

McAfee, Inc.  
Form 10-Q/A  
August 09, 2004

**Table of Contents**

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Form 10-Q/ A**  
**Amendment No. 1**

(Mark One)

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

**For the quarterly period ended March 31, 2004**

**or**

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

**For the transition period from            to**

**Commission file number: 0-20558**

**McAfee, Inc.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of  
incorporation or organization)*

**77-0316593**

*(I.R.S. Employer  
Identification Number)*

**3965 Freedom Circle  
Santa Clara, California**

*(Address of principal executive offices)*

**95054**

*(Zip Code)*

**Registrant's telephone number, including area code:**

**(408) 988-3832**

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

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

As of April 26, 2004, 165,330,464 shares of the registrant's common stock, \$0.01 par value, were outstanding.

THIS 10-Q/ A IS BEING FILED FOR THE PURPOSE OF AMENDING ITEMS 1, 2 AND 4 OF PART I OF FORM 10-Q AS OF MARCH 31, 2004 FILED ON MAY 10, 2004 TO REFLECT THE RESTATEMENT OF REVENUES AND CERTAIN EXPENSE ITEMS IN THE THREE MONTHS ENDED MARCH 31, 2004. OTHER THAN THOSE CHANGES AND CHANGES RELATED TO A CHANGE IN THE COMPANY'S NAME FROM NETWORKS ASSOCIATES, INC. TO MCAFEE, INC. EFFECTIVE JULY 1, 2004, WE HAVE MADE

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NO FURTHER CHANGES TO THE PREVIOUSLY FILED 10-Q. ALL INFORMATION IN THE FORM 10-Q/ A IS AS OF MARCH 31, 2004 AND DOES NOT REFLECT ANY SUBSEQUENT INFORMATION OR EVENTS OTHER THAN SUCH CHANGES.

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**McAFEE, INC. AND SUBSIDIARIES**

**FORM 10-Q/ A**

**March 31, 2004**

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**CONTENTS**

<b>Item Number</b>		<b>Page</b>
<b><u>PART I: FINANCIAL INFORMATION</u></b>		
<b><u>Item 1.</u></b>	<b><u>Financial Statements (Unaudited)</u></b>	
	<u>Condensed Consolidated Balance Sheets:</u>	
	March 31, 2004 (As Restated) and December 31, 2003	2
	<u>Condensed Consolidated Statements of Income and Comprehensive Income:</u>	
	Three months ended March 31, 2004 (As Restated) and 2003 (As Restated)	3
	<u>Condensed Consolidated Statements of Cash Flows:</u>	
	Three months ended March 31, 2004 (As Restated) and 2003 (As Restated)	5
	<u>Notes to Condensed Consolidated Financial Statements</u>	6
<b><u>Item 2.</u></b>	<b><u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	26
<b><u>Item 4.</u></b>	<b><u>Controls and Procedures</u></b>	44
	<u>Signatures</u>	45
	<u>Exhibit Index</u>	46
	<u>Certification Pursuant to Section 302</u>	
	<u>Certification Pursuant to Section 906</u>	

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	March 31, 2004	December 31, 2003
(Unaudited) (In thousands, except share and per share data) (As restated, see note 13)		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 430,329	\$ 333,651
Short-term marketable securities	217,432	174,499
Accounts receivable, net	109,559	170,218
Prepaid expenses, income taxes and other current assets	108,260	95,609
Deferred taxes	176,333	160,550
Assets held for sale		24,719
	<u>          </u>	<u>          </u>
Total current assets	1,041,913	959,246
Long-term marketable securities	293,449	258,107
Restricted cash	20,647	20,547
Property and equipment, net	110,294	111,672
Deferred taxes	169,980	199,196
Intangible assets, net	98,974	105,952
Goodwill	441,488	443,593
Other assets	6,314	22,185
	<u>          </u>	<u>          </u>
Total assets	<u>\$2,183,059</u>	<u>\$2,120,498</u>
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable	\$ 25,847	\$ 32,099
Accrued liabilities	123,568	147,281
Deferred revenue	383,175	342,795
Convertible debt, current portion	345,275	
Liabilities related to assets held for sale		23,310
	<u>          </u>	<u>          </u>
Total current liabilities	877,865	545,485
Deferred revenue, less current portion	102,077	116,762
Convertible debt, less current portion		347,397
Other long term liabilities	232,082	222,765
	<u>          </u>	<u>          </u>
Total liabilities	<u>1,212,024</u>	<u>1,232,409</u>
Commitments and contingencies (Notes 11 and 12)		
<b>STOCKHOLDERS EQUITY</b>		
Preferred stock, \$0.01 par value:		
Authorized: 5,000,000 shares; issued and outstanding:		
none at March 31, 2004 and December 31, 2003		
Common stock, \$0.01 par value:		
Authorized: 300,000,000 shares; Issued:	1,648	1,621
164,762,023 shares and 162,071,798 shares at March 31,		
2004 and December 31, 2003, respectively; Outstanding:		
164,412,023 shares and 161,721,798 shares at March 31,		

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2004 and December 31, 2003, respectively		
Additional paid-in capital	1,111,288	1,087,625
Deferred stock-based compensation	(537)	(598)
Accumulated other comprehensive income	35,252	34,027
Accumulated deficit	(171,909)	(229,879)
Treasury stock, at cost: 350,000 shares	(4,707)	(4,707)
	<u>          </u>	<u>          </u>
Total stockholders' equity	971,035	888,089
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$2,183,059	\$2,120,498
	<u>          </u>	<u>          </u>

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

Table of Contents

## McAFEE, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

## AND COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2004	2003
	(In thousands, except per share data) (Unaudited) (As restated, see note 13)	
Net revenue:		
Product	\$ 83,731	\$ 127,306
Services and support	135,347	92,008
Total net revenue	<u>219,078</u>	<u>219,314</u>
Cost of net revenue:		
Product	22,952	18,690
Services and support	10,847	13,230
Amortization of purchased technology	3,393	1,741
Total cost of net revenue	<u>37,192</u>	<u>33,661</u>
Operating costs:		
Research and development(1)	45,379	46,430
Marketing and sales(2)	92,958	88,941
General and administrative(3)	27,541	28,208
Gain on sale of assets and technology	(46,505)	(37)
Provision for (recovery from) doubtful accounts, net	525	(323)
Litigation settlement	(19,101)	
Amortization of intangibles	3,573	5,011
Restructuring charge	2,190	15,781
Total operating costs	<u>106,560</u>	<u>184,011</u>
Income from operations	75,326	1,642
Interest and other income	4,351	4,548
Interest and other expenses	(741)	(3,171)
Loss on redemption of zero coupon convertible debentures		(2,591)
Gain on sale of marketable securities	488	1,048
Income before provision for income taxes and cumulative effect of change in accounting principle	79,424	1,476
Provision for income taxes	21,454	144
Income before cumulative effect of change in accounting principle	57,970	1,332
Cumulative effect of change in accounting principle, net of taxes		11,142
Net income	<u>\$ 57,970</u>	<u>\$ 12,474</u>

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Other comprehensive income:		
Unrealized gain (loss) on available-for-sale securities, net	\$ 250	\$ (689)
Foreign currency translation gain	974	2,459
	<u>          </u>	<u>          </u>
Comprehensive income	\$ 59,194	\$ 14,244
	<u>          </u>	<u>          </u>
Basic income per share:		
Income before cumulative effect of change in accounting principle	\$ 0.35	\$ 0.01
Cumulative effect of change in accounting principle, net of taxes		0.07
	<u>          </u>	<u>          </u>
Net income per share basic	\$ 0.35	\$ 0.08
	<u>          </u>	<u>          </u>
Shares used in per share calculation basic	163,423	159,552
	<u>          </u>	<u>          </u>
Diluted income per share:		
Income before cumulative effect of change in accounting principle	\$ 0.33	\$ 0.01
Cumulative effect of change in accounting principle net of taxes		0.07
	<u>          </u>	<u>          </u>
Net income per share diluted	\$ 0.33	\$ 0.08
	<u>          </u>	<u>          </u>
Shares used in per share calculation diluted	186,564	165,366
	<u>          </u>	<u>          </u>

**Table of Contents**

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- (1) Includes stock-based compensation charges of \$1,314 and \$742 for the three months ended March 31, 2004 and 2003, respectively.
- (2) Includes stock-based compensation charges of \$636 and \$256 for the three months ended March 31, 2004 and 2003, respectively.
- (3) Includes stock-based compensation charges of \$276 and \$969 for the three months ended March 31, 2004 and 2003, respectively.

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



**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(In thousands) (Unaudited) (As restated, see note 13)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 57,970	\$ 12,474
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of change in accounting principle		(11,142)
Depreciation and amortization	16,634	15,978
Provision for (recovery from) doubtful accounts, net	525	(323)
Non cash restructuring charge		15,781
Non cash interest expense on convertible notes	525	1,584
Premium amortization on marketable securities	1,537	
Gain on sale of assets and technology	(45,814)	(37)
Gain on sale of marketable securities	(488)	(1,048)
Loss on redemption of zero coupon convertible debentures		2,591
Deferred taxes	14,869	(2,118)
Stock-based compensation charges	2,226	1,967
Change in fair value of derivative, net	(2,151)	(1,164)
Changes in assets and liabilities, net of divestitures:		
Accounts receivable	61,842	52,961
Prepaid expenses, taxes and other	4,142	5
Accounts payable and accrued liabilities	(22,299)	(26,964)
Deferred revenue	29,479	(4,325)
	<u>118,997</u>	<u>56,220</u>
<b>Cash flows from investing activities:</b>		
Purchase of marketable securities	(313,133)	(376,133)
Proceeds from sale and maturity of marketable securities	234,060	253,855
Proceeds from sale of Magic, net	47,565	
Purchase of property and equipment	(8,653)	(23,100)
Increase in restricted cash	(100)	(199)
Other	(28)	(165)
	<u>(40,289)</u>	<u>(145,742)</u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of stock from option and stock purchase plans	22,408	19,830
Redemption of zero coupon convertible debentures		(177,055)
	<u>22,408</u>	<u>(157,225)</u>
Effect of exchange rate fluctuations	(4,441)	5,365
Net increase (decrease) in cash and cash equivalents	<u>96,678</u>	<u>(241,382)</u>

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Cash and cash equivalents at beginning of period	333,651	674,226
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 430,329	\$ 432,844
	<u>          </u>	<u>          </u>
Non cash investing activities:		
Unrealized gain (loss) on marketable securities	\$ 250	\$ (689)
	<u>          </u>	<u>          </u>
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$ 5,645	\$ 2,415
	<u>          </u>	<u>          </u>
Cash paid for interest	\$ 2,504	\$ 2,786
	<u>          </u>	<u>          </u>

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

**Table of Contents**

**McAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Business**

McAfee, Inc. (formerly Networks Associates, Inc.) and its wholly owned subsidiaries (the Company) are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. The Company offers two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. The Company's computer security solutions are offered primarily to large enterprises, governments, small and medium sized businesses and consumers. The Company operates its business in five geographic regions: North America; Europe, Middle East and Africa ( EMEA ); Japan; Asia-Pacific and Latin America.

**2. Summary of Significant Accounting Policies and Accounting Change**

***Basis of Presentation***

The accompanying condensed consolidated financial statements include the accounts of the Company as of March 31, 2004 and for the three months ended March 31, 2004 and March 31, 2003. All significant intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2003 Consolidated Balance Sheet was derived from audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, the Company believes that all disclosures are adequate to make the information presented not misleading. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in the Company's Annual Report on Form 10-K for fiscal year ended December 31, 2003.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to fairly present the Company's financial position as of March 31, 2004, and results of operations and cash flows for the three months ended March 31, 2004 and March 31, 2003 have been included. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

Certain amounts from 2003 have been reclassified to conform to the 2004 presentation.

***Proforma Stock-Based Compensation Disclosure***

As permitted by Statement of Financial Accounting Standard ( SFAS ) No. 123, *Accounting for Stock-Based Compensation*, ( SFAS 123 ) and as amended by SFAS No. 148, *Accounting for Stock- Based Compensation Transition and Disclosure*, ( SFAS 148 ), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employee*, ( APB 25 ), and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock-Based Compensation, an interpretation of APB Opinion No. 25* ( FIN 44 ) and the related interpretations in accounting for its stock-based compensation plans. Stock-based compensation related to non-employees is based on the fair value of the related stock or options in accordance with SFAS 123 and its interpretations. Expense associated with stock-based compensation is amortized over the vesting period of each individual award.

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company utilized the following assumptions in calculating the estimated fair value of each stock option and for its employee stock purchase plan ( ESPP ) using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants and the ESPP:

	Three Months Ended March 31,	
	2004	2003
Stock grants:		
Risk free interest rate	2.59%	3.60%
Expected life	4 years	4 years
Volatility	90.17%	98.02%
Dividend yield	None	None
ESPP:		
Risk free interest rate	1.29%	1.43%
Expected life	1.25 years	1.25 years
Volatility	58%	72%
Dividend yield	None	None

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provision of SFAS 123 to all of its stock-based compensation plans.

