our") and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements and thus should be read in conjunction with the audited consolidated financial statements included in our Annual Report on Form 10-K filed on March 1, 2004. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results expected for the remainder of the year ending December 31, 2004.

All significant intercompany accounts and transactions have been eliminated in consolidation.

(b) Revenue Recognition

Our revenues are primarily generated from the sale of perpetual licenses for our proprietary SiteMinder, IdentityMinder Web Edition, IdentityMinder eProvision and TransactionMinder products and related services. We generate our services revenues from consulting and training services performed for customers and from the maintenance and support of our products. As described below, significant management judgments and estimates must be made and used in connection with the revenues recognized in any accounting period. Management analyzes various factors in making these judgments and estimates, including specific terms and conditions of a transaction, historical experience, credit worthiness of customers and current market and economic conditions. Changes in judgments based upon these factors could impact the timing and amount of revenues and cost recognized.

We generally license our software products on a perpetual basis. We apply the provisions of Statement of Position No. 97-2, "Software Revenue Recognition," as amended by Statement of Position No. 98-9, "Software Revenue Recognition, with Respect to Certain Transactions," to all transactions involving the sale of software products. We recognize revenues from the sale of software licenses when persuasive evidence of an arrangement exists, the product has been delivered, the fees are fixed or determinable and collection of the resulting receivable is reasonably assured. This policy is applicable to all sales, including sales to resellers and end users. We typically do not offer a right of return on our products.

For all sales, we use a license agreement signed by both parties and/or a purchase order with binding terms and conditions as evidence of an arrangement.

For arrangements with multiple obligations (for example, software license, undelivered maintenance and support, training and consulting), we allocate revenues to each component of the arrangement using the residual value method based on the fair value of the undelivered elements. We defer revenue from the arrangement equivalent to the fair value of the undelivered elements. Fair value for each component is either the price we charge when the same component is sold separately or the price established by the members of our management who have the relevant authority to set prices for an element not yet sold separately.

At the time of the transaction, we assess whether the fee associated with the transaction is fixed or determinable based on the payment terms associated with the transaction. If a significant portion of the fee is due after our normal payment terms, which are generally 30 to 90 days from invoice date, we account for the fee as not being fixed or determinable. In those cases, we recognize revenues as the fees become due. In addition, we assess whether collection is probable based on the credit worthiness of the customer. Initial credit worthiness is assessed through Dun & Bradstreet or similar credit rating agencies. Credit worthiness for follow-on transactions is assessed through a review of the transaction history with the customer. We do not typically request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenues at the time collection becomes reasonably assured, which is generally upon receipt of cash.

Installation by Netegrity is not considered essential to the functionality of our products as these services do not alter the product capabilities, do not require specialized skills and may be performed by the customer or other vendors. Revenues for maintenance and support are recognized ratably over the term of the support period. Revenues from consulting and training services generally are recognized as the services are performed.

(c) Cash and Cash Equivalents

Cash and cash equivalents include cash, money market investments and other highly liquid investments with original maturities of three months or less.

(d) Restricted Cash

Long-term restricted cash at September 30, 2004 represents three time deposits held at financial institutions. The first, in the amount of $774,000, is held in connection with the lease of the Company's headquarter office space and has an expiration date of March 2005; however, it has a clause that provides that the time deposit will be automatically renewed. The second, in the amount of $140,000, is held in connection with the lease of the Company's office space in Israel and has an expiration date of June 2006. The third, in the amount of $566,000, is held in connection with a prepaid maintenance contract, has an expiration date of December 2012 and is reduced ratably over the term of the contract.

(e) Marketable Securities

Investments, which primarily consist of debt securities, are accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities" issued by the Financial Accounting Standards Board (FASB). Pursuant to the provisions of SFAS No. 115, the Company has classified its investment portfolio as "available-for-sale". "Available-for-sale" securities include debt securities that are being held for an unspecified period of time and may be used for liquidity or other corporate purposes and are recorded at fair value. Unrealized gains and losses on available-for-sale securities are reported as a separate component of

accumulated other comprehensive income (loss) in stockholders' equity, net of related taxes.

(f) Other Intangible Assets, net

The Company accounts for purchased technology and software development costs in accordance with SFAS No. 86, "Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed". Under SFAS No. 86, the Company is required to test for recoverability of its capitalized software costs as of each balance sheet date or an interim period if events and circumstances indicate that the carrying amount may not be recoverable. Impairment is recorded as the excess of the unamortized cost over the expected future net realizable value of the products.

Software development costs subsequent to the establishment of technological feasibility are capitalized and amortized to non-cash cost of software. Based on the Company's product development process, technological feasibility is established upon completion of all planning, designing, coding and testing activities. Such costs are amortized over the estimated life of the product. During the three and nine months ended September 30, 2004, costs incurred by the Company between completion of all planning, designing, coding and testing activities and the point at which the product is ready for general release were insignificant and, therefore, no such costs have been capitalized during this time period.

(g) Goodwill

The Company reviews the valuation of goodwill in accordance with SFAS No. 142 "Goodwill and Other Intangible Assets." Under the provisions of SFAS No. 142, goodwill is required to be tested for impairment annually in lieu of being amortized. This testing is done in the fourth quarter of each year. Furthermore, goodwill is required to be tested for impairment on an interim basis if an event or circumstance indicates that it is more likely than not that an impairment loss has been incurred. An impairment loss is recognized to the extent that the carrying amount of goodwill exceeds its implied fair value. Impairment losses are recognized in operations. The Company's valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and projections of future operating performance. Management predominantly uses third party valuation reports to assist in its determination of the fair value. If these assumptions differ materially from future results, the Company may record impairment charges in the future.

8

(h) Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources, including foreign currency translation adjustments and unrealized gains and losses on marketable securities held as "available-for-sale". The components of comprehensive income (loss) were as follows (in thousands):

FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
2004	2003

Net income (loss)	$ (356)	$ 6
Net unrealized holding gain (loss) arising during the period, net of related tax effects	163	(
Reclassification adjustment for net realized (gains) losses, included in net income (loss), net of related tax effects	4	
	167	(
Net unrealized foreign currency translation adjustment arising during the period, net of related tax effects	18	
Comprehensive income (loss)	$ (171)	$ 5

The components of accumulated other comprehensive income (loss) as of September 30, 2004 and December 31, 2003 were as follows (in thousands):

	SEPTEMBER 30, 2004	DECEMBE
Net unrealized holding loss	$ (268)	$
Net unrealized foreign currency translation adjustment	115	
Accumulated other comprehensive loss	$ (153)	$

(i) Earnings (Loss) Per Share

Basic earnings (loss) per share (EPS) is calculated by dividing net income (loss) by the weighted average number of shares outstanding during the period. Diluted EPS is calculated by dividing net income (loss) by the weighted average number of shares outstanding plus the dilutive effect, if any, of outstanding stock options and warrants using the "treasury stock" method. During periods of net loss, diluted net loss per share does not differ from basic net loss per share since potential shares of common stock from stock options and warrants are anti-dilutive and therefore are excluded from the calculation. The following table presents the calculation for both basic and diluted EPS (in thousands, except per share data):

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2004	2003
Net income (loss)	$ (356)	$ 6
Basic weighted average shares outstanding	38,393	34,6
Dilutive effect of stock options and warrants	--	3,3
Diluted shares outstanding	38,393	38,0
Basic and diluted EPS	$ (0.01)	$ 0.

Outstanding options and warrants to purchase a total of approximately 2.4 million and 1.9 million shares of common stock for the three and nine months ended September 30, 2004, respectively, and a total of 222,000 and 394,000 shares of common stock for the three and nine months ended September 30, 2003, respectively, were excluded in the computation of diluted EPS because the effect on EPS was anti-dilutive.

9

(j) Stock-Based Compensation

The Company accounts for its stock option plans under the recognition and measurement principles of APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. No stock-based compensation cost is reflected in net income (loss) for these plans, as all options granted under these plans had exercise prices equal to the fair market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and earnings (loss) per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, "Accounting for Stock Based Compensation," to stock based compensation (in thousands, except per share data):

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2004	2003
Net income (loss), as reported	$ (356)	$
Add: Stock-based employee compensation expense not included in reported net income (loss), net of related tax effects	(1,987)	(1
Pro-forma net loss	$ (2,343)	$
Earnings (loss) per share:		
Basic and diluted--as reported	$ (0.01)	$
Basic and diluted--pro-forma	$ (0.06)	$ (

At the annual meeting of stockholders held in May 2004, the Company's stockholders approved the 2004 Stock Incentive Plan (the "2004 Plan") pursuant to which 4.0 million shares of common stock are reserved for issuance to the Company's or its subsidiaries' employees, officers, directors, consultants and advisors. The 2004 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock, stock appreciation rights and other stock based awards.

(k) Recent Accounting Pronouncements

In December 2003, the Financial Accounting Standards Board (FASB) revised Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46R), which addresses how a business enterprise should evaluate whether it has a controlling interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, which was issued in January 2003. Before concluding that it is appropriate to apply the voting interest consolidation model to an entity, an enterprise must first determine that the entity is not a variable interest entity or a special purpose entity. FIN 46R

became effective in March 2004 and the adoption of this statement did not have a material impact on the Company's financial position or results of operations.

In November 2003, the Emerging Issues Task Force (EITF) of the FASB reached a consensus on certain disclosure provisions under Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." The disclosure provisions indicate that certain quantitative and qualitative disclosures are required for debt and marketable equity securities classified as available-for-sale or held-to-maturity under SFAS Nos. 115 and 124 that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The EITF has not reached a consensus on the proposed models for evaluating impairment of equity securities and debt securities. The consensus on the required quantitative and qualitative disclosures is effective for fiscal years ending after December 15, 2003. The adoption of the disclosure provisions of this Issue during the fourth quarter of 2003 did not have a material impact on the Company's financial position or results of operations. In September 2004, the FASB approved the issuance of FASB Staff Positions EITF 03-1-1, which delays the effective date for the application and measurement provisions of EITF 03-1 to investments in securities that are impaired.