	Three Months Ended March 31,	
	2004	2003
Net income, as reported	\$ 57,970	\$ 12,474
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax	(9,146)	(16,684)
Add back: Stock-based compensation expense, net of tax, included in reported net income	1,336	1,180
Pro forma net income (loss)	\$ 50,160	\$ (3,030)
Net income (loss) per share:		
Basic as reported	\$ 0.35	\$ 0.08
Basic pro forma	\$ 0.31	\$ (0.02)
Diluted as reported	\$ 0.33	\$ 0.08
Diluted pro forma	\$ 0.28	\$ (0.02)

The impact on pro forma income (loss) per share and net income (loss) in the table above may not be indicative of the effect in future periods as options vest over several years and the Company continues to grant stock options to employees.

***New Accounting Pronouncements***

*Accounting for Enhancements to One-Time Termination Benefits*

In September 2003, the FASB issued FASB Staff Position No. FAS 146-1, *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement* ( FSP FAS 146-1 ). FSP FAS 146-1 clarifies circumstances when additional termination benefits offered in connection with an exit or disposal activity, in

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

substance, are (a) enhancements to an ongoing benefit arrangement and, therefore, subject to the provisions of FASB Statements No. 87, No. 88, No. 106 and No. 112 or (b) one-time termination benefits subject to FASB Statement No. 146. The guidance in this FSP is effective for exit or disposal activities initiated in interim or annual reporting periods beginning after September 15, 2003. The Company adopted this FSP on January 1, 2004 and its adoption did not have a significant impact on the Company's financial position, results of operations or cash flows.

*Accounting for Consolidation of Variable Interest Entities*

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), which was revised in December 2003 and subsequently referred to as FIN 46R. FIN 46R has been subsequently interpreted by three FASB Staff Positions. FIN 46 and FIN 46R applied immediately to variable interest entities (VIEs) created after January 31, 2003 and no later than the end of the first interim or annual reporting period ending after December 15, 2003. The adoption of FIN 46 and FIN 46R (and related interpretations) had no impact as the Company has no investments in special purpose entities.

*Accounting Change*

Effective January 1, 2003, the Company changed its method for recognizing commission expenses to sales personnel. Prior to January 1, 2003, the Company's policy had been to expense the commissions as incurred, however, the Company believes that expensing the commissions as incurred does not provide a fair representation of the income from operations where part or all of the revenue related to these sales transactions is deferred and recognized over time. Commission expense directly related to sales transactions is now deferred and recognized ratably over the same period as the related revenue is recognized and recorded, which the Company believes will provide greater transparency into its performance.

As required by accounting principles generally accepted in the United States of America, the cumulative effect of the change in accounting principle effective January 1, 2003 resulted in a one-time credit of \$11.1 million, net of income taxes.

**3. Stock-Based Compensation**

The Company recorded stock-based compensation charges of \$2.2 million and \$2.0 million, before taxes, in the three months ended March 31, 2004 and 2003, respectively. These charges are comprised of the following (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Exchange of McAfee.com options	\$ 1,833	\$ 741
Existing executive	106	106
Former employees	146	1,120
Extended life of vested options held by terminated employees	141	
	<hr/>	<hr/>
Total stock-based compensation	\$ 2,226	\$ 1,967
	<hr/>	<hr/>

*Exchange of McAfee.com options.* On September 13, 2002, the Company acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of Networks Associates, Inc. common stock plus \$8.00 in cash, which will be paid to the option holder only upon exercise of the option and without interest, in exchange for each McAfee.com option. McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of the Company's common stock. The assumed options have been accounted for under the guidance in EITF Issue No. 00-23 *Issues Related to the*



**Table of Contents**

**McAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB Opinion No. 25.* Accordingly, these options are subject to variable accounting treatment, which means that a compensation charge has been measured initially at the date of the closing of the merger and then remeasured at the end of each reporting period. The initial charge was based on the excess of the closing price of the Company's stock over the exercise price of the options plus the \$8.00 per share payable in cash, which will be paid upon exercise of the option. The charge has been and will be remeasured, using the same methodology, until the earlier of the date of exercise, forfeiture or cancellation without replacement. This compensation charge is recorded as an expense over the remaining vesting period of the options, using the accelerated method of amortization under FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* ( FIN 28 ). To the extent that the options issued were fully vested at the date of the closing of the McAfee.com acquisition, the Company immediately recorded a compensation expense of approximately \$10.5 million. Charges related to unvested options will be recorded in deferred stock-based compensation in stockholders' equity. Depending upon movements in the market value of the Company's common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

During the three months ended March 31, 2004 and 2003, the Company recorded a charge of approximately \$1.8 million and \$0.7 million, respectively, related to exchanged options subject to variable accounting. This stock-based compensation charge was based on the Company's closing share price of \$18.00 on March 31, 2004 and \$13.81 on March 31, 2003. As of March 31, 2004, the Company had approximately 0.7 million outstanding options subject to variable accounting.

*Existing executive.* On January 15, 2002, the Company's board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk, its chairman and chief executive officer. The price of the underlying shares is \$0.01 per share. The shares will vest and the Company's right to repurchase such shares will lapse as follows: 3,000 vested as of the grant date and 47,000 are restricted until January 15, 2005. The intrinsic value of the restricted stock was determined to be approximately \$1.4 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of our common stock on January 15, 2002. During the three months ended March 31, 2004 and 2003, the Company recorded approximately \$0.1 million in both periods related to stock-based compensation associated with Mr. Samenuk's 2002 restricted stock grant.

*Former employees.* In November and December 2003, the Company extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. As these employees' options continued to vest after termination and their exercise period was extended an additional 90 days, the Company recorded a one time stock-based compensation charge of approximately \$0.1 million.

In July 2002, one of the Company's employees became a non-employee, but continued to provide services to the Company. As he was allowed to continue to hold his vested options beyond the normal exercise period after termination and continue to vest his options, the Company recorded a stock-based compensation charge corresponding to the fair value of his vested options. The unvested options were remeasured using the Black Scholes option valuation model and recognized over the remaining vesting period using the accelerated method of amortization required in FIN 28. Stock-based compensation of approximately \$30,000 was expensed during the three months ended March 31, 2003. No future stock compensation charges will be recorded.

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire the Company's common stock. These options are subject to variable accounting as discussed above. Upon the executives' termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former



**Table of Contents**

**McAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

McAfee.com executives were exercised within the first quarter of 2003. As a result, the Company recorded a final stock-based compensation charge of \$1.1 million during the three months ended March 31, 2003.

*Repriced Options.* During the three months ended March 31, 2004 and 2003, the Company did not incur a charge related to these repriced options subject to variable plan accounting. For the three months ended March 31, 2004 and 2003, the Company's stock-based compensation charge calculation related to options subject to variable plan accounting were based on quarter-end per share price of the Company's stock of \$18.00 and \$13.81, respectively. As of March 31, 2004, the Company had options to purchase approximately 0.5 million shares, which were outstanding and subject to variable plan accounting.

*Extended life of vested options held by terminated employees.* During a significant portion of 2003, the Company suspended exercises of stock options until its required public company reports were filed with the SEC. The period during which stock options were suspended is known as the blackout period. Due to the blackout period, the Company extended the exercisability of any options of terminated employees that would otherwise expire during the blackout period for a period of time equal to a specified period after termination of the blackout period. Accordingly, the Company recorded a stock-based compensation charge on the date the options should have terminated based on the intrinsic value of the option on the modification date and the option price. In the first quarter of 2004, the Company recorded a final stock-based compensation charge of approximately \$0.1 million. No charge was recorded in the first quarter of 2003, however approximately \$3.7 million was recorded in the remainder of 2003.

**4. Business Combinations and Divestitures**

***IntruVert Networks, Inc.***

On May 14, 2003, the Company acquired 100% of the outstanding capital shares of IntruVert Networks, Inc., ( IntruVert ) a provider of network-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for \$98.1 million in cash and \$5.2 million of direct expenses, totaling \$103.3 million. The Company acquired IntruVert to enhance its network protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company's current product offering, and sell IntruVert products to its existing customer base. The results of operations of IntruVert have been included in these condensed consolidated financial statements since the date of acquisition.

The Company recorded approximately \$5.7 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The ongoing project at IntruVert at the time of purchase was the development of the Infinity model of the IntruShield sensor. The product was completed in the third quarter of 2003. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to five years or a weighted average period of 4.5 years. The Company accrued approximately \$0.3 million in duplicative site costs for lease space no longer being utilized and permanently vacated related to the IntruVert acquisition. The accrual has been fully utilized.

As part of the IntruVert acquisition, the Company cancelled all outstanding IntruVert restricted stock and outstanding stock options and agreed to make cash payments to former IntruVert employees contingent upon their continued employment with the Company based on the same vesting terms of their restricted stock or stock option agreements. The payments to former IntruVert employees are recorded ratably over the vesting period as salary expense as the employees are currently providing services to the Company. Payments under the restricted stock plan are paid monthly from an escrow account and will total approximately \$3.0 million from the purchase date through the fourth quarter of 2006. Payments under the stock option plan are being paid monthly through the Company's payroll and will total approximately \$4.1 million from the purchase date through the second quarter of 2007. Cash payments that were fully vested at the date of acquisition were

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

included in the purchase price. If a former IntruVert employee ceases employment with the Company, unvested payment amounts will be returned to the Company.

***Entercept Security Technologies, Inc.***

On April 30, 2003, the Company acquired 100% of the outstanding capital shares of Entercept Security Technologies, Inc. ( Entercept ), a provider of host-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for \$121.9 million in cash and \$3.9 million of direct expenses, totaling \$125.8 million. The Company acquired Entercept to enhance its system protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company's current product offering, and sell Entercept products to its existing customer base. The results of operations of Entercept have been included in these condensed consolidated financial statements since the date of acquisition.

The Company recorded approximately \$0.9 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The ongoing project at Entercept at the time of purchase in was a Linux version of their current product. The project was delayed and product availability is expected in July 2004. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to six years or a weighted average period of 5.6 years.

The Company accrued \$2.8 million in duplicative sites costs for permanently vacated facilities at the acquisition date. The accrual will be fully utilized by 2006, the end of the original lease term. In the fourth quarter of 2003, the Company entered into a sublease for the vacated facility, and therefore, adjusted the accrual by the value of the sublease. The following is a summary of activity in the restructuring accrual related to Entercept (in thousands):

Original accrual, April 30, 2003	\$ 2,837
Cash payments	(821)
Adjustments	(1,137)
	<hr/>
Balance, March 31, 2004	\$ 879
	<hr/>

As part of the Entercept acquisition, the Company assumed all outstanding unvested Entercept cash bonus units and agreed to make specified per unit cash payments to former Entercept employees contingent upon their continued employment with the Company for one year based on the vesting terms of such units, generally one year. The payments to former Entercept employees are expensed monthly as salary expense as the employees are currently providing services to the Company. Total payments subject to remaining vesting are estimated to be \$2.4 million as of March 31, 2004. Amounts to be paid under the cash bonus plan are held in escrow and will be paid generally at the end of one year from the Entercept purchase date. Employees that are no longer with the Company at the payment date will not receive any payment, and any forfeited amounts will be allocated to the former Entercept stockholders.

Management determined the purchase price allocation of the above acquisitions based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

at utilizing recognized valuation techniques and the assistance of valuation consultants. The following is a summary of the assets acquired and liabilities assumed in the acquisitions (in thousands):

	<b>IntruVert Networks, Inc.</b>	<b>Entercept Security Technologies, Inc.</b>	<b>Total Assets Acquired and Liabilities Assumed</b>
Deferred tax assets	\$ 436	\$ 10,560	\$ 10,996
Technology	18,200	21,700	39,900
Other intangible assets	1,900	2,800	4,700
Cash	10,986	1,028	12,014
Goodwill	71,598	99,440	171,038
Other assets	4,984	3,517	8,501
	<hr/>	<hr/>	<hr/>
Total assets acquired	108,104	139,045	247,149
	<hr/>	<hr/>	<hr/>
Current liabilities	2,649	4,614	7,263
Deferred tax liabilities	7,839	9,555	17,394
	<hr/>	<hr/>	<hr/>
Total liabilities assumed	10,488	14,169	24,657
	<hr/>	<hr/>	<hr/>
Net assets acquired	\$ 97,616	\$ 124,876	\$ 222,492
	<hr/>	<hr/>	<hr/>
In-process research and development (expensed)	\$ 5,700	\$ 900	\$ 6,600
	<hr/>	<hr/>	<hr/>
Total acquisition cost	\$ 103,316	\$ 125,776	\$ 229,092
	<hr/>	<hr/>	<hr/>

The following unaudited pro forma financial information presents the combined results of the Company, IntruVert and Entercept as if the acquisitions had occurred at the beginning of 2003 (in thousands except per share amounts):

	<b>Three Months Ended March 31, 2003</b>
Net revenue	\$ 222,031
	<hr/>
Net income	\$ 2,634
	<hr/>
Basic net income per share	\$ 0.02
	<hr/>
Shares used in per share calculation basic	159,552
	<hr/>
Diluted net income per share	\$ 0.02
	<hr/>
Shares used in per share calculation diluted	165,366
	<hr/>

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The above unaudited pro forma financial information includes adjustments for interest income on cash disbursed for the acquisitions, amortization of identifiable intangible assets and adjustments for expenses incurred in conjunction with the acquisitions. The pro forma financial information excludes the effects of the in-process research and development totaling \$6.6 million that was expensed immediately.

### ***Magic Solutions, Inc.***

In December 2003, the Company announced the sale of its Magic Solutions business ( Magic ) to BMC Software for \$47.0 million in cash plus final purchase price adjustments. At December 31, 2003, the carrying

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

values of assets and liabilities related to Magic were presented as held for sale on the consolidated balance sheet. The following were the components of the Magic disposal group at December 31, 2003 (in thousands):

Assets:	
Accounts receivable, net of allowance for doubtful accounts of \$215	\$ 12,991
Prepaid expenses	888
Inventory	20
Equipment, net	1,023
Goodwill	9,797
	<hr/>
Assets held for sale	\$ 24,719
	<hr/>
Liabilities:	
Accounts payable	\$ 215
Accrued liabilities	1,050
Deferred revenue	22,045
	<hr/>
Liabilities related to assets held for sale	\$ 23,310
	<hr/>

The assets and liabilities of Magic were located primarily in the Company's North American and EMEA reporting units. Magic assets and liabilities in the Company's other reporting units were not material. Depreciation on equipment held for sale was ceased in December 2003. Revenues related to Magic were approximately \$2.9 million and \$15.3 million for the three months ended March 31, 2004 and 2003, respectively and \$63.2 million for the year ended 2003.

The Company completed the transaction on January 30, 2004. As a result of the sale, the Company recorded a gain of approximately \$46.5 million for the three months ended March 31, 2004.

**5. Goodwill and Other Intangible Assets**

The Company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. In lieu of amortization, the Company performs an impairment review of its goodwill on at least an annual basis. The Company completed its annual goodwill impairment review as of October 1, 2003, during the fourth quarter of 2003 and concluded that goodwill was not impaired. The fair value of the reporting units was estimated using the average of the expected present value of future cash flows and of the market multiple value. Furthermore, as a result of the sale of Magic, the Company also tested its reporting units excluding Magic as required by SFAS 142 and no impairment was present. The Company will continue to test for impairment annually unless an impairment indicator occurs.

Goodwill information is as follows (in thousands):

	January 1, 2004	Goodwill Acquired	Adjustments	Effects of Foreign Currency Exchange	March 31, 2004
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
North America	\$ 364,325	\$	\$ (376)	\$ (59)	\$ 363,890
EMEA	44,360		(61)	109	44,408
Japan	16,748		(10)		16,738
Asia-Pacific (excluding Japan)	6,087		(13)		6,074
Latin America	12,073		(1,385)	(310)	10,378

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Total	<u>\$443,593</u>	<u>\$</u>	<u>\$(1,845)</u>	<u>\$(260)</u>	<u>\$441,488</u>
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**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of intangible assets are as follows (in thousands):

	March 31, 2004			December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount
Other intangible assets:						
Purchased technologies	\$ 111,320	\$ (63,219)	\$ 48,101	\$ 116,037	\$ (64,439)	\$ 51,598
Trademarks, patents, customer base, and other intangibles	88,726	(37,853)	50,873	103,431	(49,077)	54,354
	<u>\$ 200,046</u>	<u>\$ (101,072)</u>	<u>\$ 98,974</u>	<u>\$ 219,468</u>	<u>\$ (113,516)</u>	<u>\$ 105,952</u>

The aggregate amortization expenses for the intangible assets listed above totaled \$7.0 million and \$6.8 million for the three months ended March 31, 2004 and 2003, respectively.

Expected future intangible asset amortization expense is as follows (in thousands):

Fiscal Years:	
Remainder of 2004	\$ 18,973
2005	23,270
2006	20,401
2007	17,646
2008	12,277
Thereafter	6,407
	<u>\$ 98,974</u>

**6. Restructuring****2004 Restructuring**

In the first quarter of 2004, the Company recorded a restructuring charge of approximately \$2.2 million related to the severance of approximately 160 employees, of which \$0.7 million and \$1.5 million was related to its North American and EMEA operating segments, respectively. The workforce size was reduced primarily due to the Company's sale of Magic. Substantially all employees under this severance arrangement had been terminated as of March 31, 2004.

The following table summarizes the Company's restructuring accrual established through March 31, 2004 (in thousands):

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	<b>Severance and Other Benefits</b>
Balance, January 1, 2004	\$
Restructuring accrual	2,217
Cash payments	(1,548)
	<hr/>
Balance, March 31, 2004	\$ 669
	<hr/>



**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2003 Restructuring**

In January 2003, as part of a restructuring effort to gain operational efficiencies, the Company consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into its newly constructed regional headquarters facility in Plano, Texas. The facility houses employees working in finance, legal, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses.

As part of the consolidation of activities into the Plano facility, the Company relocated employees from its Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, the Company recorded a restructuring charge of \$15.8 million which consisted of a non-cash charge of \$2.1 million related to asset disposals and discontinued use of certain leasehold improvements, furniture and equipment; non-cash write off of \$1.9 million deferred rent liability; and a \$15.6 million accrual for estimated lease related costs associated with the permanently vacated facilities in Santa Clara, California. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The total restructuring charge and related cash outlay are based on management's current estimates. As of March 31, 2004, \$1.7 million of the accrued lease termination costs have been classified as current accrued liabilities, while the remaining balance of \$12.1 million has been classified as other long term liabilities.

During the second and third quarter of 2003, the Company recorded restructuring charges of \$6.8 million and \$0.6 million, respectively, which consisted of \$6.7 million related to a headcount reduction of 210 employees and \$0.7 million related to other expenses such as legal expenses incurred in international locations in conjunction with the headcount reduction. The employees were located in the Company's domestic and international locations and were primarily in the sales, product development and customer support areas. In the third and fourth quarters of 2003, the Company reversed a total of \$1.0 million of restructuring accrual in Europe that was no longer necessary after paying out substantially all accrued amounts to the former employees.

The following table summarizes the Company's restructuring accrual established in 2003 and activity through March 31, 2004 (in thousands):

	<b>Lease Termination Costs</b>	<b>Severance and Other Benefits</b>	<b>Other Costs</b>	<b>Total</b>
Balance, January 1, 2003	\$	\$	\$	\$
Restructuring accrual	15,734	6,692	739	23,165
Cash payments	(1,707)	(6,259)	(167)	(8,133)
Adjustment to liability	(273)	(116)	(572)	(961)
Accretion	463			463
Balance, December 31, 2003	14,217	317		14,534
Restructuring accrual				
Cash payments	(545)	(194)		(739)
Adjustment to liability	(33)	6		(27)
Accretion	146			146
Balance, March 31, 2004	\$ 13,785	\$ 129	\$	\$ 13,914

The Company's estimates of the excess facilities charge may vary significantly depending, in part, on factors which may be beyond the Company's control, such as the Company's success in negotiating with its



**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if further consolidations are required or if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charge was not allocated to reporting segments. The restructuring charge related to headcount reductions was \$0.9 million and \$5.8 million in the Company's North American and EMEA operating segments, respectively.

**7. Convertible Debt**

Convertible debt comprises the following amounts (in thousands):

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
<b>5.25% Convertible Subordinated Notes due 2006</b>		
Face Value (including accumulated fair value adjustment of \$275 and \$2,397 at March 31, 2004 and December 31, 2003, respectively)	\$ 345,275	\$ 347,397

**5.25% Convertible Subordinated Note Due 2006**

In August 2001, the Company issued 5.25% convertible subordinated notes (Notes) due 2006 with an aggregate principal amount of \$345.0 million. The issuance generated net proceeds (after deducting fees and expenses) of \$335.1 million. The amortization of the issuance costs related to the Notes is calculated using the effective interest method and recorded as additional interest expense in the statements of income. The Notes are unsecured and are subordinated to all existing and future Senior Indebtedness (as defined in the related indenture). The Notes have no restrictive financial covenants.

The Notes mature on August 15, 2006, unless earlier redeemed by the Company at its option or converted at the holder's option. At the option of the holder, the Notes may be converted into the Company's common stock at any time, unless previously redeemed, at a conversion price of \$18.07 per share. The Notes may also be redeemed at the option of the holder in the event of a Change of Control (as defined in the related indenture). At any time between August 20, 2004 and August 14, 2005, the Company may redeem all or a portion of the Notes for cash at a repurchase price of 101.3125% of the principal amount. After August 14, 2005, the repurchase price is 100.0% of the principal amount. The Company intends to redeem the Notes in accordance with the Indenture, on or after its call date of August 20, 2004, and accordingly, have been classified as current liabilities in the accompanying condensed consolidated balance sheet at March 31, 2004.

Interest is payable in cash semi-annually in arrears on February 15 and August 15 of each year, and started on February 15, 2002 and is approximately \$18.1 million, annually without giving effect to the related floating rate interest swap (See Note 8).

**Zero Coupon Convertible Debentures Due 2018**

In February 1998, the Company completed a private placement of zero coupon convertible subordinated debentures due in 2018 (the Debentures). The Debentures, with an aggregate face amount at maturity of \$885.5 million, generated net proceeds to the Company of approximately \$337.6 million. The Company redeemed varying amounts of the debentures during 2002 and 2001.

In February 2003, outstanding Debentures, with an aggregate face amount at maturity of \$358.5 million, became redeemable for cash at the option of the holders thereof, at which time the Company repurchased Debentures which had an aggregate face amount at maturity of \$358.0 million for a net price of \$177.1 million. In June 2003, the Company redeemed the remaining Debentures with an aggregate face amount at maturity of \$0.5 million for a net price of \$0.2 million. The Company recognized a loss of



**Table of Contents**

**McAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$2.6 million on the redemption of Debentures during 2003. The loss was calculated as the difference between the accreted value of the debt, net of unamortized issuance costs and the cost of redemption.

**8. Interest Rate Swap Transaction**

In July 2002, the Company entered into interest rate swap transactions (the Transactions) with two investment banks (the Banks), to hedge the interest rate risk of its outstanding 5.25% Convertible Subordinated Notes due 2006 (See Note 7 of Notes to these condensed consolidated financial statements).

The notional amount of the Transactions was \$345.0 million to match the entire principal amount of the Notes. The Company will receive from the Banks fixed payments equal to 5.25% percent of the notional amount, payable on February 15 and August 15 which started on August 15, 2002. In exchange, the Company will pay to the Banks floating rate payments based upon the London InterBank Offered Rate (LIBOR) plus 1.66% multiplied by the notional amount of the Transactions with the LIBOR resetting every three months which began on August 15, 2002.

The Transactions will terminate on August 15, 2006 (Termination Date), subject to certain early termination provisions if on or after August 20, 2004 and prior to August 15, 2006 the closing price of the Company's common stock equals or exceeds \$22.59 per share. Depending on the timing of the early termination event, the Banks would be obligated to pay the Company an amount equal to the repurchase premium called for under the terms of the Notes.

The Transactions qualified and were designated as a fair value hedge against movements in the fair value of the Notes due to changes in the benchmark interest rate. Under the fair value hedge model, the derivative is recognized at fair value on the balance sheet with an offsetting entry to the income statement. In addition, changes in fair value of the Notes due to changes in the benchmark interest rate are recognized as a basis adjustment to the carrying amount of the Notes with an offsetting entry to the income statement. The gain or loss from the change in fair value of the Transaction and the offsetting change in the fair value of the Notes are recognized as interest and other expense. The net unrealized gain recorded as of March 31, 2004 and 2003 was approximately \$2.2 million and \$1.2 million, respectively. The estimated fair value of the Transactions was \$9.5 million and \$13.4 million at March 31, 2004 and 2003, respectively.

To test effectiveness of the hedge, regression analysis is performed at least quarterly comparing the change in fair value of the Transactions and the Notes. The fair values of the Transactions and the Notes are calculated as the present value of the contractual cash flows to the expected maturity date, where the expected maturity date is based on probability-weighted analysis of interest rates relating to the five-year LIBOR curve and the Company's stock prices. For 2004 and 2003, the hedge was highly effective and therefore, the ineffective portion did not have a material impact on earnings.

In support of the Company's obligation under the Transactions, the Company is required to maintain with the Banks a minimum level of cash and investment collateral of \$20.0 million and periodically adjust the overall level of collateral depending on the fair market value of the Transactions. This minimum amount of collateral is presented as restricted cash in the condensed consolidated balance sheets.

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Net Income Per Share**

A reconciliation of the numerator and denominator of basic and diluted net income per share is provided as follows (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2004	2003
<b>Numerator Basic</b>		
Income before cumulative effect of accounting change	\$ 57,970	\$ 1,332
Cumulative effect of accounting change, net of taxes		11,142
Net income	<u>\$ 57,970</u>	<u>\$ 12,474</u>
<b>Numerator Diluted</b>		
Net income	\$ 57,970	\$ 1,332
Interest on convertible debentures(1), net of tax	2,989	
Income before cumulative effect of accounting change	60,959	1,332
Cumulative effect of accounting change, net of taxes		11,142
Net income, adjusted	<u>\$ 60,959</u>	<u>\$ 12,474</u>
<b>Denominator Basic</b>		
Basic weighted average common stock outstanding	163,423	159,552
<b>Denominator Diluted</b>		
Basic weighted average common stock outstanding	163,423	159,552
Effect of dilutive securities:		
Convertible debentures(1)	19,092	
Common stock options and shares subject to repurchase(2)	4,002	5,641
Warrants	47	173
Diluted weighted average shares	<u>186,564</u>	<u>165,366</u>
<b>Basic net income per share:</b>		
Income before cumulative effect of accounting change	\$ 0.35	\$ 0.01
Cumulative effect of accounting change, net of taxes		0.07
Net income per share Basic	<u>\$ 0.35</u>	<u>\$ 0.08</u>
<b>Diluted net income per share:</b>		
Income before cumulative effect of accounting change	\$ 0.33	\$ 0.01
Cumulative effect of accounting change, net of taxes		0.07
Net income per share Diluted	<u>\$ 0.33</u>	<u>\$ 0.08</u>

- 
- (1) For the three months ended March 31, 2003, convertible debt interest and related as-if converted shares were excluded from the calculation since the effect was anti-dilutive. The total number of shares excluded from the calculation related to as-if converted shares was 19.1 million.
- (2) At March 31, 2004 and 2003, 8.7 million and 14.8 million options to purchase common stock, respectively, were excluded from the calculation since the effect was anti-dilutive.