NOTE 2: ACQUISITION

Business Layers

On December 30, 2003, the Company acquired Business Layers, Inc., a Delaware corporation (Business Layers) and a provider of provisioning solutions, through a merger of Business Layers and a subsidiary of the Company. As a result of the acquisition, Business Layers became a wholly-owned subsidiary of the Company. The aggregate consideration for the acquisition of $42.5 million included approximately $15.0 million in cash, reimbursement of $920,000 in acquisition costs and 2,556,940 shares of the Company's common stock valued at approximately $26.6 million. A portion of the purchase price consideration, comprised of approximately 358,000 shares of Netegrity common stock and approximately $400,000 of cash, has been placed in escrow for up to one year from the acquisition date to secure the indemnification obligations of certain former employees and the stockholders of Business Layers under the merger agreement. The acquisition was accounted for using the purchase method of accounting. The results of operations of Business Layers from the acquisition date are included in the Company's consolidated results of operations for the three and nine months ended September 30, 2004.

In connection with the acquisition, the Company initiated an overall integration plan that included the elimination of redundant headcount and facilities. The Company accrued approximately $1.4 million of costs related to the integration plan, consisting of approximately $545,000 of facilities costs and approximately $888,000 for planned workforce reductions primarily of duplicative selling, general and administrative employees. The Company paid the majority of these costs during the nine months ended September 30, 2004, although the facilities costs will not be paid in full until April 2006.

The Company engaged a third-party appraiser to conduct a valuation of the intangible assets and to assist in the determination of useful lives for such assets. Based on the appraisal, approximately $7.5 million of the purchase price was allocated to developed technology and $3.8 million was allocated to in-process research and development, which was expensed upon closing of the transaction. The amount allocated to developed technology is being amortized over its estimated useful life ranging from two to five years. Amortization expense was $510,000 for the three months ended September 30,2004 and $1.5

million for the nine months ended September 30, 2004. Accumulated amortization as of September 30, 2004 was $1.5 million.

The valuation of in-process research and development was determined using the income method. Revenue and expense projections for the in-process research and development project were prepared by management. The value was determined using the present value of the cash flows from the projections using a 30% discount rate. The technologies under development were completed by June 30, 2004.

In accordance with SFAS No. 142, the total goodwill of approximately $34.5 million related to the acquisition will not be amortized. In lieu of being amortized, goodwill is required to be tested for impairment annually in the fourth quarter or on an interim basis if an event or circumstance indicates that it is more likely than not that an impairment loss has been incurred.

NOTE 3: OPERATING SEGMENTS AND GEOGRAPHICAL INFORMATION

Based on the information provided to the Company's chief operating decision maker for purposes of making decisions about allocating resources and assessing performance, the Company's continuing operations have been classified into a single segment. The Company primarily operates in the United States of America, Europe, the Middle East and Asia Pacific. Revenues (based on the location of the customer) and long-lived assets by geographic region are as follows (in thousands):

	FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2004	2003
Revenues:		
United States of America	$ 13,812	$ 15,43
Europe and the Middle East	4,147	3,88
Asia Pacific	965	89
Canada	1,379	18
Total	$ 20,303	$ 20,39

	S
Long-Lived Assets:	
United States of America	$
Europe and the Middle East	
Asia Pacific	
Canada	
Total	$

NOTE 4: RELATED PARTY TRANSACTIONS

LOAN TO OFFICER

The condensed consolidated balance sheets as of September 30, 2004 and December 31, 2003 include $99,000 and $116,000, respectively, in a loan to an officer of Netegrity issued in connection with the exercise of stock options in 1996. The loan is reflected as a reduction of stockholders' equity in the accompanying condensed consolidated balance sheets. The loan is payable upon demand and bears interest at 7% per annum. The loan was originally represented by a secured note; however, in May 2002, the note was amended such that it became a full recourse unsecured note. This loan will be repaid upon the consummation of the merger contemplated by the agreement and plan of merger entered into with Computer Associates on October 6, 2004 (see note 6).

MARKETING SERVICES

During the three and nine months ended September 30, 2004 the Company paid approximately $34,000 and $97,000, respectively, and during the three and nine months ended September 30, 2003, the Company paid approximately $32,000 and $74,000, respectively, to a company for marketing services. The principal shareholder of that Company is the son-in-law of a former member of the Company's Board of Directors whose term expired in May 2004. The Company has similar arrangements with other marketing services firms and believes the arrangement was entered into on substantially the same terms and conditions as its arrangements with such other firms.

SOFTWARE LICENSE AGREEMENT

On June 30, 2004, the Company entered into a software license agreement with a third party under which the Company purchased software for its internal use. The Vice President of Client Services of this third party is the brother of an officer of Netegrity. The Company has licensed software under similar terms and conditions with other software providers and believes the arrangement was entered into on substantially the same terms and conditions as its arrangements with such other firms. The Company paid approximately $80,000 in the third quarter of 2004 under this agreement.

NOTE 5: COMMITMENTS AND CONTINGENCIES

The Company has commitments that expire at various times through 2010. Non-cancelable operating leases shown below are primarily for facility costs for the Company's corporate headquarters, customer service, research and development and world-wide sales offices. Other contractual obligations shown below primarily consist of minimum guaranteed payments to a software service provider for various development projects. (in thousands)

2004 (three months ending)..
2005..
2006..
2007..
2008..
Thereafter..

Included in the operating lease commitments above is approximately $337,000 related to excess facilities which have been accrued in purchase accounting related to the Company's acquisition of Business Layers and are payable through April 2006.

The Company incurred total operating lease expense, primarily related to certain facilities and equipment under non-cancelable operating leases, of approximately $752,000 for the three months ended September 30, 2004, and $2.3 million for the nine months ended September 30, 2004, and approximately $1.0 million for the three months ended September 30, 2003, and $3.0 million for the nine months ended September 30, 2003.

In April 2002, the Company entered into an agreement with a system integrator to assist the Company in the development and launch of one of its products. Under the terms of the agreement, as consideration for the system integrator's time in assisting with the development of the product, the Company agreed to promote the system integrator as an integrator of the developed product. The Company's obligation under the agreement would have been considered satisfied once the system integrator received consulting revenues totaling approximately $3.9 million from the Company's customers, or by the expiration date of the agreement. The agreement expired in May 2004. No royalties were due to the system integrator under this agreement during its term.

In August 2002, the Company entered into a five year non-cancelable operating lease for an office building for its corporate headquarters. The Company occupied the new facility in March 2003. In connection with the lease agreement, the Company delivered to the landlord an irrevocable, unconditional, negotiable letter of credit in the amount of $774,000 as a security deposit.

In February 2004, the Company entered into an agreement with a software service provider located in India under which the Company has guaranteed to pay this software service provider a minimum of $4.0 million annually for various product development projects. The initial term of this agreement expires in December 2004. As of September 30, 2004, approximately $3.5 million had been paid to this software service provider.

In June 2004, the Company entered into a letter of credit with a financial institution. The letter of credit in the amount of $566,000, which is held in connection with a prepaid customer maintenance contract, has an expiration date of December 2012 and is reduced ratably over the term of the contract.

In September 2004, the Company received a letter from a customer of its subsidiary Business Layers GmbH ("BLG"), making a claim for rescission of its contract with BLG for alleged breach of such contract under German law. The customer has requested compensation in the amount of approximately 2.2 million Euro plus interest, reserving a right to assert additional unspecified damages. The customer may also assert an additional claim for pre-paid maintenance fees in the amount of approximately 575,000 Euro. The Company has notified the indemnification representatives for the Business Layer's escrow that the Company intends to seek indemnification for any damages incurred relating to this claim, subject to the limitations of the escrow and the Business Layers merger agreement.

The Company enters into standard indemnification agreements with its business partners and customers in the ordinary course of business. Pursuant to these agreements, the Company agrees to repair or replace the product, pay royalties for a right to use, or reimburse the indemnified party for actual damages awarded by a court against the indemnified party for an intellectual property infringement claim by a third party with respect to products. The term

of these indemnification agreements is generally perpetual. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company had no liabilities recorded for these agreements as of September 30, 2004.

The Company enters into standard indemnification agreements with its customers, whereby the Company indemnifies them for certain damages, such as personal property damage, which may be incurred in connection with consulting services performed at a customer location by the Company's employees or subcontractors. The potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has general and umbrella insurance policies that enable it to recover a portion of any amounts paid. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2004.

The Company generally warrants for ninety days from delivery to a customer that its software products will perform free from material errors which prevent performance in accordance with user documentation. Additionally, the Company warrants that its consulting services will be performed consistent with generally accepted industry standards. The Company has never incurred significant expense under its product or service warranties. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2004.

The Company has entered into employment and executive retention agreements with certain employees and executive officers which, among other things, include certain severance and change of control provisions. The consummation of the merger contemplated by the agreement and plan of merger entered into with Computer Associates on October 6, 2004 (see note 6) would constitute a change in control under such agreements. The Company has also entered into agreements whereby the Company indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity.

From time to time, the Company is involved in litigation relating to claims arising out of the Company's operations in the normal course of business. The Company is not presently a party to any legal proceedings, the adverse outcome of which, in the Company's opinion, would have a material adverse effect on the Company's results of operations or financial position.