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****10. Business Segment Information**

The Company has concluded that it has one business and operates in one industry, developing, marketing, distributing and supporting computer security solutions for large enterprises, governments, small and medium sized business and consumer users, as well as resellers and distributors. Management measures profitability based on the Company's five geographic regions: North America; Europe, Middle East and Africa ( EMEA ); Japan; Asia-Pacific (excluding Japan) and Latin America. The regions are evidence of the operating structure of the Company's internal organization.

The Company markets and sells, through its geographic regions, anti-virus and security software, hardware and services and network management software, hardware and services. These products and services are marketed and sold worldwide primarily through resellers, distributors, systems integrators, retailers, original equipment manufacturers, Internet service providers and directly by the Company. In addition, the Company offers web sites, which provide suites of on-line products and services personalized for the user based on the user's PC configuration, attached peripherals and resident software. The Company also offers managed security and availability applications to corporations and governments on the Internet.

Following is the summary of the Company's net revenue from external customers and income before provision for income taxes and cumulative effect of change in accounting principle by geographic region (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Net revenue by region:</b>		
North America	\$ 134,121	\$ 135,675
EMEA	56,848	62,079
Japan	13,817	10,675
Asia-Pacific (excluding Japan)	7,490	6,660
Latin America	6,802	4,225
	<u>          </u>	<u>          </u>
Net revenue	\$ 219,078	\$ 219,314
	<u>          </u>	<u>          </u>
<b>Income (loss) from operations by region:</b>		
North America	\$ 68,257	\$ (11,045)
Europe	3,806	5,224
Japan	(2,262)	1,612
Asia-Pacific (excluding Japan)	8,552	6,706
Latin America	1,071	(1,021)
	<u>          </u>	<u>          </u>
Income before provision for income taxes and cumulative effect of change in accounting principle	\$ 79,424	\$ 1,476
	<u>          </u>	<u>          </u>



**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net revenue information on a product and service basis is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Software licenses	\$ 57,040	\$ 104,624
Support and maintenance	103,015	68,422
Hardware	25,229	17,480
Consulting	3,984	7,117
Training	1,882	2,069
Hosting arrangements	26,466	14,400
Retail and other	1,462	5,202
	<hr/>	<hr/>
Total	\$ 219,078	\$ 219,314
	<hr/>	<hr/>

Net revenue information on a product family basis is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
McAfee	\$ 166,006	\$ 150,056
Sniffer	42,253	48,908
Magic	2,850	15,284
IntruShield	6,609	
NAI Labs	1,360	3,722
PGP		1,344
	<hr/>	<hr/>
Total	\$ 219,078	\$ 219,314
	<hr/>	<hr/>

**11. Litigation****General**

From time to time, the Company has been subject to litigation including the pending litigation described below. The Company's current estimated range of liability related to some of the pending litigation below is based on claims for which management can estimate the amount and range of loss. The Company has recorded the minimum estimated liability related to those claims, where there is a range of loss. Because of the uncertainties related to both the amount and range of loss on the remaining pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, the Company will assess its potential liability and revise its estimates. Pending or future litigation could have a material adverse effect on the business, results of operations, financial condition and cash flow.

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In addition, the Company is engaged in certain legal and administrative proceedings incidental to its normal business activities and believes that these matters will not have a material adverse effect on its financial position, results of operations or cash flows.

During the first quarter of 2004, the Company received net insurance reimbursements from our insurance carriers of approximately \$19.1 million. The insurance reimbursements are a result of the settling of the class action securities litigation case against the Company in October 2003. In October 2003, the Company paid approximately \$70.0 million to settle the litigation.

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Securities Case***

Certain investment bank underwriters, the Company, and certain of our directors and officers have been named in a putative class action lawsuit for violation of the federal securities laws in the United States District Court for the Southern District of New York, captioned *In re McAfee.com Corp. Initial Public Offering Securities Litigation*, 01 Civ. 7034 (SAS). This is one of a number of cases challenging underwriting practices in the initial public offerings ( IPOs ) of more than 300 companies. These cases have been coordinated for pretrial proceedings as *In re Initial Public Offering Securities Litigation*, 21 MC 92 (SAS). Plaintiffs generally allege that certain underwriters engaged in undisclosed and improper underwriting activities, namely the receipt of excessive brokerage commissions and customer agreements regarding post-offering purchases of stock in exchange for allocations of IPO shares. Plaintiffs also allege that various investment bank securities analysts issued false and misleading analyst reports. The complaint against the Company claims that the purported improper underwriting activities were not disclosed in the registration statements for McAfee.Com's IPO and seeks unspecified damages on behalf of a purported class of persons who purchased the Company's securities or sold put options during the time period from December 1, 1999 to December 6, 2000. On February 19, 2003, the Court issued an Opinion and Order dismissing certain of the claims against the Company with leave to amend. A settlement proposal was accepted by the Company on July 15, 2003 and is awaiting Court approval. The proposed settlement would not have material impact on the Company's financial position, results of operations or cash flows, if approved by the court.

***Other Matters***

On June 6, 2002, Paul Cozza filed a Complaint in the United States District Court, District of Massachusetts alleging breach of contract, fraud and bad faith arising out of a dispute concerning the licensing of certain technology used in the Company's Virex 6.1 product. The Complaint seeks royalties on the Company's sale of Virex 6.1 products from January 1, 2002 to the present. The Company filed papers in opposition to the Complaint and asserted various defenses. The Company also moved to compel arbitration, which was denied by the District Court. The Company appealed, and the case is currently stayed pending a ruling by the First Circuit Court of Appeals on the arbitration issue.

On March 22, 2002, the Securities and Exchange Commission notified the Company that it has commenced a Formal Order of Private Investigation into the Company's accounting practices. The SEC investigation is continuing, and the Company continues to provide documents and information to the SEC.

**12. Contingencies and Guarantees**

The Company uses the guidance of FASB Interpretation No. 45 ( FIN 45 ), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee or indemnification. FIN 45 also requires additional disclosure by a guarantor in its interim and annual consolidated financial statements about its obligations under certain guarantees and indemnifications. The following is a summary of the agreements that the Company has determined are within the scope of FIN 45.

Under the terms of the Company's software license agreements with its customers, the Company agrees that in the event the software sold infringes upon any patent, copyright, trademark, or any other proprietary right of a third party, it will indemnify its customer licensees, against any loss, expense, or liability from any damages that may be awarded against its customer. The Company includes this infringement indemnification in all of its software license agreements and selected managed service arrangements. In the event the customer cannot use the software or service due to infringement and the Company can not obtain the right to use, replace or modify the license or service in a commercially feasible manner so that it no longer infringes then the Company may terminate the license and provide

**Table of Contents**

**McAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the customer a pro-rata refund of the fees paid by the customer for the infringing license or service. The Company has recorded no liability associated with this indemnification, as it is not aware of any pending or threatened infringement actions that are probable losses. The Company believes the estimated fair value of these intellectual property indemnification clauses is minimal. The Company has not paid any significant amounts under these agreements.

Under the terms of certain vendor agreements, in particular, vendors used as part of the Company's managed services, the Company has agreed that in the event the service provided to the customer by the vendor on behalf of the Company infringes upon any patent, copyright, trademark, or any other proprietary right of a third party, it will indemnify its vendor, against any loss, expense, or liability from any damages that may be awarded against its customer. No maximum liability is stipulated in these vendor agreements. The Company has recorded no liability associated with this indemnification, as it is not aware of any pending or threatened infringement actions or claims that are probable losses. The Company believes the estimated fair value of these indemnification clauses is minimal. The Company has not paid any significant amounts under these agreements.

The Company has agreed to indemnify members of the board of directors, as well as officers of the Company, if they are made a party or are threatened to be made a party to any proceeding (other than an action by or in the right of the Company) by reason of the fact that they are an agent of the Company, or by reason of anything done or not done by them in any such capacity. The indemnity is for any and all expenses and liabilities of any type whatsoever (including but not limited to, judgments, fines and amounts paid in settlement) actually and reasonably incurred by the directors or officers in connection with the investigation, defense, settlement or appeal of such proceeding, provided they acted in good faith. The Company maintains insurance coverage for directors and officers liability (D&O insurance). No maximum liability is stipulated in these agreements that include indemnifications of members of the board of directors and officers of the Company. The Company has recorded no liability associated with these indemnifications as it is not aware of any pending or threatened actions or claims against its members of board of directors or officers that are probable losses in excess of amounts covered by its D&O insurance. As a result of the insurance policy coverage, the Company believes the estimated exposure of these indemnification agreements is minimal.

Under the terms of the Company's agreements to sell the PGP and Gauntlet assets in 2001, the Company agreed to indemnify the purchasers for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). The maximum potential loss related to the indemnification for breach of representations or warranties is \$2.4 million. No maximum liability is stipulated in the agreement related to any undiscovered liabilities. To date, the Company has paid \$0.4 million under the representations and warranties indemnification. The company has not recorded any accruals related to these agreements.

Under the terms of the Company's agreement to sell Magic in January 2004, the Company agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is \$10.0 million. To date, the Company has paid no amounts under the representations and warranties indemnification. The company has not recorded any accruals related to these agreements.

If the Company believes a liability associated with any of the aforementioned indemnifications becomes probable and the amount of the liability is reasonably estimable or the maximum amount of a range of loss is reasonably estimable, then an appropriate liability will be established.

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****13. Restatement***2004 Restatement*

Subsequent to the issuance of its condensed consolidated financial statements for the quarter ended March 31, 2004, the Company determined that its method of revenue recognition for certain products was incorrect due to a limited number of product stock keeping units ( SKUs ) being set up improperly. As a result, the accompanying condensed consolidated financial statements for the quarter ended March 31, 2004 have been restated. In addition, certain other adjustments, previously considered immaterial individually and in the aggregate, were also recorded in the condensed consolidated financial statements for the quarter ended March 31, 2004. A summary of the significant effects of the restatement follows (in thousands):

**Balance Sheet Information**

	<b>March 31, 2004</b>	
	<b>As Previously Reported</b>	<b>As Restated</b>
Accounts receivable, net	\$ 109,759	\$ 109,559
Prepaid expenses, income taxes and other current assets	\$ 108,561	\$ 108,260
Deferred taxes, short term	\$ 177,304	\$ 176,333
Total current assets	\$1,043,385	\$1,041,913
Deferred taxes, long term	\$ 169,861	\$ 169,980
Total assets	\$2,184,412	\$2,183,059
Accrued liabilities	\$ 124,102	\$ 123,568
Deferred revenue, short term	\$ 385,864	\$ 383,175
Current liabilities	\$ 881,088	\$ 877,865
Other long term liabilities	\$ 232,200	\$ 232,082
Total liabilities	\$1,215,365	\$1,212,024
Accumulated other comprehensive income	\$ 35,217	\$ 35,252
Accumulated deficit	\$ (173,861)	\$ (171,909)

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Total stockholders' equity	\$ 969,047	\$ 971,035
Total liabilities and stockholders' equity	\$2,184,412	\$2,183,059

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Statement of Income Information**

	<b>Three Months Ended March 31, 2004</b>	
	<b>As Previously Reported</b>	<b>As Restated</b>
Product revenue	\$ 81,203	\$ 83,731
Services and support revenue	135,421	135,347
<b>Net revenue</b>	<b>\$216,624</b>	<b>\$219,078</b>
Marketing and sales	\$ 92,657	\$ 92,958
General and administrative	\$ 28,076	\$ 27,541
<b>Total operating costs</b>	<b>\$106,794</b>	<b>\$106,560</b>
<b>Income from operations</b>	<b>\$ 72,638</b>	<b>\$ 75,326</b>
Provision for income taxes	\$ 20,718	\$ 21,454
<b>Net income</b>	<b>\$ 56,018</b>	<b>\$ 57,970</b>
Basic income per share:		
Income before cumulative effect of change in accounting principle	\$ 0.34	\$ 0.35
Cumulative effect of change in accounting principle net of taxes		
<b>Earnings per share Basic</b>	<b>\$ 0.34</b>	<b>\$ 0.35</b>
Diluted income per share:		
Income before cumulative effect of change in accounting principle	\$ 0.32	\$ 0.33
Cumulative effect of change in accounting principle net of taxes		
<b>Earnings per share Diluted</b>	<b>\$ 0.32</b>	<b>\$ 0.33</b>

*2003 Restatement*

During analysis of the Company's international subsidiaries' 2003 deferred revenue balances, the Company detected that its accounting system was recognizing deferred revenue using fluctuating foreign currency exchange rates. However, the subsidiaries' deferred revenue should be recognized using the exchange

**Table of Contents****McAFEE, INC. AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

rate applied when the deferred revenue was initially recorded. As a result, the Company made the following adjustments to previously reported first quarter of 2003 amounts (in thousands):

	<b>Three Months Ended March 31, 2003</b>	
	<b>As Previously Reported</b>	<b>As Restated</b>
Product revenue	\$ 126,391	\$ 127,306
Services and support revenue	92,050	92,008
Net revenue	<u>\$ 218,441</u>	<u>\$ 219,314</u>
Income from operations	<u>\$ 769</u>	<u>\$ 1,642</u>
Provision for income taxes	<u>\$ 121</u>	<u>\$ 144</u>
Net income	<u>\$ 11,624</u>	<u>\$ 12,474</u>
Basic income per share:		
Income before cumulative effect of change in accounting principle	\$	\$ 0.01
Cumulative effect of change in accounting principle net of taxes	0.07	0.07
Earnings per share Basic	<u>\$ 0.07</u>	<u>\$ 0.08</u>
Diluted income per share:		
Income before cumulative effect of change in accounting principle	\$	\$ 0.01
Cumulative effect of change in accounting principle net of taxes	0.07	0.07
Earnings per share Diluted	<u>\$ 0.07</u>	<u>\$ 0.08</u>

**14. Subsequent Events**

In April 2004, the Company announced that it was selling its Sniffer product line to a partnership of two investment firms for \$275.0 million in cash, subject to a working capital adjustment. The transaction is expected to be completed in the third quarter of 2004. The Company also announced that it would be changing its name to McAfee, Inc. when the transaction is completed.

In April 2004, the Company renewed and expanded its \$16.5 million credit facility with a bank. The credit facility was increased \$2.0 million and is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including, but not limited to, interest rate, maturity, representations, covenants and events of default, as mutually agreed between the Company and bank at the time of each specific transaction. The credit facility is intended to be used for short term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time.



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On April 30, May 3, and May 4, 2004, the Company repurchased a total of 1,792,000 shares of its common stock for approximately \$28.8 million.

**Table of Contents****Item 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations***  
**Forward-Looking Statements; Trademarks**

Some of the statements contained in this Report on Form 10-Q are forward-looking statements that involve risks and uncertainties. The statements contained in the Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, pr targets, goals, projects, continue, or variations of such words, similar expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors beginning on page 42 in our Form 10-Q for the first quarter of 2004 originally filed on May 10, 2004. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

This report includes registered trademarks and trade names of McAfee and other corporations. Trademarks or trade names owned by McAfee and/or our affiliates include the marks: Network Associates, McAfee and Sniffer.

The following discussion should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this report. The results shown herein are not necessarily indicative of the results to be expected for the full year or any future periods.

As described in note 13 to these condensed consolidated financial statements, we restated certain quarterly information for the quarter ended March 31, 2004 and also as described in note 13 and in Item 8 of our 2003 Annual Report on Form 10-K, we restated certain quarterly financial information for the quarters ended March 31, June 30 and September 30, 2003. The discussion below gives effect to these restatements. We did not amend our previously filed Form 10-Qs for the relevant quarters of 2003.

***Overview and Executive Summary***

We are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. We offer two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. Our computer security solutions are offered primarily to large enterprises, governments, small and medium sized business and consumer users. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific and Latin America. See note 10 to our condensed consolidated financial statements for a description of revenues and operating income by geographic region.

We derive our revenue and generate cash from customers from primarily two sources (i) product revenue, which includes software license, hardware and royalty revenue, and (ii) services and support revenue, which includes software license maintenance, training, consulting and on-line subscription arrangements revenue. For the three months ended March 31, 2004 and 2003, our net revenue was \$219.1 million and \$219.3 million, respectively, and our net income was \$58.0 million and \$12.5 million, respectively. Net income for the three months ended March 31, 2004 was favorably impact by a \$46.5 million gain from the sale of our Magic assets in January 2004 and insurance reimbursements of approximately \$19.1 million relating to our previously settled class action lawsuit. Our net revenue is impacted by corporate, government and consumer

**Table of Contents**

spending levels. In addition to total net revenue and net income, in evaluating our business, management considers, among many other factors, the following:

*Sales by geography.* We operate our business in five geographic regions: North America (U.S. and Canada); Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific and Latin America. During the three months ended March 31, 2004 and 2003, 39% and 38% of our net revenue, respectively, was generated outside of North America, with North America and EMEA collectively accounting for approximately 87% and 90%, respectively, of our total net revenue. During all of fiscal 2003 and the first quarter of 2004, sales in EMEA were favorably impacted by the strengthening of the Euro and the British Pound.

Sales by product and customer category:

*McAfee.* Our McAfee products include enterprise, small and medium sized businesses and consumer products, with enterprise including our Intercept host-based intrusion protection products which were acquired in connection with the Intercept acquisition in April 2003. While sales to enterprises and small and medium sized businesses have been down, we have experienced significant growth in the consumer market. Our consumer market is comprised of our McAfee consumer on-line subscription service and retail boxed product sales. In the quarter ended March 31, 2004, we added a record 860,000 net new subscribers. At March 31, 2004, we had a total subscriber base of approximately 4.6 million customers and our average subscription per subscriber was 1.4. Drivers of this subscriber growth include (i) numerous virus outbreaks during the second half of 2003 and in early 2004, including variations of MyDoom, Bagle and NetSky, and (ii) continued strategic relationships with OEMs and others, such as AOL, Dell and MSN. As compared to the quarters ended December 31 and March 31, 2003, consumer revenue attributable to our retail channel for the quarter ended March 31, 2004 was down by \$21.7 million and \$9.7 million, respectively. Retail revenue is traditionally higher in the fourth quarter and, as compared to the comparable quarter in 2003, decreased retail revenue reflects increased promotional activities and related costs that benefit future periods but are offset against revenues in the current period.

*IntruShield.* Our IntruShield network protection products, acquired by us in the second quarter of 2003, are sold primarily to enterprises and small and medium sized businesses. During the three months ended March 31, 2004, we recorded \$6.6 million of sales of IntruShield products as compared to \$9.0 million during the fourth quarter of 2003. We believe this decrease reflects general seasonality, rather than a lessening of demand for these products, as the fourth quarter is typically our highest quarter for sales.

*Sniffer Technologies.* Sniffer revenues decreased 14% from \$48.9 million in the first quarter of 2003 to \$42.3 million in the first quarter of 2004. As part of our continued effort to streamline our business, in April 2004, we announced plans to sell our Sniffer product line for \$275.0 million in cash, subject to a working capital adjustment. The transaction is expected to close in the third quarter of 2004. In the near term, the loss of future Sniffer revenues may increase our operating expenses as a percentage of net revenue as we will not be able to reduce expenses as quickly as revenue will be reduced following the Sniffer sale.

*Magic.* We sold the assets of our Magic Solutions service desk business to BMC Software, Inc. The sale closed on January 30, 2004 and we received cash proceeds of approximately \$47.6 million, net of direct expenses. During the three months ended March 31, 2004 and 2003, net revenue from the sale of Magic Solutions products totaled approximately \$2.9 million and \$15.3 million, respectively.

See note 10 to our condensed consolidated financial statements for a description of revenues on a product and service basis and a product family basis.

*Deferred revenue balances.* Our deferred revenue balance at March 31, 2004 and December 31, 2003 was \$485.3 million and \$481.6 million, respectively, of which approximately \$22.0 million relates to our Magic business at December 31, 2003 classified as liabilities related to assets held for sale. We believe

**Table of Contents**

that the deferred revenue balance improves predictability of future revenues. In the middle of 2003, we introduced our perpetual plus licensing program in EMEA and have now completed the planned implementation of perpetual plus worldwide with its introduction in North America in the first quarter of 2004. Under the perpetual plus licensing program more revenue is allocated to service and support, therefore increasing the deferred revenue balance. As a result of the perpetual licensing program, the balance of deferred revenue has increased from \$327.7 million at March 31, 2003 to \$485.3 million at March 31, 2004, or 48%.

*Bookings.* Bookings represent contractual and other arrangements entered into in a particular period for which revenue may be recognized by us in the current or future periods. Although deferred revenue is a better predictor of future revenues, we believe bookings are also an indicator of future revenues. There is no certainty that bookings will result in future revenues because, among other things, customers may modify or cancel these orders or we may be unable to fulfill our obligations under the arrangements. For the three months ended March 31, 2004 and December 31, 2003, bookings totaled \$259.4 million and \$348.9 million, respectively. Excluding Sniffer and Magic bookings, for the three months ended March 31, 2004 and December 31, 2003, bookings totaled \$222.9 million and \$252.8 million, respectively.

*Cash, cash equivalents and investment balances.* Cash, cash equivalents and investment balances at March 31, 2004 and December 31, 2003 totaled \$941.2 million and \$766.3 million, respectively. During the first quarter of 2004, we generated \$119.0 million of cash from operations; used \$40.3 million of cash in investing activities; and generated \$22.4 million of cash from financing activities. Our cash, cash equivalents and investment balances grew due to payments from our customers from sales recorded in the fourth quarter, which is our highest quarter of sales. We also received approximately \$47.6 million of cash, net of direct expenses, related to our sale of Magic.

*Cost reduction and profitability plan.* In conjunction with the planned Sniffer sale, we have begun to implement a cost reduction and profitability plan, which has been under development for several months. The plan is designed to significantly enhance our operating margins by mid-2005. Some of these measures, including programs designed to improve our sales process efficiencies or to rationalize the facilities and infrastructure required to deliver product and customer support, will require initial investments with the related benefits expected in later periods or may only be implemented in full following closing of the Sniffer transaction.

In the remainder of 2004, our management remains focused, on among other things, (i) continuing to build on the current momentum in the consumer market and to grow faster than the competition in the consumer space; (ii) increasing revenue from the small to medium sized business customers by improving our channel distribution relationships; (iii) completing the sale of Sniffer; (iv) implementing cost controls and business streamlining measures required to improve operating margins; and (v) continuing to grow our intrusion prevention business.

Our McAfee Protection-in-Depth Strategy is designed to provide a complete set of system and network protection solutions differentiated by intrusion prevention technology that can detect and block known and unknown attacks. To more effectively market our products in our various geographic sales regions, as more fully described below, we have combined complementary products into separate product groups as follows:

McAfee System Protection Solutions, which delivers anti-virus and security products and services designed to protect systems such as desktops and servers and

McAfee Network Protection Solutions, which offers products designed to maximize the performance and security of networks, including Sniffer Technologies network analysis and availability technologies, network intrusion prevention with McAfee IntruShield and InfiniStream Security Forensics.

## **Table of Contents**

### **McAfee System Protection Solutions**

McAfee System Protection Solutions help large enterprises, small/medium businesses, consumers, government agencies and educational organizations assure the availability and security of their desktops, application servers and web service engines. The McAfee System Protection Solutions portfolio features a range of products including anti-virus, managed services, McAfee SpamKiller anti-spam solutions, McAfee ThreatScan vulnerability assessment and McAfee Enterecept for host-based intrusion prevention. Each is backed by the McAfee Anti-Virus Emergency Response Team, a leading threat research organization. A substantial majority of our net revenue has historically been derived from our McAfee Security anti-virus products.

McAfee System Protection Solutions also includes McAfee Consumer Security, offering both traditional retail products and our on-line subscription services. Our consumer retail and on-line subscription applications allow users to protect their PCs from malicious code and other attacks, repair PCs from damage caused by viruses and block spam and other undesirable content. Our retail products are sold through retail outlets, including Best Buy, CompUSA, Dixons and Staples, to single users and small home offices in the form of traditional boxed product. These products include free and for-fee software updates and technical support services. Our on-line subscription services are delivered through the use of an Internet browser at our McAfee.com web site and through multiple on-line service providers and original equipment manufacturers, or OEMs.

Until recently, McAfee System Protection Solutions also included our Magic Service Desk business, offering management and visibility of desktop and server systems. In January 2004, we sold our Magic Service Desk business to BMC Software.

### **McAfee Network Protection Solutions**

McAfee Network Protection Solutions helps enterprises, small businesses, government agencies, educational organizations and service providers maximize the availability, performance and security of their network infrastructure. The McAfee Network Protection Solutions portfolio features a range of products including Sniffer and the nPO Solution for network management. Sniffer's products capture data, monitor network traffic and collect and report on key network statistics. These products, which as described above we have agreed to sell, are also designed to optimize network and application performance and increase network reliability by uncovering and analyzing network problems and network security vulnerabilities and recommending solutions to such problems. Other McAfee Network Protection Solutions products include InfiniStream Security Forensics for security forensics and McAfee IntruShield for network intrusion detection and prevention. Customers for these products include enterprises, government agencies and educational organizations, as well as service providers.

### **Expert Services and Technical Support**

We have established Expert Services and Technical Support to provide professional assistance in the design, installation, configuration and implementation of our customers' networks and acquired products. Expert Services is focused on two service markets: Consulting Services and Education Services.