NOTE 6. SUBSEQUENT EVENT

On October 6, 2004, Computer Associates International, Inc., a Delaware corporation ("Computer Associates"), and the Company entered into an Agreement and Plan of Merger (the "Agreement") pursuant to which the Company would merge with a wholly owned subsidiary of Computer Associates and become a wholly owned subsidiary of Computer Associates. If the merger is completed, at the effective time of the merger, each issued and outstanding share of common stock, par value $0.01 per share, of Netegrity will be converted into the right to receive $10.75 in cash. The Agreement has been approved by Netegrity's Board of Directors, and the transactions contemplated by the Agreement are subject to the approval of Netegrity's stockholders, any required antitrust clearance, any required

international regulatory approvals and other customary closing conditions and is expected to be completed in the fourth quarter of 2004.

In connection with the execution of the Agreement, certain directors, executive officers and stockholders of Netegrity executed agreements with Computer Associates and the Company to vote their shares of Netegrity Common Stock in favor of the proposed merger and against any other proposal or offer to acquire Netegrity (the "Stockholder Agreements"). The shares subject to the Stockholder Agreements represent in the aggregate approximately 12% of the outstanding shares of Netegrity Common Stock.

The Company expects to incur expenses of approximately $5.0 million related to the merger with Computer Associates. These merger-related expenses include investment banking fees, and legal and professional fees.

A contingent termination fee of $13.0 million plus reimbursement of up to $2.0 million of Computer Associates' expenses related to the transaction is payable by the Company to Computer Associates in the event that the Agreement is terminated as a result of certain events as detailed in the Agreement.

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

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements about our plans, objectives, expectations and intentions. You can identify these statements by words such as "expect," "anticipate," "intend," "plan," "believe," "seek," "estimate," "may," "will" and "continue" or similar words. You should read statements that contain these words carefully. They discuss our future expectations, contain projections of our future results of operations or our financial condition or state other forward-looking information, and may involve known and unknown risks over which we have no control. You should not place undue reliance on forward-looking statements. We cannot guarantee any future results, levels of activity, performance or achievements. Moreover, we assume no obligation to update forward-looking statements or update the reasons actual results could differ materially from those anticipated in forward-looking statements, except as required by law. The factors discussed in the sections captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Certain Factors that May Affect Future Results," in this report identify important factors that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements.

OVERVIEW

Netegrity's objective is to be a leading provider of enterprise security software solutions specifically for managing user identities and access. Our identity and access management product line provides companies a secure way to make corporate information assets and resources available online. We believe open, protected access is essential as companies seek to leverage the Web to grow their businesses.

With Netegrity identity and access management products, companies are able to securely use the Web -- Internet, Intranet or Extranet -- to meet the information access needs of partners, suppliers, customers and employees. Netegrity solutions are designed to enable businesses to ensure that the right people have the right access to the right information across a variety of applications, business systems and computing architectures. This enables more

business to be securely conducted online, providing opportunities to improve customer service and productivity, increase sales of products and services and enhance business partnerships.

We derive our revenues from our core products, SiteMinder, IdentityMinder Web Edition, IdentityMinder eProvision and TransactionMinder, which offer a single source solution for integrated, centralized identity management, user access and administration and account provisioning/de-provisioning. Our solution supports a broad range of technology environments, and aims to ensure that companies optimize their existing information technology investments while incorporating new technologies. We also offer various levels of consulting and support services that enable our customers to successfully implement our products in their organizations.

Our products are generally sold on a perpetual license basis. Customers typically place an initial order for a limited number of users and purchase additional users as their need for our products within their enterprise increases. We believe that our product line synergies and the strength of our customer base create opportunities to sell additional products to existing customers. Customers also enter into an annual support agreement for their software license at the time of initial purchase and typically renew this support agreement annually. Our support agreement entitles customers to software license updates, telephone support and online support.

We believe sales of our products will be driven by customers' desire for a comprehensive single-source identity access management solution whose key benefits include reduced costs by reducing information technology complexity, increased employee productivity, increased revenue potential by improving customer service online, expanded business opportunities by creating real-time business networks and support for regulatory compliance and risk mitigation. As a result, we expect that companies will spend their discretionary information technology dollars on technology that will help them drive revenue and reduce costs while mitigating risk. The combined impact of the high growth potential of the identity and access management market, our broadened product portfolio and the focus of our direct sales resources on larger companies in selected industries has enabled us to continue to drive business through our installed base while at the same time adding new customers.

Some of our products contain technology that is licensed from third parties. Our cost of software licenses consists primarily of royalty fees that we pay for the licensed technologies as well as product fulfillment costs. Non-cash cost of software licenses include amortization of acquired software. Cost of services includes salaries and related expenses for our consulting, training and technical support services organizations, and the associated cost of training facilities.

Our professional services group provides customers with project management, deployment, architecture and design, custom development services and training. Our customers typically pay for professional services at an hourly rate for the time it takes us to complete the project. We strive to maintain effective staffing levels and to limit the amount of turnover of our professional services staff. If we are not successful in maintaining effective staffing levels, our ability to achieve our service revenue and profitability objectives may be adversely affected.

The majority of our sales are made directly with customers. Our direct sales to customers in countries outside of the United States are denominated in U.S. dollars and local currency, with the majority of our sales denominated in U.S. dollars. Our sales through indirect distribution channels are generally

denominated in U.S. dollars. For countries outside of the United States, we generally pay our operating expenses in local currency. Where we do invoice customers in local currency, we are exposed to foreign exchange rate fluctuations from the time the contract is signed until collection occurs. We are also exposed to foreign currency fluctuations between the time we collect in U.S. dollars and the time we pay our operating expenses in local currency. Fluctuations in currency exchange rates could affect the profitability and cash flows in U.S. dollars of our products sold in international markets. To date, these fluctuations have not been significant.

Our future revenues and operating results may also fluctuate from quarter to quarter based on the number and size of license deals and the size and scope of the professional service projects in which we are engaged. In addition, license revenues from a large customer deal may constitute a significant portion of our total revenues in a particular quarter. Any such deal may result in increased royalty payments and commission expenses. Any decline in our revenues will have a significant impact on our financial results, particularly because a significant portion of our operating costs, such as personnel, rent and depreciation, are fixed in advance of a particular quarter. As a result, despite cost savings realized to date, our costs for services personnel, sales and marketing and general and administrative could increase as a percentage of revenue, thereby adversely affecting our operating results.

On October 6, 2004, we and Computer Associates entered into a merger agreement, pursuant to which, if the merger is completed, at the effective time of the merger, each outstanding share of our common stock will be converted into the right to receive $10.75 in cash and we will become a wholly owned subsidiary of Computer Associates. The merger agreement has been approved by our Board of Directors, and the transactions contemplated by the merger agreement are subject to the approval of our stockholders, any required antitrust clearance, any required international regulatory approvals and other customary closing conditions and is expected to be completed in the fourth quarter of 2004. See Note 6 to the accompanying Condensed Consolidated Financial Statements for additional information.

CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT JUDGMENTS AND ESTIMATES

Our 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. The preparation of these financial statements requires our management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported revenues and expenses during the reporting periods. On an ongoing basis, our management evaluates its estimates and judgments, including those related to revenue recognition, accounts receivable reserves, valuation of long-lived and intangible assets, goodwill, in-process research and development, and income taxes. Our management bases its estimates on historical experience and on various other factors that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

There have been no significant changes in our critical accounting policies during the nine months ended September 30, 2004 as compared to what was previously disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2003.

RESULTS OF OPERATIONS

THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED TO THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2003

The following discussion reviews the results of operations for the three months ended September 30,2004 (the "2004 Quarter") and the nine months ended September 30, 2004 (the "2004 Period") compared to the three months ended September 30, 2003 (the "2003 Quarter") and the nine months ended September 30, 2003 (the "2003 Period").

REVENUES ($ IN MILLIONS)

	THREE MONTHS ENDED					
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003			
	$	% OF TOTAL REVENUES	$	% OF TOTAL REVENUES	$ CHANGE 2003 TO 2004	% CHANGE 2003 TO 20
Software licenses	$ 8.7	43%	$ 11.4	56%	$ (2.7)	(24)%
Services	11.3	56%	8.1	40%	3.2	40%
Other	0.3	1%	0.9	4%	(0.6)	(67)%
Total revenues	$ 20.3	100%	$ 20.4	100%	$ (0.1)	0%

	NINE MONTHS ENDED					
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003			
	$	% OF TOTAL REVENUES	$	% OF TOTAL REVENUES	$ CHANGE 2003 TO 2004	% CHANGE 2003 TO 20
Software licenses	$ 35.1	52%	$ 30.5	55%	$ 4.6	15%
Services	31.2	46%	23.3	42%	7.9	34%
Other	1.4	2%	2.1	3%	(0.7)	(33)%
Total revenues	$ 67.7	100%	$ 55.9	100%	$ 11.8	21%

Revenues. Total revenues in the 2004 Quarter were relatively consistent with the same period in the prior year. The small decrease in total revenues was primarily due to a decrease in software license revenues offset by an increase in service revenue, which includes consulting, training, maintenance and support. Total revenues for the 2004 Period increased as compared to the same period in the prior year. This increase was due to an increase in software license revenues from the sale of our SiteMinder product, as well as sales generated by our new product offerings, IdentityMinder Web Edition, IdentityMinder eProvision and TransactionMinder and from the sale of our service offerings.