Consulting Services support product integrations and deployment with an array of standardized and custom offerings. Consulting Services also offer other services in both the security and networking areas, including early assessment and design work, as well as emergency outbreak and network troubleshooting assistance. Our consulting services organization is organized around our product groups.

Education Services offer customers an extensive curriculum of computer network technology courses, including protocol analysis and troubleshooting, security and network management tools. Education Services provides public classes and customized on-site training at customer locations.

The PrimeSupport program provides our customers on-line and telephone-based technical support in an effort to ensure that our products are installed and working properly. To meet customers' varying needs, PrimeSupport offers a choice of the on-line ServicePortal or the telephone-based Connect, Priority and

## **Table of Contents**

Enterprise. All PrimeSupport programs include software updates and upgrades. PrimeSupport is available to all customers worldwide from various regional support centers.

*PrimeSupport ServicePortal* Consists of a searchable, knowledge base of technical solutions and links to a variety of technical documents such as product FAQs and technical notes.

*PrimeSupport Connect* Provides toll-free telephone access to technical support during regular business hours and access to the on-line ServicePortal.

*PrimeSupport Priority* Provides priority, unlimited, toll-free (where available) telephone access to technical support 24 hours a day, seven days a week and access to the on-line ServicePortal.

*PrimeSupport Enterprise* Offers proactive, personalized service and includes an assigned technical support engineer from our Enterprise support team, proactive support contact (telephone or email) with customer-defined frequency, election of five designated customer contacts and access to the on-line ServicePortal.

In addition, we also offer our consumer users technical support services made available at our McAfee.com website on both a free and fee-based basis, depending on the support level required.

## **McAfee Research**

McAfee Research is our research and development organization dedicated to advanced network and host system intrusion detection and prevention and security technology. McAfee Research currently conducts research in the areas of host intrusion prevention, network intrusion prevention, wireless intrusion prevention, malicious code defense, security policy and management, high-performance assurance and forensics and threats, attacks, vulnerabilities and architectures. McAfee Research has ongoing projects funded through the U.S. Defense Advanced Research Projects Agency, the U.S. Intelligence Community Advanced Research & Development Activity, Air Force, Navy, Army, NSA and other Department of Defense and U.S. government agencies. McAfee Research focuses on exploiting government research to advance the capabilities of our product-line offerings.

## **Strategic Alliances**

From time to time, we enter into strategic alliances with third parties to serve as a catalyst for our future growth. These relationships may include joint technology development and integration, research cooperation, co-marketing activities and sell-through arrangements. For example, we have an alliance with America Online under which, among other things, we offer our on-line PC anti-virus services to AOL members as a co-branded premium service and provide our host-based email scanning services and personal firewall services as a value-added service. We also have alliances with, among others, Cox Communications, Checkpoint, Dell, Freeserve, Microsoft, MSN, NEC, NTT DoCoMo, Phoenix Technologies, Telecom Italia and Telefonica.

## **Product Licensing Model**

We typically license our products to corporate and government customers on a perpetual basis. Most of our licenses are sold with maintenance contracts, and typically these are sold on an annual basis. As the maintenance contracts near expiration, we contact customers to renew their contracts, as applicable. We typically sell perpetual licenses in connection with sales of our hardware-based products in which software is bundled with the hardware platform.

For our largest customers (over 2000 nodes), we also offer two-year term-based licenses. Our two-year term licensing model also creates the opportunity for recurring revenue through the renewal of existing licenses. By offering two-year licenses, as opposed to traditional perpetual licenses, we are also able to meet a lower initial cost threshold for customers with annual budgetary constraints. The renewal process also provides an opportunity to cross-sell new products and product lines to existing customers.

**Table of Contents****On-Line Subscription Services and Managed Applications**

For our on-line subscription services, customers essentially rent the use of our software. Because our on-line subscription services are version-less, or self-updating, customers subscribing to these services are assured of using the most recent version of the software application, eliminating the need to purchase product updates or upgrades. Our on-line subscription consumer products and services are found at our McAfee.com web site where consumers download our anti-virus application using their Internet browser which allows the application to detect and eliminate viruses on their PCs, repair their PCs from damage caused by viruses, optimize their hard drives and update their PCs virus protection system with current software patches and upgrades. Our McAfee.com web site also offers customers access to McAfee Personal Firewall Plus, McAfee SpamKiller and McAfee Internet Privacy Service, as well as combinations of these services through suites. At March 31, 2004, we had 4.6 million McAfee consumer on-line subscribers.

Similarly, our small and medium sized business on-line subscription products and services, or our ASaP offerings, provide these customers the most up-to-date anti-virus software. Our ASaP offerings include VirusScan ASaP, which provides anti-virus protection to desktops and file servers, VirusScreen ASaP, which screens e-mails to detect and quarantine viruses and infected attachments and Desktop Firewall ASaP, which blocks unauthorized network access and stops known network threats.

We also make our on-line subscription products and services available over the Internet in what we refer to as a managed environment. Unlike our on-line subscription service solutions, these managed service providers; or MSP, solutions are customized, monitored and updated by networking professionals for a specific customer. We also allow intermediaries, such as Internet service providers, to sell and host our products and services in a managed environment.

**Critical Accounting Policies**

There have been no material changes to our critical accounting policies and estimates as disclosed in our report on Form 10-K for the year ended December 31, 2003.

**Results of Operations**

*Three Months Ended March 31, 2004 and 2003*

**Net Revenue**

The following table sets forth for the periods indicated, our product revenue and services and support revenue as a percent of net revenue.

	Three Months Ended March 31,		Percentage of Net Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Product	\$ 83,731	\$ 127,306	38%	58%
Services and support	135,347	92,008	62	42
Net revenue	\$ 219,078	\$ 219,314	100%	100%

Net revenue decreased \$0.2 million from 2003 to 2004. The decline reflects (i) a \$12.4 million decrease related to the January 2004 sale of Magic, (ii) a Sniffer revenue decline of \$6.7 million, (iii) the introduction of our perpetual plus licensing arrangements and (iv) a \$12.2 million increase in our McAfee business and \$6.7 million increase in IntruShield product sales following our May 2003 IntruVert acquisition. Many of our customers and potential customers have: (i) delayed initiating the purchase process; (ii) increased the evaluation time to complete a purchase or postponed, sometimes indefinitely, full IT deployments; and/or (iii) reduced their capital expenditure budgets, thereby restricting their software/services purchases to those believed by them to be necessary to satisfy an immediate need.





**Table of Contents**

In the first quarter of 2004, we expanded our perpetual plus licensing arrangements to North America and have completed the planned worldwide introduction of this model. Under these arrangements, we provide a perpetual license coupled with additional support, with a higher percentage of the contract value allocated to support revenues. As a result of these arrangements, there has been (i) an increase in services and support revenue relative to product revenue, due to higher renewal rates for support bundled in these arrangements and (ii) an increase of revenue being deferred to future periods as support revenues are deferred and recognized over the life of the arrangement. The perpetual plus licensing model is designed to make our products more competitive in the channel and increase channel volumes, while having the added effect of improving the visibility and predictability of our business through increased deferred revenue balances. Deferred revenue increased \$25.7 million, or 6% to \$485.3 million at March 31, 2004 from \$459.6 million at December 31, 2003. Deferred revenue has grown 48% when comparing the first quarter of 2004 to the first quarter of 2003.

We expect the Sniffer sale to close in the third quarter of 2004. Net revenue from our Sniffer product line in the first quarter of 2004 and 2003 was \$42.3 million and \$48.9 million, respectively. Net revenue from Sniffer for the year ended 2003 was \$210.2 million.

**Net Revenue by Geography**

The following table sets forth, for the periods indicated, net revenue in each of the five geographic regions in which we operate:

	Three Months Ended March 31,		Percentage of Net Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Net Revenue:				
North America	\$ 134,121	\$ 135,675	61%	62%
EMEA	56,848	62,079	26	28
Japan	13,817	10,675	6	5
Asia-Pacific	7,490	6,660	4	3
Latin America	6,802	4,225	3	2
Total net revenue	\$ 219,078	\$ 219,314	100%	100%

Net revenue outside of North America (United States and Canada) accounted for approximately 39% and 38% of net revenue for the three months ended March 31, 2004 and 2003, respectively. Historically and continuing during the first quarter of 2004 and 2003, net revenue from North America and EMEA has comprised 87% to 90% of our business. In comparing the first quarter of 2003 and 2004, we saw a weakening of the U.S. dollar against many currencies, but most dramatically against the Euro and Great Britain Pound. As a result, we have experienced positive impacts on our net revenue in EMEA region.

For the three months ended March 31, 2004, total net revenue in North America decreased 1% or \$1.6 million compared to the three months ended March 31, 2003. The decrease in revenue is due primarily to the introduction of our perpetual plus licensing model in North America in the first quarter of 2004. As described earlier, the perpetual plus licensing model allocates more value to services and support revenue, which is deferred and recognized over the service period, and not recorded into revenue immediately.

In EMEA, total net revenue decreased 8% or \$5.2 million for the three months ended March 31, 2004 compared to the three months ended March 31, 2003. The decrease in EMEA net revenues is primarily the result of the perpetual plus licensing model. The perpetual plus licensing model allocates more value to services and support revenue, which is deferred and recognized over the service period, and not recorded into revenue immediately.

Our Japan, Latin America and Asia-Pacific operations combined have historically been less than 15% of our total business, and we expect this trend to continue.



**Table of Contents**

Risks inherent in international revenue include the impact of longer payment cycles, greater difficulty in accounts receivable collection, unexpected changes in regulatory requirements, seasonality due to the slowdown in European business activity during the third quarter, tariffs and other trade barriers, currency fluctuations, product localization and difficulties staffing and managing foreign operations. These factors may have a material adverse effect on our future international revenue.

The following table sets forth, for the periods indicated, each major category of our product revenue as a percent of product revenue.

	Three Months Ended March 31,		Percentage of Product Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Term subscription licenses	\$ 17,530	\$ 42,160	21%	33%
Perpetual licenses	39,510	62,464	47	49
Hardware	25,229	17,480	30	14
Retail and other	1,462	5,202	2	4
<b>Total product revenue</b>	<b>\$ 83,731</b>	<b>\$ 127,306</b>	<b>100%</b>	<b>100%</b>

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. The \$43.6 million, or 34%, decrease in product revenue from 2003 to 2004 is due to (i) the introduction of our perpetual plus licensing arrangements in North America, which has now been implemented worldwide, resulting in reduced product revenues and increased services and support revenue and (ii) our continued shift in focus from retail boxed products to our on-line subscription model for consumers and small and medium sized businesses. Our hardware revenue increased \$7.7 million from 2003 to 2004, primarily as the result of sales of our IntruShield product. We purchased IntruVert in the second quarter of 2003. Retail and other revenue decreased due to an increase in retailers converted to the consignment model as well as additional return reserves recorded for the retail channel.

Our customers license our software on a perpetual or term subscription basis depending on their preference. We are continuing to see perpetual licenses become a larger percentage of product revenue as we have implemented our perpetual plus licensing model worldwide. We expect the remaining mix of product revenue to remain relatively consistent as a percentage of revenue.

The following table sets forth, for the periods indicated, each major category of our services and support as a percent of services and support revenue.

	Three Months Ended March 31,		Percentage of Services and Support Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Support and maintenance	\$ 103,015	\$ 68,422	76%	74%
Consulting	3,984	7,117	3	8
Training	1,882	2,069	1	2
On-line subscriptions	26,466	14,400	20	16
<b>Total services and support revenue</b>	<b>\$ 135,347</b>	<b>\$ 92,008</b>	<b>100%</b>	<b>100%</b>

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Services and support revenues include revenues from software support and maintenance contracts, consulting, training and on-line subscription arrangements. The \$43.3 million, or 47%, increase in service and support revenue is due to (i) a \$34.6 million increase in support and maintenance due to our perpetual plus licensing model and (ii) a \$12.1 million increase in our on-line subscription (McAfee consumer on-line and McAfee ASaP) arrangements offset by a \$3.3 million combined decrease in consulting and training revenues. The increase in our on-line subscription arrangements is due to an increase in our customer base to

**Table of Contents**

approximately 4.6 million subscribers at March 31, 2004 from 2.1 million subscribers at March 31, 2003, as well as an increase in our McAfee ASaP on-line service for small-to-medium sized businesses. The increase in customers was due to our continued OEM relationships with Dell, AOL and others, as well as an outbreak of computer viruses in the second half of 2003 through the first quarter of 2004. The decrease in our consulting and training revenues of \$3.3 million was due to reducing consulting and training budgets when reducing overall IT costs and projects.

Our future profitability and rate of growth, if any, will be directly affected by increased price competition and the size of our revenue base. Our growth rate and net revenue depend significantly on renewals of existing orders as well as our ability to respond successfully to the pace of technological change and expand our customer base. If our renewal rate or our pace of new customer acquisition slows, our net revenues and operating results would be adversely affected.