Software license revenues decreased in the 2004 Quarter as compared to the same period in the prior year. During the 2004 Quarter we closed 91 deals, 17 (or 19%) of which were with new customers. This compares to 109 deals closed in the 2003 Quarter, 30 (or 28%) of which were with new customers. The average deal size in the 2004 Quarter was $107,000 as compared to an average deal size of $123,000 in the 2003 Quarter. The decrease in software license revenue as well as the decrease in the number of deals and the average size of those deals was primarily due to a longer than anticipated sales cycle in the 2004 Quarter, particularly on a couple of large deals. This resulted in some deals not closing in the 2004 Quarter as expected. Overall, during the 2004 Period we closed 296 deals, 63 (or 21%) of which were with new customers. This compares to 263 deals closed in the 2003 Period, 81 (or 31%) of which were with new customers. The average deal size in the 2004 Period was $139,000 which was consistent with the average deal size in the 2003 Period.

Services revenues increased in both the 2004 Quarter and the 2004 Period as compared to the same periods in the prior year, primarily due to an increase in maintenance revenue and to a lesser extent an increase in consulting and training revenue. The increase in maintenance revenue of $2.3 million in the 2004 Quarter and $5.8 million in the 2004 Period, as compared to the same periods in the prior year, is attributable (1) to an increase in the license revenue base, (2) a significant number of maintenance renewals by our existing customer base, some of which were delayed renewals from the fourth quarter of 2003 and the first half of 2004 and (3) an increase in the sale of our specialized, on-site support services. Consulting revenue increased by $900,000 in the 2004 Quarter and $1.8 million in the 2004 Period, as compared to the same periods in the prior year, primarily due to increased demand for our design and

architecture services resulting in higher utilization rates of our professional services employees. Training revenue increased by $22,000 in the 2004 Quarter and $342,000 in the 2004 Period, as compared to the same periods in the prior year, primarily due to increased focus on selling our training courses to our new and existing customers, particularly our customers outside of the United States.

Other revenues, which are derived from our Firewall legacy business, decreased in both the 2004 Quarter and the 2004 Period as compared to the same periods in the prior year due to our decision during the second quarter of 2004 to reallocate the resources previously used in this business in order to focus them on our core identity and access management business. While we plan to support the existing Firewall customers through the end of their current support term, we will no longer sell these products.

GROSS PROFIT ($ IN MILLIONS)

	THREE MONTHS ENDED					
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003			
	$	GROSS PROFIT %	$	GROSS PROFIT %	$ CHANGE 2003 TO 2004	% CHANGE 2003 TO 2
Gross profit - software licenses	$ 7.9	91%	$ 10.9	96%	$ (3.0)	(28)%
Gross profit - services	7.5	66%	5.4	66%	2.1	39%
Gross profit - other	0.1	32%	0.3	33%	(0.2)	(67)%
Total gross profit	$ 15.5	76%	$ 16.6	81%	$ (1.1)	(7)%

======= == ======= == ====== ===

	NINE MONTHS ENDED					
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003			
	$	GROSS PROFIT %	$	GROSS PROFIT %	$ CHANGE 2003 TO 2004	% CHANGE 2003 TO 2
Gross profit - software licenses	$ 32.8	93%	$ 23.8	78%	$ 9.0	38%
Gross profit - services	20.7	66%	14.7	63%	6.0	41%
Gross profit - other	0.4	29%	0.8	38%	(0.4)	(50)%
Total gross profit	$ 53.9	80%	$ 39.3	70%	$ 14.6	37%

Gross profit. Gross profit is calculated as revenues less cost of revenues. Cost of revenues includes, among other things, royalties due to third parties for technology included in our products, amortization of capitalized software, product fulfillment costs, salaries and related expenses for our consulting, education and technical support services organizations, and the associated cost of training facilities. Historically, we have realized overall gross profit margins of between 60% and 80%. The wide range in these percentages is the result of significant software amortization expenses being included in certain periods. Gross profit margins on license revenue in periods where there has not been significant amortization of capitalized software are typically in excess of 90% and gross profit margins on services revenue are typically in excess of 50%.

The decrease in gross profit on software licenses in the 2004 Quarter as compared to the same period in the prior year is due to a decrease in software license revenue and an increase in the cost of software licenses, which includes non-cash cost of software licenses. Non-cash cost of software licenses in the 2004 Quarter increased by approximately $500,000 related to the amortization of capitalized software acquired from Business Layers. These capitalized software assets are being amortized over their estimated useful lives of two to five years. The increase in gross profit on software licenses in the 2004 Period as compared to the same period in the prior year is due to an increase in software license revenue and a significant decrease in the non-cash cost of software licenses. Non-cash cost of software licenses in the 2004 Period was $1.5 million, a $3.9 million decrease as compared to the same period in the prior year due to the purchased software related to the portal technology, which was recorded in connection with the acquisition of DataChannel, and was fully amortized as of June 30, 2003. This decrease was slightly offset by the amortization of capitalized software acquired from Business Layers.

Gross profits on our services revenue are primarily driven by gross profits on maintenance and professional services revenue. We experienced an increase in gross profit on services revenues in both the 2004 Quarter and 2004 Period as compared to the same periods in the prior year as a result of an increase in service revenue partially offset by an increase in the corresponding cost of providing these services. The cost of maintenance revenue increased slightly due to an investment in the technical support organization in order to enhance overall customer satisfaction. The cost of professional services revenue also increased resulting from the increase in salary and related expenses, commissions and the use of outside consultants.

Gross profits on Other, which is derived from our Firewall legacy business, decreased in both the 2004 Quarter and the 2004 Period as compared to the same periods in the prior year due to a decrease in revenue from this business attributable to our decision during the second quarter of 2004 to reallocate the resources previously used in this business in order to focus them on our core

identity and access management business. While we plan to support the existing Firewall customers through the end of their current support term, we will no longer sell these products.

OPERATING EXPENSES ($ IN MILLIONS)

	THREE MONTHS ENDED				
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003		
	$	% OF TOTAL REVENUES	$	% OF TOTAL REVENUES	$ CHANG 2003 TO 2
Selling, general and administrative expenses	$ 10.3	51%	$ 10.9	53%	$ (0.6
Research and development expenses	5.8	29%	5.4	26%	0.4
Total operating expenses	$ 16.1	80%	$ 16.3	80%	$ (0.2

	NINE MONTHS ENDED				
	SEPTEMBER 30, 2004		SEPTEMBER 30, 2003		
	$	% OF TOTAL REVENUES	$	% OF TOTAL REVENUES	$ CHANG 2003 TO 2
Selling, general and administrative expenses	$ 34.0	50%	$ 31.8	57%	$ 2.2
Research and development expenses	17.7	26%	15.3	27%	2.4
Total operating expenses	$ 51.7	76%	$ 47.1	84%	$ 4.6

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of salaries and other related costs for selling, administrative and marketing personnel, sales commissions, travel, legal and accounting services, public relations, marketing materials, trade shows and certain facilities-related expenses. The decrease in selling, general and administrative expenses in the 2004 Quarter as compared to the same quarter in the prior year was primarily attributable to decreased commission expense resulting from lower software license revenue, a decrease in bad debt expense, a reversal of an accrual for sales tax and a decrease in depreciation expense. This decrease was slightly offset by an increase in salary and related expenses as a result of the acquisition of Business Layers, an increase in legal and accounting expenses related to the proposed merger with Computer Associates and

an increase in accounting and consulting expenses related to our efforts to comply with the requirements of Sarbanes-Oxley. The increase in the 2004 Period as compared to the same period in the prior year was due to an increase in salary and related expenses and transition related expenses as a result of the acquisition of Business Layers and an increase in accounting and consulting expenses related to our efforts to comply with the requirements of Sarbanes-Oxley. These increases were partially offset by reduced insurance expenses and facility-related expenses, including office rent, depreciation and utilities, primarily resulting from the consolidation of field offices and the move of our corporate headquarters to a new facility in March 2003.

Research and Development Expenses. Research and development expenses consist primarily of personnel and outside contractor costs to support product development. The increase in research and development expenses in both the 2004 Quarter and 2004 Period as compared to the same periods in the prior year was primarily due to an increase in salary and related expenses incurred as a result of the addition of approximately 30 research and development employees located in Israel that were added as part of the acquisition and integration of Business Layers in December 2003.

Other Income, Net. The decrease in Other income, net, in both the 2004 Quarter and the 2004 Period as compared to the same periods in the prior year was primarily attributable to lower interest income earned due to lower average cash, cash equivalents and marketable securities balances in the 2004 Quarter and 2004 Period. Our cash and investment balances decreased as a result of cash payments made as part of the purchase price for Business Layers. Our investment portfolio is generally comprised of highly liquid, high quality investments, and therefore we do not expect significant fluctuations in other income as a result of changes in investment yields.

Provision for Income Taxes. The provision for income taxes was $0 for the 2004 Quarter and $328,000 for the 2004 Period, as compared with a provision of approximately $63,000 for the 2003 Quarter and approximately $122,000 for the 2003 Period. The 2004 Period provision reflects estimated federal alternative minimum taxes and foreign taxes on income generated in the 2004 Period. Our policy is to provide for income taxes in our interim financial statements at an effective rate based upon our estimate of full year earnings and projected tax expense. We have recorded a full valuation allowance against deferred tax assets as of September 30, 2004 due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of certain net operating losses carried forward, before they expire.

19

LIQUIDITY AND CAPITAL RESOURCES

In the current and prior years, we have primarily funded our operations with cash flows generated from operations and the proceeds of our equity issuances. We invest our cash primarily in instruments that are highly liquid, investment grade securities. As of September 30, 2004, we had cash and cash equivalents totaling $12.4 million, short-term marketable securities of $55.5 million and working capital of $52.9 million, compared to cash and cash equivalents totaling $20.1 million, short-term marketable securities of $51.6 million and working capital of $46.9 million as of December 31, 2003. In addition, we had long-term marketable securities totaling $21.3 million as of September 30, 2004 and $19.4 million as of December 31, 2003.