**Cost of Net Revenue; Gross Margin.**

	Three Months Ended March 31,		Percentage of Cost of Net Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Cost of net revenue:				
Product	\$ 22,952	\$ 18,690	62%	56%
Services and support	10,847	13,230	29	39
Amortization of purchased technology	3,393	1,741	9	5
Total cost of net revenue	\$ 37,192	\$ 33,661	100%	100%
Gross margin	\$ 181,886	\$ 185,653		
Gross margin percentage	83%	85%		

Our total cost of net revenue increased \$3.5 million, or 10% due primarily to increased hardware sales of IntruShield during the three months ended March 31, 2004 (none in the first quarter of 2003), and an increase in revenue-sharing costs related to our McAfee consumer on-line subscription model due to higher subscriptions originated through strategic partners.

*Cost of Product Revenue.* Our cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels; royalties; and, with respect to hardware-based anti-virus products and network fault and performance products, computer platforms and other hardware components. The increase from 56% to 62% in the cost of product revenue as a percentage of total cost of net revenue from the three months ended March 31, 2003 to the three months ended March 31, 2004 is due to the sales of IntruShield hardware in the first quarter of 2004, and an increase in costs related to revenue-sharing arrangements with our McAfee consumer on-line strategic partners. We anticipate that cost of product revenue will continue to fluctuate as a percent of cost of net revenue.

*Cost of Services and Support.* Cost of services and support revenue consists principally of salaries and benefits related to employees providing customer support and consulting services. Services and support as a percentage of cost of net revenue decreased from 39% to 29% from the three months ended March 31, 2003 to the three months ended March 31, 2004 due primarily to our sale of Magic in January 2004. We anticipate that cost of service revenue will continue to fluctuate as a percent of cost of net revenue.

*Amortization of Purchased Technology.* Amortization of purchased technology increased, \$1.7 million or 95%, from the three months ended March 31, 2003 to the three months ended March 31, 2004. The increase is due to our acquisitions of Entercept and IntruVert, in which we recorded purchased technology of \$21.7 million and \$18.2 million, respectively. The purchased technology is being amortized over its estimated useful life of seven years. Amortization of purchased technology is expected to be \$12.4 million in 2004.



**Table of Contents**

*Gross Margins.* Our gross margins decreased from 85% to 83% from the three months ended March 31, 2003 to the three months ended March 31, 2004. The decrease was due to the factors noted above, primarily, higher hardware sales which carry higher cost of sales amounts.

**Operating Costs Three Months Ended March 31, 2004 and 2003**

Set forth below for the indicated periods are our operating costs, including and excluding stock-based compensation. Our management believes that a presentation of operating costs excluding stock-based compensation provides investors a meaningful basis of evaluating our underlying cost and expense levels. The size and amount of our stock based compensation charges has varied, and in the future will vary, from period to period based on movements in our stock price, making period to period comparisons difficult and, in some cases, not meaningful. See Stock-Based Compensation below.

The following sets forth for the periods indicated, our operating expenses, including the effects of stock-based compensation:

	Three Months Ended March 31,		Percentage of Net Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Research and development	\$ 45,379	\$ 46,430	21%	21%
Marketing and sales	92,958	88,941	43	41
General and administrative	27,541	28,208	13	13
Gain on sale of assets and technology	(46,505)	(37)	(21)	
Provision for (recovery from) doubtful accounts, net	525	(323)		
Litigation settlement	(19,101)		(9)	
Amortization of intangibles	3,573	5,011	1	2
Restructuring charge	2,190	15,781	1	7
<b>Total operating costs, including the effects of stock-based compensation</b>	<b>\$ 106,560</b>	<b>\$ 184,011</b>	<b>49%</b>	<b>84%</b>

The following sets forth for the periods indicated, our operating expenses, excluding the effects of stock-based compensation:

	Three Months Ended March 31,		Percentage of Net Revenue	
	2004	2003	2004	2003
(In thousands, except percentages)				
Research and development(1)	\$ 44,065	\$ 45,688	20%	21%
Marketing and sales(2)	92,322	88,685	43	41
General and administrative(3)	27,265	27,239	13	12
Gain on sale of assets and technology	(46,505)	(37)	(21)	
Provision for (recovery from) doubtful accounts, net	525	(323)		
Litigation settlement	(19,101)		(9)	
Amortization of intangibles	3,573	5,011	1	2
Restructuring charge	2,190	15,781	1	7
<b>Total operating costs, excluding the effects of stock-based compensation</b>	<b>104,334</b>	<b>182,044</b>	<b>48</b>	<b>83</b>
Stock based compensation	2,226	1,967	1	1
	<b>\$ 106,560</b>	<b>\$ 184,011</b>	<b>49%</b>	<b>84%</b>

Total operating costs, including the effects of stock  
based-compensation

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**Table of Contents**

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- (1) Excludes stock-based compensation charges of \$1,314 and \$742 for the three months ended March 31, 2004 and 2003, respectively.
- (2) Excludes stock-based compensation charges of \$636 and \$256 for the three months ended March 31, 2004 and 2003, respectively.
- (3) Excludes stock-based compensation charges of \$276 and \$969 for the three months ended March 31, 2004 and 2003, respectively.

*Research and Development.* Research and development expenses consist primarily of salary, benefits, and contractors fees for our development and technical support staff, and other costs associated with the enhancements of existing products and services and development of new products and services. Excluding the effects of stock-based compensation of \$1.3 million and \$0.7 million in the three months ended March 31, 2004 and 2003, respectively, research and development expenses decreased \$1.6 million to \$44.1 million. The decrease is due to our cost savings measures and increased headcount at our Bangalore facility, whose employees carry lower salaries. We plan to increase our research and development expenditures in Bangalore, India.

We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to increase in future periods. We anticipate that research and development expenses will continue to increase in absolute dollars, but will continue to fluctuate as a percent of net revenue.

*Marketing and Sales.* Marketing and sales expenses consist primarily of salary, commissions and benefits for marketing and sales personnel and costs associated with advertising and promotions. Excluding the effects of stock-based compensation of \$0.6 million and \$0.3 million in the three months ended March 31, 2004 and 2003, respectively, marketing and sales expenses increased \$3.6 million, or 4% from 2003 to 2004. The increase can be attributed to higher sales commissions in the first quarter of 2004 due to higher bookings.

We anticipate that marketing and sales expenses will increase in absolute dollars, but will continue to fluctuate as a percentage of net revenue.

*General and Administrative.* General and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. Excluding the effects of stock-based compensation of \$0.3 million and \$1.0 million for the three months ended March 31, 2004 and 2003, respectively, general and administrative expenses have remained relatively flat due to cost savings measures.

In the near-term, we continue to expect our general and administrative expenses to remain generally flat as we maintain cost control measures, but increase as a percentage of net revenue. We expect this increase as a percentage of net revenue as we will not be able to reduce expenses as quickly as revenue will be reduced following the Sniffer sale. As a result, we are currently engaged in a comprehensive cost reduction and productivity plan to significantly enhance our operating margins by mid-2005.

*Gain on Sale of Assets and Technology.* In December 2003, we announced the sale of our Magic assets to BMC Software. We completed the transaction in January 2004, and as a result, recognized a gain of approximately \$46.5 million. We received net cash proceeds of approximately \$47.6 million related to the sale. The assets and liabilities of Magic were located primarily in our North American and EMEA reporting units. This gain was offset by a write off of equipment of approximately \$0.7 million.

*Provision for (Recovery from) Doubtful Accounts, Net.* Provision for doubtful accounts consists of our estimates for the uncollectibility of receivables, net of recoveries of amounts previously written off. The provision for doubtful accounts was a net charge of approximately \$0.5 million for the three months ended March 31, 2004 from a net recovery of \$0.3 million for the three months ended March 31, 2003.

*Litigation Settlement.* During the first quarter of 2004, we received insurance reimbursements of approximately \$19.1 million from our insurance carriers. The reimbursements were a result of our insurance

**Table of Contents**

coverage related to the class action lawsuit we settled in October 2003 for \$70.0 million. The \$70.0 million was expensed in 2002.

*Amortization of Intangibles.* We recorded \$3.6 million and \$5.0 million of amortization related to intangibles for the three months ending March 31, 2004 and 2003, respectively. The decrease in amortization of intangibles is as a result of several intangibles becoming fully amortized at the end of 2003.

**Restructuring Charge.***2004 Restructuring*

In the first quarter of 2004, we recorded a restructuring charge of approximately \$2.2 million related to the severance of approximately 160 employees, of which \$0.7 million and \$1.5 million was related to our North American and EMEA operating segments, respectively. The workforce size was reduced primarily due to our sale of Magic. Substantially all employees under this severance arrangement have been terminated as of March 31, 2004.

The following table summarizes our restructuring accrual established through March 31, 2004 (in thousands):

	<b>Severance and Other Benefits</b>
Balance, January 1, 2004	\$
Restructuring accrual	2,217
Cash payments	(1,548)
Balance, March 31, 2004	\$ 669

*2003 Restructuring*

In January 2003, as part of a restructuring effort to gain operational efficiencies, we consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into our newly constructed regional headquarters facility in Plano, Texas. The facility houses employees working in finance, legal, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses.

As part of the consolidation of activities into the Plano facility, we relocated employees from our Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, we recorded a restructuring charge of \$15.8 million which consisted of a non-cash charge of \$2.1 million related to asset disposals and discontinued use of certain leasehold improvements, furniture and equipment; non-cash write off of \$1.9 million deferred rent liability; and a \$15.6 million accrual for estimated lease related costs associated with the permanently vacated facilities in Santa Clara, California. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The total restructuring charge and related cash outlay are based on our management's current estimates. As of March 31, 2004, \$1.7 million of the accrued lease termination costs have been classified as current accrued liabilities, while the remaining balance of \$12.1 million has been classified as other long term liabilities.

During the second and third quarter of 2003, we recorded restructuring charges of \$6.8 million and \$0.6 million, respectively, which consisted of \$6.7 million related to a headcount reduction of 210 employees and \$0.7 million related to other expenses such as legal expenses incurred in international locations in conjunction with the headcount reduction. The employees were located in our domestic and international locations and were primarily in the sales, product development and customer support areas. In the third and



**Table of Contents**

fourth quarters of 2003, we reversed a total of \$1.0 million of restructuring accrual in Europe that was no longer necessary after paying out substantially all accrued amounts to the former employees.

The following table summarizes our restructuring accrual established in 2003 and activity through March 31, 2004 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2003	\$	\$	\$	\$
Restructuring accrual	15,734	6,692	739	23,165
Cash payments	(1,707)	(6,259)	(167)	(8,133)
Adjustment to liability	(273)	(116)	(572)	(961)
Accretion	463			463
	<hr/>	<hr/>	<hr/>	<hr/>
Balance, December 31, 2003	14,217	317		14,534
Restructuring accrual				
Cash payments	(545)	(194)		(739)
Adjustment to liability	(33)	6		(27)
Accretion	146			146
	<hr/>	<hr/>	<hr/>	<hr/>
Balance, March 31, 2004	\$ 13,785	\$ 129	\$	\$ 13,914
	<hr/>	<hr/>	<hr/>	<hr/>

Our estimates of the excess facilities charge may vary significantly depending, in part, on factors which may be beyond our control, such as our success in negotiating with our lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if further consolidations are required or if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charge was not allocated to reporting segments. The restructuring charge related to headcount reductions was \$0.9 million and \$5.8 million in our North American and EMEA operating segments, respectively.

*Interest and Other Income.* Interest and other income decreased \$0.1 million to \$4.4 million from \$4.5 million for the three months ended March 31, 2004 and 2003, respectively. The decrease is due higher average cash and investment balances in the first quarter of 2003 as compared to the first quarter of 2004. In the first quarter of 2003, the payments we made to redeem zero coupon convertible debentures were made late in the quarter, therefore, increasing the average cash and investment balances over the entire quarter.

*Interest Expense.* Interest expense decreased \$2.5 million to \$0.7 million from \$3.2 million for the three months ended March 31, 2004 and 2003, respectively. The decrease in interest expense of approximately \$1.0 million was primarily due to the redemption of zero coupon convertible debentures in the first and second quarters of 2003, and an increase in the fair market value of the interest-rate swap of approximately \$1.0 million. All zero coupon convertible debentures were fully redeemed in June 2003.

*Loss on Redemption of Zero Coupon Convertible Debentures.* In the three months ended March 31, 2003, we recognized a \$2.6 million loss on the redemption of substantially all of the remaining zero coupon convertible subordinated debentures. We redeemed debentures which had an aggregate face amount at maturity of \$358.0 million for approximately \$177.1 million. The aggregate accreted value of the debentures on the date of redemption was \$174.5 million.

*Provision for Income Taxes.* Our consolidated provision for income taxes for the three months ended March 31, 2004 and 2003 was \$21.5 million and \$2.9 million (including the tax effect on the cumulative effect of change in accounting principle), respectively, reflecting an effective tax rate of 27% and 19%, respectively. The effective tax rate differs from the statutory rate primarily due to the impact of research and development tax credits, utilization of foreign tax credits, and lower effective rates in some overseas jurisdictions. Our future effective tax rates could be adversely affected if earnings are lower than anticipated in countries where we have lower statutory rates or by unfavorable changes in tax laws and regulations.

**Table of Contents**

*Cumulative Effect of Change in Accounting Principle.* In the three months ended March 31, 2003, we had a one-time credit of \$11.1 million, net of income taxes, in connection with a change in the way we account for sales commission to sales personnel. Prior to January 1, 2003, we expensed sales commissions as incurred. Commission expense now directly related to sales transactions and is deferred and recognized ratably over the same period as the related revenue is recognized and recorded.