Cash provided by operating activities for the 2004 Period was $6.6 million. This resulted primarily from income of $2.8 million, which included non-cash charges for depreciation and amortization of $3.8 million, and an increase in deferred revenue of $1.6 million, partially offset by an increase in

accounts receivable of $1.9 million and a decrease in other accrued expenses of $1.4 million. Deferred revenue increased as a result of increased revenue and strong maintenance renewals in the first nine months of 2004. Accrued expenses decreased due to lower commission amounts payable. Finally, while we continued to experience strong collection results in the 2004 Period, accounts receivable increased due to the increase in revenue, the timing of when deals are invoiced and the volume of maintenance renewals. The increase in accounts receivable resulted in an increase of our day's sales outstanding to 73 days in the quarter ended September 30, 2004 from 53 days in the quarter ended December 31, 2003.

Cash used for investing activities was $18.3 million for the 2004 Period. Investing activities consisted primarily of $8.5 million of net cash used for the payment of the remaining purchase consideration and transaction costs associated with the acquisition of Business Layers and the purchases of marketable securities of approximately $56.6 million, offset by sales and maturities of marketable securities of approximately $49.2 million.

Cash provided by financing activities in the period ended September 30, 2004 was $3.7 million, primarily related to proceeds received from the exercise of stock options in the 2004 Period and the issuance of shares in connection with our employee stock purchase plan during May 2004.

Any increase or decrease in our accounts receivable balance and accounts receivable days outstanding (calculated as net accounts receivable divided by revenue per day) affects our cash flow from operations and liquidity. Our accounts receivable and accounts receivable days outstanding may increase due to changes in factors such as the timing of when sales are invoiced and the length of our customers' payment cycles. We also record deferred maintenance billings as accounts receivable, and the timing of these billings can affect the accounts receivable days outstanding, as it did in the 2004 Period. Historically, international and indirect customers pay at a slower rate than domestic and direct customers do. An increase in revenues generated from international customers may increase our accounts receivable balance and accounts receivable days outstanding. Due to the current economic climate, we may observe an increase in the length of our customers' payment cycles and, as a result, our day's sales outstanding may increase in future periods. To the extent that our accounts receivable balance increases, we may incur increased bad debt expense and will be subject to greater general credit risks.

We anticipate our short-term cash requirements to primarily include the continued funding of our operating expenses and to a lesser extent the funding of capital expenditures. We believe that our existing cash and cash equivalent balances together with our marketable securities will be sufficient to meet these requirements for at least the next twelve months in the event that our proposed merger with Computer Associates is not consummated. We anticipate our long-term cash requirements to primarily include the funding of acquisitions or investments in businesses, technologies, products or services that are complementary to our business.

COMMITMENTS AND CONTRACTUAL OBLIGATIONS

In April 2002, we entered into an agreement with a system integrator to assist us in the development and launch of one of our products. Under the terms of the agreement, as consideration for the system integrator's time in assisting with the development of the product, we agreed to promote the system integrator as an integrator of the developed product. Our obligation under the agreement would have been considered satisfied once the system integrator received consulting revenues totaling approximately $3.9 million from our customers, or by the expiration date of the agreement. The agreement expired in May 2004. No royalties were due to the system integrator under this agreement during its term.

In February 2004, we entered into an agreement with a software service provider located in India under which we have guaranteed to pay this software service provider a minimum of $4.0 million annually for various product development projects. The initial term of this agreement expires in December 2004. As of September 30, 2004, approximately $3.5 million had been paid to this software service provider.

In August 2002, we entered into a five year non-cancelable operating lease for an office building for our corporate headquarters. We occupied the new facility in March 2003. In connection with the lease agreement, we delivered to the landlord an irrevocable, unconditional, negotiable letter of credit in the amount of $774,000 as a security deposit.

In June 2004, we entered into a letter of credit with a financial institution. The letter of credit in the amount of $566,000, which is held in connection with a prepaid customers maintenance contract, has an expiration date of December 2012 and is reduced ratably over the term of the contract.

We enter into standard indemnification agreements with our business partners and customers in the ordinary course of business. Pursuant to these agreements, we agree to repair or replace the product, pay royalties for a right to use, or reimburse the indemnified party for actual damages awarded by a court against the indemnified party for an intellectual property infringement claim by a third party with respect to our products. The term of these indemnification agreements is generally perpetual. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2004.

We enter into standard indemnification agreements with our customers, whereby we indemnify them for certain damages, such as personal property damage, which may be incurred in connection with consulting services performed at a customer location by our employees or subcontractors. The potential amount of future payments we could be required to make under these indemnification agreements is unlimited. However, we have general and umbrella insurance policies that enables us to recover a portion of any amounts paid. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2004.

We generally warrant for ninety days from delivery to a customer that our software products will perform free from material errors which prevent performance in accordance with user documentation. Additionally, we warrant that our consulting services will be performed consistent with generally accepted industry standards. We have never incurred significant expense under our product or service warranties. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2004.

We have entered into employment and executive retention agreements with certain employees and executive officers which, among other things, include certain severance and change of control provisions. We have also entered into agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity.

From time to time, we are involved in litigation relating to claims arising out of our operations in the normal course of business. We are not presently a party to any legal proceedings, the adverse outcome of which, in our opinion, would have a material adverse effect on our results of operations or financial position.

In September 2004, we received a letter from a customer of Business Layers GmbH (BLG) making a claim for rescission of their contract with BLG for alleged breach of its contract under German law. The customer has requested compensation in the amount of approximately 2.2 million Euro plus interest, reserving a right to assert additional unspecified damages. The customer may also assert an additional claim for pre-paid maintenance fees in the amount of approximately 575,000 Euro. We have notified the indemnification representatives for the Business Layer's escrow that we intend to seek indemnification for any damages incurred relating to this claim, subject to the limitations of the escrow and the Business Layers merger agreement.

On October 6, 2004, we entered into an Agreement and Plan of Merger (the "Agreement") with Computer Associates International, Inc., a Delaware corporation ("Computer Associates") pursuant to which we would merge with a wholly owned subsidiary of Computer Associates and become a wholly owned subsidiary of Computer Associates. If the merger is completed, at the effective time of the merger, each outstanding share of our common stock will be converted into the right to receive $10.75 in cash. The Agreement has been approved by our Board of Directors, and the transactions contemplated by the Agreement are subject to the

21

approval of our stockholders, any required antitrust clearance, any required international regulatory approvals and other customary closing conditions and is expected to be completed in the fourth quarter of 2004. We expect to incur expenses of approximately $5.0 million related to the merger with Computer Associates. These merger-related expenses include investment banking fees, and legal and professional fees. A contingent termination fee of $13.0 million plus reimbursement of up to $2.0 million of Computer Associates' expenses related to the transaction is payable by us to Computer Associates in the event that the Agreement is terminated as a result of certain events as detailed in the Agreement.

CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

We caution you that the following important factors, among others, in the future could cause our actual results to differ materially from those expressed in forward-looking statements made by us or on our behalf in filings with the Securities and Exchange Commission, press releases, communications with investors and oral statements. Any or all of our forward-looking statements in this Quarterly Report on Form 10-Q and in any other public statements we make may turn out to be wrong. They can be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties. Many factors mentioned in the discussion below will be important in determining future results. Consequently, no forward-looking statement can be guaranteed. Actual future results may vary materially. We undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. You are advised, however, to consult any further disclosure we make in our reports filed with the Securities and Exchange Commission.

IF THE PROPOSED MERGER WITH COMPUTER ASSOCIATES IS NOT COMPLETED, OUR BUSINESS AND STOCK PRICE COULD BE ADVERSELY AFFECTED.

On October 6, 2004, we entered into an Agreement and Plan of Merger (the

"Agreement") with Computer Associates International, Inc., a Delaware corporation ("Computer Associates") pursuant to which we would merge with a wholly owned subsidiary of Computer Associates and become a wholly owned subsidiary of Computer Associates. If the merger is completed, at the effective time of the merger, each outstanding share of our common stock will be converted into the right to receive $10.75 in cash. The Agreement has been approved by our Board of Directors, and the transactions contemplated by the Agreement are subject to the approval of our stockholders, any required antitrust clearance, any required international regulatory approvals and other customary closing conditions and is expected to be completed in the fourth quarter of 2004. We expect to incur expenses of approximately $5.0 million related to the merger with Computer Associates. These merger-related expenses include investment banking fees, and legal and professional fees. A contingent termination fee of $13.0 million plus reimbursement of up to $2.0 million of Computer Associates' expenses related to the transaction is payable by us to Computer Associates in the event that the Agreement is terminated as a result of certain events as detailed in the Agreement.

Our business and stock price could be adversely affected if the merger with Computer Associates is not completed as a result of several factors, including, but not limited to, the following:

- our customers, prospective customers and investors in general may view this failure as a poor reflection on our business or prospects;

- customers or prospective customers may have delayed their purchase commitments until the merger was complete and the product integration plan and roadmap was clarified or may have chosen to not purchase at all;

- certain of our suppliers, distributors, and other business partners may have sought to change or terminate their relationships with us as a result of the proposed merger;

- our key employees may have sought other employment opportunities; and

- our management team may have been distracted from day to day operations as a result of the proposed transaction with Computer Associates.

ALTHOUGH WE ARE NOW PROFITABLE, WE HAVE INCURRED SUBSTANTIAL LOSSES IN THE PAST AND MAY NOT CONTINUE TO BE PROFITABLE IN THE FUTURE.

In recent years, we have incurred substantial operating losses. While we were profitable for the nine months ended September 30, 2004, we generated an operating loss during the third quarter of 2004 and we cannot predict if we will maintain profitability for any substantial period of time. To achieve operating profitability on a quarterly and annual basis, we will need to continue to increase our

revenues, particularly our license revenues. Failure to maintain levels of profitability as expected by investors may adversely affect the market price of our common stock. We had an accumulated deficit of $108.1 million as of September 30, 2004.

OUR QUARTERLY RESULTS MAY FLUCTUATE WIDELY.

Our quarterly revenues and operating results are difficult to predict and may continue to fluctuate significantly from quarter to quarter for several reasons, including, but not limited to, the following:

- customers choosing to delay their purchase commitments or purchase in smaller than expected quantities due to our pending merger with Computer Associates, a general slowdown in the economy or in anticipation of the introduction of new products by us or our competitors;
- market acceptance of our SiteMinder, IdentityMinder Web Edition, IdentityMinder eProvision and TransactionMinder products;
- the timing and size of orders from our customers, including the tendency for a significant amount of our sales to occur in the final two weeks of each fiscal quarter;
- increased dependency on large transactions as more customers make enterprise wide purchased of our products;
- our ability to obtain follow-on sales from existing customers;
- the long sales and deployment cycle of our products;
- our ability to hire and retain personnel, particularly in development, services and sales and marketing;
- the loss of or changes in key management personnel;
- the timing of the release of new versions of our SiteMinder, IdentityMinder Web Edition, IdentityMinder eProvision and TransactionMinder or other products;
- pricing pressures that result in increased discounts or changes in our or competitors' pricing policies;
- changes in our operating expenses;
- the development of our direct and indirect distribution channels;
- integration issues with acquired technology and businesses; and
- general economic conditions.

In addition, because our revenues from services, particularly maintenance revenues, are largely correlated with our software revenues, a decline in software revenues could also cause a decline in our services revenues in the same quarter or in subsequent quarters. Other factors, many of which are outside our control, could also cause variations in our quarterly revenues and operating results.

Most of our expenses, such as employee compensation and rent, are relatively fixed. As a result, any shortfall in revenues in relation to our expectations could cause significant changes in our operating results from quarter to quarter and could result in future losses.

OUR SUCCESS WILL DEPEND ON OUR ABILITY TO MARKET OUR PRODUCTS AND RELATED SERVICES SUCCESSFULLY.

Our revenues are primarily generated from the sale of perpetual licenses for our proprietary SiteMinder, IdentityMinder Web Edition, IdentityMinder eProvision, TransactionMinder and related services. Broad market acceptance of our products will depend on the continued development of a market for identity and access management, the education of our customers on the use of business

software applications in general and the relevance of our products specifically. Market acceptance of our products, and customer demand for the services they provide, may not develop.

We have released several new product offerings in the past 18 months. If we fail to gain market acceptance for these products, our business, operating results and financial position could be materially adversely affected. Additionally, with the continued constraints in information technology spending in all industries we will need to be successful in conveying the value of our products to customers who may be hesitant to replace a "homegrown" system due to the costs involved with switching to a purchased solution.

Our ability to succeed in the market for our products depends in part on our ability to provide support services on a 24 hour per day, seven day per week basis. Any damage or disruptions to our service centers, including our service centers in Malaysia and Israel, whether as a result of employee attrition, acts of terrorism, language barriers, or some other cause, could seriously impact our ability to provide the necessary service to our customers and fulfill our service contracts.

OUR SUCCESS IS DEPENDENT ON OUR ABILITY TO ENHANCE OUR PRODUCT LINES AND DEVELOP NEW PRODUCTS.

We believe our success is dependent, in large part, on our ability to enhance and broaden our product lines to meet the evolving needs of the business market. Our success also depends on the ability of our customers to link our software to their existing systems and applications through various connectors and agents that we have developed. We may not be able to efficiently integrate recently acquired technologies into our products or provide the most effective connector or agent. We may be unable to respond effectively to technological changes or new industry standards or developments. Product development cycles are unpredictable and, in the past, we have delayed the introduction of several new product versions due to delays in development.

We have arrangements with a third party located in India to perform certain testing of our products, as well as internationalization and porting of our products to new platforms, and with third party software vendors who provide software which is embedded in our products. Any adverse change in our relationship with these third parties could result in delays in the release of our products. In the future, we could be adversely affected and be at a competitive disadvantage if we incur significant delays or are unsuccessful in enhancing our product lines or developing new products, or if any of our enhancements or new products experience higher than anticipated error rates or do not gain market acceptance.

As we continue to release new versions of our existing software, we may be required to assist customers in migrating to the latest version once we announce the end of life of the previous version. Additionally, we may be required to assist Business Layers customers in migrating to more standardized versions of the provisioning product. We could be adversely affected if we experience significant migration issues and a decline in customer satisfaction related to such transitions.

OUR ACQUISITION OF BUSINESS LAYERS AND OTHER COMPANIES MAY INCREASE THE RISKS WE FACE.

We recently acquired Business Layers. In the future, we may pursue other acquisitions to obtain complementary products, services and technologies. These acquisitions may not produce the revenues, earnings or business synergies that

we anticipate, and an acquired product, service or technology might not perform as we expect. In pursuing any acquisition, our management could spend significant time and effort in identifying and completing the acquisition. We will have to devote significant management resources to integrate with our existing businesses the business we acquired from Business Layers and any other business we might acquire. We might not be able to successfully transfer the knowledge of the employees or integrate the operations of acquired businesses, including Business Layers. As a result of acquisitions, we might assume contracts and other agreements that subject us to burdensome liabilities, including obligations to indemnify third parties, or impose unfavorable terms on us, including significant royalty obligations and termination fees. We may not be able to renegotiate these agreements. To pay for an acquisition, we might use our stock or cash. Alternatively, we might borrow money from a bank or other lender. If we use our stock, our stockholders would experience dilution of their ownership interests. If we use cash or debt financing, our financial liquidity will be reduced.

OUR PERFORMANCE DEPENDS ON OUR ABILITY TO WIN BUSINESS AND OBTAIN FOLLOW-ON SALES IN PROFITABLE SEGMENTS.

Customers typically place small initial orders for our products to allow them to evaluate our products' performance. A key element of our strategy is to pursue more significant follow-on sales after these initial installations. Our financial performance depends on successful initial deployments of our products that, in turn, lead to follow-on sales. If the initial deployments of our products are not successful or if our customers do not remain satisfied with our products and services, we may be unable to obtain follow-on sales. In

addition, even if initial deployments are successful, we cannot assure you that customers will choose to make follow-on purchases, which could have a material adverse effect on our ability to generate revenues.

WE FACE SIGNIFICANT COMPETITION FROM OTHER TECHNOLOGY COMPANIES AND WE MAY NOT BE ABLE TO COMPETE EFFECTIVELY.

The market for identity and access management is highly competitive. We expect the level of competition to increase as a result of the anticipated growth of the identity and access management market. Our primary competitor in the identity and access management market is the Tivoli Division of IBM. We also compete against traditional security and software companies, such as Oblix, RSA and Novell, and stack vendors such as Sun MicroSystems. In addition, a number of other security and software companies, including appliance vendors, are beginning to offer products that may compete with our identity and access management solution. Competition may also develop as the market matures and other companies begin to offer similar products, and as our product offerings expand to other segments of the marketplace. We also face competition from Web development professional services organizations. We expect that additional competitors will emerge in the future. Current and potential competitors have established, or may in the future establish, cooperative selling relationships with third parties to increase the distribution of their products to the marketplace. Accordingly, it is possible that new competitors may emerge and acquire significant market share. If we fail to establish our leadership in the identity and access management market, we may not be able to compete effectively. It is possible that current and potential competitors may attempt to hire our employees and although we have non-compete agreements in place with most of our employees they may or may not be enforceable. It is possible that new competitors or alliances may emerge and rapidly acquire significant market share. Today, many of our competitors have shorter operating histories and fewer financial and technical resources than we have. In addition, these smaller

competitors have smaller customer bases. Some of our competitors, however, are larger companies who have large financial resources, well-established development and support teams, and large customer bases. These larger competitors may initiate pricing policies for their software products or services that would make it more difficult for us to maintain our competitive position against these companies. It is also possible that current and potential competitors may be able to respond more quickly to new or emerging technologies or customer requirements, resulting in increased market share. If, in the future, a competitor chooses to bundle a competing point product with other applications within a suite, the demand for our products might be substantially reduced. Because of these factors, many of which are outside of our control, we may be unable to maintain or enhance our competitive position against current and future competitors.

REGULATIONS OR CONSUMER CONCERNS REGARDING THE USE OF "COOKIES" ON THE INTERNET COULD REDUCE THE EFFECTIVENESS OF OUR SOFTWARE PRODUCTS.

Certain of our products use cookies to support their single sign-on functionality. A cookie is information keyed to a specific user that is stored on the hard drive of the user's computer, typically without the user's knowledge. Cookies are generally removable by the user, and can be refused by the user at the point at which the information would not be stored on the user's hard drive. A number of governmental bodies and commentators in the United States and abroad have urged passage of laws limiting or abolishing the use of cookies. The passage of laws limiting or abolishing the use of cookies, or the widespread deletion or refusal of cookies by Web site users, could reduce or eliminate the effectiveness of our single sign-on functionality and could reduce market demand for our products.

WE MAY BE UNABLE TO HIRE AND RETAIN SKILLED PERSONNEL.

Qualified personnel are in great demand throughout the software industry. Our success depends, in large part, upon our ability to attract, train, motivate and retain highly skilled employees, particularly software engineers, professional services personnel, sales and marketing personnel and other senior personnel. Our failure to attract and retain the highly trained technical personnel that are integral to our product development, professional services and direct sales teams, particularly software engineers, may limit the rate at which we can generate sales, develop new products or product enhancements or transfer technical knowledge across our employee base. A change in key management could result in transition and attrition in the affected department. In addition, we may experience attrition by employees we acquire as a result of acquisitions of other companies if those employees experience difficulties in integrating with our existing employees and management. This could have a material adverse effect on our business, operating results and financial condition.

OUR SUCCESS DEPENDS ON OUR ABILITY TO OPTIMIZE OUR DIRECT SALES AND INDIRECT DISTRIBUTION CHANNELS.

To increase our revenues, we must optimize our direct sales force and continue to enhance relationships with systems integrators, resellers and technology partners to increase the leverage of our partners. There is intense competition for sales personnel in our business, and we cannot be sure that we will be successful in attracting, integrating, motivating and retaining sales personnel. In addition, we must effectively leverage our relationships with our strategic partners and other third-party system integrators, vendors of Internet-related systems and application software and resellers in order to reach a larger customer population than we could reach alone through our direct

sales and marketing efforts.

We may not be able to find appropriate strategic partners or may not be able to enter into relationships on commercially favorable terms, particularly if these partners decide to compete directly in the identity and access management market. Furthermore, the relationships we do enter into may not be successful. Our strategic relationships are generally non-exclusive, and therefore, our strategic partners may decide to pursue alternative technologies or to develop alternative products in addition to or instead of our products, either on their own or in collaboration with our competitors.

WE RELY ON THIRD PARTY TECHNOLOGY TO ENHANCE OUR PRODUCTS.

We incorporate into our products software licensed from third party software companies that enhances, enables or provides functionality for our products and, therefore, we need to create relationships with third parties, including some of our competitors, to ensure that our products will interoperate with the third parties' products. Third party software may not continue to be available on commercially reasonable terms or with acceptable levels of support or functionality, or at all. Failure to maintain those license arrangements, failure of the third party vendors to provide updates, modifications or future versions of their software or defects and errors in or infringement claims against those third party products could delay or impair our ability to develop and sell our products and potentially cause us to incur additional costs. Third party products are also incorporated into the provisioning products that we recently acquired from Business Layers. We expect to renegotiate some of the terms of the licensing arrangements for these products.

There can be no assurance that we will be able to renegotiate those agreements on commercially favorable terms. In addition, if we discover that third party products are no longer available as a result of changes in a third party's operations or financial position, there can be no assurance that we would be able to offer our product without substantial reengineering, or at all.

Often these third party software companies require prepayment of royalties on their products and, in the past, we have had to expense these prepaid royalties to cost of sales when it was determined that they may not have future realizable value.

OUR FAILURE TO EXPAND OUR RELATIONSHIP WITH GLOBAL SYSTEMS INTEGRATORS COULD LIMIT OUR ABILITY TO SUPPORT OUR CUSTOMERS' DEPLOYMENT OF OUR PRODUCTS.

Our professional services organization and our relationship with global systems integrators provide critical support to our customers' installation and deployment of our products. If we fail to adequately develop our relationship with global systems integrators, our ability to increase products sales may be limited. In addition, if we or our partners cannot adequately support product installations, our customers may not be able to use our products, which could harm our reputation and hurt our business.

OUR LENGTHY SALES CYCLE MAKES IT DIFFICULT TO PREDICT OUR QUARTERLY OPERATING RESULTS.

The length of our sales cycle varies depending on the size, type and complexity of the customer contemplating a purchase, whether we have conducted business with a potential customer in the past and the size of the deal. In addition, some of our customers may also need to invest substantial resources and modify their computer network infrastructures to take advantage of our products. As a result, these potential customers frequently need to obtain approvals from multiple decision makers prior to making purchase decisions, a process that has been, at times, further lengthened as a result of market conditions surrounding technology spending. Our long sales cycle, which can

range from several weeks to several months or more, makes it difficult to predict the quarter in which sales will occur. Delays in sales could cause significant variability in our revenues and operating results for any particular quarterly period. Our sales cycle is subject to a number of uncertainties such as:

- the need to educate potential customers regarding the benefits of our products;
- customers' budgetary constraints;
- the timing of customers' budget cycles;

- customers' willingness to make changes in their network infrastructures; and
- delays caused by customers' internal review processes.

OUR FAILURE TO EFFECTIVELY MANAGE CHANGES IN THE BUSINESS ENVIRONMENT IN WHICH WE OPERATE COULD HARM OUR BUSINESS.

Our failure to effectively manage changes in the business environment in which we operate could have a material adverse effect on the quality of our products, our ability to retain key personnel and our business, operating results and financial condition. In the past, we have experienced periods of rapid growth as well as periods of economic slowdown which have resulted in reductions in workforce. Both of these situations have placed a significant strain on our resources. We may experience similar changes in the future. Additionally, we may experience disruptions as a result of attacks from electronic viruses which could result in reduced productivity. To effectively manage changes in the business environment in which we operate we must maintain and enhance our financial and accounting systems and controls, maintain the security of our infrastructure, maintain our ability to retain key personnel, integrate new personnel and manage operations.

IF WE LOSE THE SERVICES OF BARRY BYCOFF OR ANY OTHER MEMBER OF OUR MANAGEMENT TEAM, OUR BUSINESS COULD SUFFER.

Our future success depends, to a significant degree, on the skill, experience and efforts of Barry Bycoff, our chief executive officer, and the rest of our management team. A change in our management team or the inability of our officers and key employees to work effectively as a team could have a material adverse effect on our business, operating results and financial condition.

AS WE CONTINUE TO OPERATE IN INTERNATIONAL MARKETS, WE WILL FACE CONTINUED RISKS TO OUR SUCCESS.

We operate in several international markets, including Israel as a result of our recent acquisition of Business Layers. Our international operations are subject to increased regulatory, economic and political risks. We have limited experience in international markets and we cannot be sure that our continued expansion into global markets will be successful. In addition, we will face increased risks in conducting business internationally, including the ability to develop, market and distribute localized versions of our products in a timely manner or at all. These risks could reduce demand for our products and services, increase the prices at which we can sell our products and services or otherwise have an adverse effect on our success in international markets. If we are not successful in continuing to increase our international revenues we may

experience an adverse affect on our operating results. Among the risks related to international operations we believe are most likely to affect us are:

- longer decision making cycles;

- longer payment cycles and problems in collecting accounts receivable;

- adverse changes in trade and tax regulations, including restrictions on the import and export of sensitive technologies, such as encryption technologies, that we use or may wish to use in our software products;

- the absence or significant lack of legal protection for intellectual property rights;

- selling under contracts governed by local law;

- difficulties in managing an organization spread over multiple countries, including complications arising from cultural, language and time differences that may lengthen development, sales and implementation cycles and delay the resolution of customer support issues;

- currency risks, including fluctuations in exchange rates;

- political and economic instability;

- localization of technology, including delays in localizing the most recent versions of our products;

- increased use of contractors on a global basis for both professional services and development, that may result in increased cost of services and less direct control; and

- disruption caused by terrorist activities in various regions around the world.

OUR SUCCESS DEPENDS ON OUR ABILITY TO PROTECT OUR PROPRIETARY RIGHTS.

Our success depends to a significant degree upon the protection of our software and other proprietary technology. The unauthorized reproduction or other misappropriation of our proprietary technology would enable third parties to benefit from our technology without paying us for it. This could have a material adverse effect on our business, operating results and financial condition. We depend upon a combination of patent, trademark, trade secret and copyright laws, license agreements and non-disclosure and other contractual provisions to protect proprietary and distribution rights in our products. In addition, we attempt to protect our proprietary information and the proprietary information of our vendors and partners through confidentiality and/or license agreements with our employees and others. Although we have taken steps to protect our proprietary technology, they may be inadequate and the unauthorized use of our source code could have an adverse effect on our business. Existing trade secret, copyright and trademark laws offer only limited protection. Moreover, the laws of other countries in which we market our products may afford little or no effective protection of our intellectual property. If we resort to legal proceedings to enforce our intellectual property rights, the proceedings could be burdensome and expensive, even if we were to prevail.

CLAIMS BY OTHER COMPANIES THAT WE INFRINGE THEIR PROPRIETARY TECHNOLOGY COULD HURT OUR FINANCIAL CONDITION.

If we discover that any of our products or third party products embedded in our products violates third party proprietary rights, there can be no assurance that we would be able to reengineer our product or to obtain a license on commercially reasonable terms to continue offering the product without substantial reengineering. We do not conduct comprehensive patent searches to determine whether the technology used in our products infringes patents held by third parties. In addition, product development is inherently uncertain in a rapidly evolving technology environment in which there may be numerous patent applications pending for similar technologies, many of which are confidential when filed. Any claim of infringement, even if invalid, could cause us to incur substantial costs defending against the claim and could distract our management from our business. Furthermore, a party making such a claim could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from selling our products. Any of these events could have a material adverse effect on our business, operating results and financial condition.

OUR BUSINESS COULD BE ADVERSELY AFFECTED IF OUR PRODUCTS CONTAIN ERRORS OR FLAWS.

Software products as complex as ours may contain undetected errors or "bugs" that result in product failures. The occurrence of errors could result in loss of, or delay in, revenues, loss of market share, failure to achieve market acceptance, diversion of development resources, injury to our reputation, or damage to our efforts to build brand awareness, any of which could have a material adverse effect on our business, operating results and financial condition. Additionally, the security features included in our products to prevent unauthorized access to the application may not meet all of our customers' requirements.

WE COULD INCUR SUBSTANTIAL COSTS RESULTING FROM PRODUCT LIABILITY CLAIMS RELATING TO OUR CUSTOMERS' USE OF OUR PRODUCTS.

Many of the business applications supported by our products are critical to the operations of our customers' businesses. Any failure in a customer's Web site or application caused or allegedly caused by our products could result in a claim for substantial damages against us, regardless of our responsibility for the failure. Although we maintain general liability insurance, including coverage for errors and omissions, and contractually attempt to limit liability, we cannot be sure that our existing coverage will continue to be available on reasonable terms or will be available in amounts sufficient to cover one or more large claims, or that the insurer will not disclaim coverage as to any future claim.

OUR FORMER INDEPENDENT PUBLIC ACCOUNTANT, ARTHUR ANDERSEN LLP, HAS BEEN FOUND GUILTY OF A FEDERAL OBSTRUCTION OF JUSTICE CHARGE, AND YOU MAY BE UNABLE TO EXERCISE EFFECTIVE REMEDIES AGAINST ARTHUR ANDERSEN IN ANY LEGAL ACTION.

Our former independent public accountant, Arthur Andersen LLP, provided us with auditing services during the year ended December 31, 2001, including issuing an audit report with respect to our audited consolidated financial statements as of and for the

year ended December 31, 2001. On June 15, 2002, a jury in Houston, Texas found Arthur Andersen guilty of a federal obstruction of justice charge arising from the federal government's investigation of Enron Corp. On August 31, 2002, Arthur

Andersen ceased practicing before the SEC.

We were unable to obtain Arthur Andersen's consent to include its report with respect to our audited consolidated financial statements as of and for the year ended December 31, 2001 in our Annual Reports on Form 10-K for the years ended December 31, 2003 and 2002. Rule 437a under the Securities Act of 1933, or the Securities Act, permits us to dispense with the requirement to file Arthur Andersen's consent. As a result, you may not have an effective remedy against Arthur Andersen in connection with a material misstatement or omission with respect to our audited consolidated financial statements. In addition, even if you were able to assert such a claim, as a result of its conviction and other lawsuits, Arthur Andersen may fail or otherwise have insufficient assets to satisfy claims made by investors or by us that might arise under federal securities laws or otherwise relating to any alleged material misstatement or omission with respect to our audited consolidated financial statements.

INCREASED UTILIZATION AND COSTS OF OUR TECHNICAL SUPPORT SERVICES AND INCREASED DEMANDS ON OUR OTHER TECHNICAL RESOURCES MAY ADVERSELY AFFECT OUR FINANCIAL RESULTS.

Our products involve very complex technology and the failure or inability of our technical support staff to meet customer expectations in a timely manner or customer dissatisfaction with our product functionality or performance could result in loss of revenues, loss of market share, failure to achieve market acceptance, injury to our reputation, liability for service or warranty costs and claims and other increased costs. We may be unable to respond to fluctuations in customer demand for support services as well as resolve customer issues in a manner that is timely and satisfactory to them. We also may be unable to modify the format of our support services to compete with changes in support services provided by competitors.

As we win business from larger, more complex customers with highly customized environments there may be an increased demand on our resources, particularly product development and support, which may affect the allocation of our resources. Additionally, as we continue to sell our new products to existing customers, our customers might expect us to provide the same level of product support on the new products as we do on the old products. This could increase demand on our product support resources beyond levels we could provide.

THE MARKET PRICE OF OUR COMMON STOCK HAS BEEN AND MAY CONTINUE TO BE VOLATILE.

Our stock price, like that of other technology companies, has been extremely volatile. The announcement of new products, services, technological innovations, customers or distribution partners by us or our competitors, quarterly variations in our operating results, changes in coverage by securities analysts, changes in revenues or earnings estimates by securities analysts, speculation in the press or investment community and overall economic conditions are among the factors affecting our stock price.

In addition, the stock market in general and the market prices for technology companies in particular have experienced extreme volatility that often has been unrelated to the operating performance of these companies. These broad market and industry fluctuations may adversely affect the market price of our common stock, regardless of our operating performance. Recently, when the market price of a stock has been volatile, holders of that stock have often instituted securities class action litigation against the company that issued the stock. If any of our stockholders brought a lawsuit against us, we could incur substantial costs defending the lawsuit. The lawsuit could also divert the time and attention of our management.

The general economic uncertainties in the United States and abroad continue to cause significant volatility in the stock markets. The continued

threat of terrorism in the United States and abroad and the ongoing military action and heightened security measures undertaken in response to that threat can be expected to cause continued volatility in securities markets. In addition, foreign political unrest may continue to adversely affect the economy.

WE MAY LOSE MONEY ON FIXED-PRICE CONSULTING CONTRACTS.

Although the majority of our services have historically been performed on a time and material basis, we have in the past performed services under fixed price contracts at the request of a customer. In the future, it is possible that an increased portion of our services revenues could be derived from fixed-price contracts, particularly since we assumed several fixed-price contract obligations as a result of the Business Layers acquisition. We work with complex technologies in compressed time frames and it can be difficult to judge the time and resources necessary to complete a project. If we miscalculate the resources or time we need to complete work under fixed-price contracts, we may suffer losses, and our operating results could be materially adversely affected.

CONTINUED WEAKNESS IN THE GLOBAL ECONOMY MAY ADVERSELY AFFECT OUR BUSINESS.

The global economy is still weak and may continue to be weak in the foreseeable future. In addition, the United States' continued involvement in Iraq, as well as the political unrest in other parts of the world, have contributed to global economic uncertainty. We believe the current economic slowdown has caused some potential or current customers to defer purchases. In response to the current economic conditions, many companies have reduced their spending budgets for information technology products and services, which could reduce or eliminate potential sales of our products and services.

CERTAIN PROVISIONS OF OUR CHARTER AND OF DELAWARE LAW MAKE A TAKEOVER OF OUR COMPANY MORE DIFFICULT.

Our corporate documents and Delaware law contain provisions that might enable us to resist a takeover of our company. These provisions might discourage or delay a change in the control of Netegrity or a change in our management. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors and take other corporate actions. The existence of these provisions could limit the price that investors might be willing to pay in the future for shares of our common stock. Additionally, we have entered into employment and executive retention agreements with certain employees and all of our executive officers which, among other things, include certain severance and change of control provisions that may have similar effects.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency

In the three and nine months ended September 30, 2004, we generated approximately 32% and 31%, respectively, of our revenues outside of the United States Our international sales are typically denominated in U.S. dollars. Our foreign subsidiaries incur most of their expenses in the local currency. Accordingly, all foreign subsidiaries use the local currency as their functional currency. Translation gains (which were $115,000 as of September 30, 2004) are deferred and accumulated as a separate component of stockholders' equity (accumulated other comprehensive income (loss)). Net losses resulting from

foreign exchange transactions, which were $29,000 for the three months ended September 30, 2004 and $32,000 for the nine months ended September 30, 2004, are included in other income, net in the accompanying condensed consolidated statements of operations. A 10% change in the valuation of the functional currencies relative to the U.S. dollar as of September 30, 2004 would not have a material impact on our results of operations for the three and nine months ended September 30, 2004.

Interest Rates

We invest our cash in a variety of financial instruments including floating rate bonds, municipal bonds, asset-backed securities and money market instruments in accordance with an investment policy approved by our Board of Directors. These investments are denominated in U.S. dollars. Cash balances in foreign currencies overseas are operating balances and are only invested in short-term deposits of the local operating bank.

Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. However, due to the conservative nature of our investment portfolio, a sudden change in interest rates would not have a material effect on the value of the portfolio. We estimate that if the average yield of our investments had decreased by 100 basis points, our interest income for the quarter ended September 30, 2004 would have decreased by less than $100,000. This estimate assumes that the decrease occurred on the first day of the year and reduced the yield of each investment instrument by 100 basis points. The same 100 basis point change in interest rates would not have a material impact on the fair value of the investment portfolio. The impact on our future interest income and future changes in investment yields will depend largely on the gross amount of our investment portfolio.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2004. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as September 30, 2004, our disclosure controls and procedures were (1) designed to ensure that material information relating to Netegrity, including our consolidated subsidiaries, is made known to our Chief Executive Officer and Chief Financial Officer by others within those entities, particularly during the period in which this report was being prepared and (2) effective, in that they provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended September 30, 2004 that has materially affected or is reasonably likely to materially affect, our internal control over financial reporting.

31

PART II. - OTHER INFORMATION

ITEM 6. EXHIBITS

EXHIBIT

ITEM NO.	ITEM AND REFERENCE
10.01	Form of Executive Retention Agreement by and between Netegrity, Inc. and Regina O. S dated September 13,2002; by and between Netegrity, Inc. and William Bartow dated Sep 13,2002; by and between Netegrity, Inc. and Stephanie Feraday dated November 4, 2002 most recently incorporated by reference for each executive was the incorrect version agreement).
10.02	Executive Employment Agreement by and between Netegrity, Inc. and Barry N Bycoff, da as of May 22, 2002 (Filed as Exhibit 10.1 to Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, and incorporated by reference. Version most recently incorporated by reference was the incorrect version of this agreement).
31.1	Rule 13a-14(a)/15d-14(a) Certification of President and Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer and Treasurer.
32.1	Section 1350 Certification of President and Chief Executive Officer.
32.2	Section 1350 Certification of Chief Financial Officer and Treasurer.

SIGNATURES

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

Netegrity Inc.

Date: October 29, 2004 By: /s/ Barry N. Bycoff

Barry N. Bycoff
President, Chief Executive Officer and
Chairman of the Board
(Principal Executive Officer)

Date: October 29, 2004 By: /s/ Regina O. Sommer

Regina O. Sommer
Chief Financial Officer and Treasurer
(Principal Financial Officer and Principal
Accounting Officer)