**Stock-Based Compensation**

We recorded stock-based compensation charges of \$2.2 million and \$2.0 million in the three months ended March 31, 2004 and 2003, respectively. These charges are comprised of the following (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Exchange of McAfee.com options	\$ 1,833	\$ 741
Existing executive	106	106
Former employees	146	1,120
Extended life of vested options held by terminated employees	141	
	<hr/>	<hr/>
Total stock-based compensation	\$ 2,226	\$ 1,967
	<hr/>	<hr/>

*Exchange of McAfee.com options.* For the three months ended March 31, 2004 and 2003, we recorded a charge of approximately \$1.8 million and \$0.7 million, respectively, related to exchanged options subject to variable accounting. Our stock-based compensation charge related to exchanged options subject to variable accounting was based on our closing share price of \$18.00 and \$13.81 on March 31, 2004 and 2003, respectively. As of March 31, 2004, we had outstanding exchanged options to acquire approximately 0.7 million shares subject to this variable accounting.

*Existing executive.* On January 15, 2002, our board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is \$0.01 per share. During the three months ended March 31, 2004 and 2003, we recorded in both periods approximately \$0.1 million related to stock-based compensation associated with Mr. Samenuk's 2002 restricted stock grant.

*Former employees.* In November and December 2003, we extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. As these employees options continued to vest after termination and their exercise period was extended an additional 90 days, the Company recorded a one time stock-based compensation charge of approximately \$0.1 million.

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire the Company's common stock. These options are subject to variable accounting as discussed above. Upon the executives' termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former McAfee.com executives were exercised during the quarter ended March 31, 2003. As a result, the Company recorded a final stock-based compensation charge of \$1.1 million during the three months ended March 31, 2003.

*Repriced Options.* During the three months ended March 31, 2004 and 2003, we did not incur a charge related to these repriced options subject to variable plan accounting. For the three months ended March 31, 2004, our stock-based compensation charges related to options subject to variable plan accounting were based on quarter-end per share price of our stock of \$18.00. For the three months ended March 31, 2003, stock-based compensation charges related to options subject to variable plan accounting were based on quarter end per share price of our stock of \$13.81. As of March 31, 2004, we had options to purchase approximately 0.5 million shares, which were outstanding and subject to variable plan accounting.

*Extended life of vested options held by terminated employees.* During a significant portion of 2003, the Company suspended exercises of stock options until its required public company reports were filed with the



**Table of Contents**

SEC. The period during which stock options were suspended is known as the blackout period. Due to the blackout period, the Company extended the exercisability of any options that would otherwise terminate during the blackout period for a period of time equal to a specified period after termination of the blackout period. Accordingly, the Company recorded a stock-based compensation charge on the date the options should have terminated based on the intrinsic value of the option on the modification date and the option price. In the first quarter of 2004, the Company recorded a stock-based compensation charge of approximately \$0.1 million. No charge was recorded in the first quarter of 2003, however approximately \$3.7 million was recorded in the remainder of 2003.

**Recent Accounting Pronouncements**

See Note 2 to the condensed consolidated financial statements.

**Liquidity and Capital Resources**

	Three Months Ended March 31,	
	2004	2003
Net cash provided by operating activities	\$ 118,997	\$ 56,220
Net cash used in investing activities	\$ (40,289)	\$ (145,742)
Net cash provided by (used in) financing activities	\$ 22,408	\$ (157,225)

**Overview**

At March 31, 2004, we had cash, cash equivalents and marketable securities totaling \$941.2 million, as compared to \$895.0 million at March 31, 2003. In the three months ended March 31, 2004, we received cash proceeds of approximately \$19.1 million of insurance reimbursements from our insurance carriers related to the settling of our class action lawsuit. We also received approximately \$47.6 million from the sale of Magic, as well as the receipt of approximately \$22.4 million related to our employee stock purchase plan and stock option exercises. Uses of cash during the quarter included the purchase of approximately \$8.7 million of property and equipment, and net purchase of marketable securities of approximately \$79.1 million, as well as the payment of our routine operating expenses. A more detailed discussion of changes in our liquidity follows.

**Operating Activities**

Net cash provided by operating activities for the three months ended March 31, 2004 and 2003 was the result of our net income of \$58.0 million and \$12.5 million, respectively, which is adjusted for non-cash items such as depreciation and amortization, non-cash restructuring charges, non-cash interest, non-cash loss on repurchase of convertible debentures, stock-based compensation and changes in various assets and liabilities such as accounts payable, accounts receivable and other current assets.

Our historical and primary source of operating cash flow is the collection of accounts receivable from our customers and the timing of payments to our vendors and service providers. One measure of the effectiveness of our collection efforts is average accounts receivable days sales outstanding ( DSO ). DSOs were 46 days and 45 days at March 31, 2004 and 2003, respectively. We calculate accounts receivable DSO on a net basis by dividing the accounts receivable balance at the end of the quarter by the amount of revenue recognized for the quarter multiplied by 90 days. We expect DSO s to vary from period to period because of changes in quarterly revenue and the effectiveness of our collection efforts. In 2004 and 2003, we have not made any significant changes to our payment terms for our customers, which are generally net 30.

Our balances in accounts payable and accrued liabilities decreased \$30.0 million. Our operating cash flows, including changes in accounts payable and accrued liabilities, is impacted by the timing of payments to our vendors for accounts payable. We typically pay our vendors and service providers in accordance with invoice terms and conditions, and take advantage of invoice discounts when available. The timing of future cash payments in future periods will be impacted by the nature of accounts payable arrangements. In the three

**Table of Contents**

months ended March 31, 2004 and 2003, we did not make any significant changes to our payment timing to our vendors.

Our cash balances are held in numerous locations throughout the world, including substantial amounts held outside the United States. As of March 31, 2004 and 2003, approximately \$326.1 million and \$231.4 million, respectively, were held outside the United States. Most amounts held outside the United States could be repatriated to the United States, but, under current law, would be subject to United States federal income taxes, less applicable foreign tax credits. Repatriation of some foreign balances is restricted by local laws. We have provided for United States federal tax liability on these amounts for consolidated financial statement purposes except for foreign earnings that are considered indefinitely reinvested outside the United States. Repatriation could result in additional United States federal income tax payments in future years. Where local restrictions prevent an efficient intercompany transfer of funds, our intent is that cash balances would remain in the foreign country and United States liquidity needs would be met through ongoing cash flows. We utilize a variety of tax planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed.

Our working capital, defined as current assets minus current liabilities, was \$164.0 million and \$415.8 million at March 31, 2004 and December 31, 2003, respectively. The decrease in working capital of approximately \$251.8 million from December 31, 2003 to March 31, 2004 is due to an increase of cash and short-term marketable securities balances, offset by lower accounts receivable due to customer payments, offset by final sale of Magic assets and liabilities held for sale of \$24.7 million and \$23.3 million, respectively and the classification of our convertible debt of \$345.3 million and related assets of \$15.2 million as current at March 31, 2004 due to our intent to redeem the convertible debt earlier than its maturity. Current liabilities increased \$332.4 million due to a \$40.4 million increase in current deferred revenue and reclassification of our convertible debt to current liabilities offset by lower accrued liabilities and accounts payable of \$30.0 million. Our perpetual plus licensing model, now introduced worldwide, results in less revenue recognition up-front, therefore causing increases in our deferred revenue.

We are currently under Securities and Exchange Commission ( SEC ) and Department of Justice investigations. As a result of these investigations, we may be exposed to penalties that may be material to our consolidated financial statements.

We expect to meet our obligations as they become due through available cash and internally generated funds. We expect to continue generating positive working capital through our operations. However, we cannot predict whether current trends and conditions will continue or what the effect on our business might be from the competitive environment in which we operate. We believe the working capital available to us will be sufficient to meet our cash requirements for at least the next 12 months.

**Investing Activities**

A summary of our investing activities at March 31, 2004 and 2003 is as follows (in thousands). The detail of these line items can be seen in our condensed consolidated statement of cash flows.

	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
Net purchases of marketable securities	\$(79,073)	\$(122,278)
Cash payments for property and equipment	(8,653)	(23,100)
Proceeds from sale of assets and technology, net	47,565	
Cash payments for restricted cash	(100)	(199)
Other	(28)	(165)
	<hr/>	<hr/>
Net cash used in investing activities	\$(40,289)	\$(145,742)
	<hr/>	<hr/>



**Table of Contents**

*Investments*

We made net purchases of our marketable securities of \$79.1 million and \$122.3 million for the three months ended March 31, 2004 and 2003, respectively. We have classified our investment portfolio as available for sale, and our investments are made with a policy of capital preservation and liquidity as the primary objectives. We generally hold investments in money market, fixed income and U.S. government agency securities. We may sell an investment at any time if the quality rating of the investment declines, the yield on the investment is no longer attractive or we are in need of cash. Because we invest only in investment securities that are highly liquid with a ready market, we believe that the purchase, maturity and sale of our investments has no material impact on our overall liquidity.

*Property and Equipment*

We purchased \$8.7 million of equipment during the first quarter of 2004 to update hardware for our employees and enhance various back office systems, including the finalization of our new customer relationship management system which we are deploying in early 2004. In the first quarter of 2003, we added \$23.1 million of property and equipment, related to new computer equipment for employees moving from California to Texas, and continued investments in updating hardware and enhancing various back office systems. Our property and equipment additions have historically been funded from operations.

The decrease in purchases of property and equipment from 2003 to 2004 can be attributed to our cost saving measures that have been implemented. We anticipate that we will continue to purchase property and equipment necessary in the normal course of our business. The amount and timing of these purchases and the related cash outflows in future periods is difficult to predict and is dependent on a number of factors including our hiring of employees, the rate of change in computer hardware/ software used in our business and our business outlook.

*Proceeds from Sale of Assets and Technology*

We completed the sale of Magic to BMC Software in January 2004, and as a result, recognized a gain of approximately \$46.5 million. We received net cash proceeds of approximately \$47.6 million related to the sale. We were expecting an additional \$0.9 million final purchase price payment related to the sale of Magic, which was accrued as a receivable in our March 31, 2004 condensed consolidated balance sheet, and subsequently received in April 2004.

*Restricted Cash*

At March 31, 2004 and 2003, we had on deposit approximately \$20.1 million and \$20.9 million, respectively, as collateral for our interest rate swap arrangements we entered into related to our \$345.0 million of 5.25% subordinated convertible debt. The arrangements require we keep a minimum amount of \$20.0 million on deposit with the swap counterparties, subject to increase based on the fair value of the swap.

*Financing Activities*

Cash flows from financing activities in the three months ended March 31, 2004 was the receipt of \$22.4 million of cash related to exercises of stock options and stock purchases from the employee stock purchase plan. Net cash used in the three months ended March 31, 2003 amounted to \$157.2 million, consisting of the redemption of zero coupon convertible debentures for \$177.1 million offset, in part, by proceeds received of \$19.8 million for the issuance of common stock under our stock option and employee stock purchase plans.

Historically, our recurring cash flows provided by financing activities have been from the receipt of cash from the issuance of common stock under stock option and employee stock purchase plans. For example, we received cash proceeds from these plans in the amount of \$35.4 million and \$109.9 million in 2003 and 2002, respectively. While we expect to continue to receive these proceeds in future periods, the timing and amount

## **Table of Contents**

of such proceeds are difficult to predict and is contingent on a number of factors including the price of our common stock, the number of employees participating in the plans and general market conditions.

As our stock price rises, more participants are in the money in their options, and thus, more likely to exercise their options, which results in cash to us. As our stock price decreases, more of our employees are out of the money or under water in regards to their options, and therefore, are not able to exercise options and results in no cash received by us. From March 2003 through November 2003, all purchases under our stock option plans and employee stock purchase plan were suspended pending the filing with the SEC of our public company reports, including our restated financial results. Following the October 31, 2003 filing of these reports, activity under our plans was resumed.

In November 2003, our board of directors authorized the repurchase of up to \$150.0 million of our common stock in the open market from time to time over the next two years, depending upon market conditions, share price and other factors. We purchased 350,000 shares for a total of \$4.7 million in the fourth quarter of 2003 and none for the quarter ended March 31, 2004. Due to the pending divestiture of Sniffer, we were restricted from repurchasing shares of stock on the open market. We intend to buy back shares opportunistically in subsequent quarters.

## **Convertible Debt and Line of Credit**

In August 2001, we issued 5.25% convertible subordinated notes due 2006 with an aggregate principal amount of \$345.0 million. The issuance generated net proceeds to us of approximately \$335.1 million (after deducting fees and expenses). The notes mature on August 15, 2006, unless earlier redeemed by us at our option or converted at the holder's option. Interest is payable semi-annually in cash in arrears on February 15 and August 15 of each year, commencing February 15, 2002. At the option of the holder, the notes may be converted into our common stock at any time, unless previously redeemed, at a conversion price of \$18.07 per share. At any time between August 20, 2004 and August 14, 2005, we may redeem all or a portion of the notes for cash at a repurchase price of 101.3125% of the principal amount. After August 14, 2005, the repurchase price is 100.0% of the principal amount. The notes are unsecured and are subordinated to all of our existing and future Senior Indebtedness (as defined in the related Indenture). We have no financial covenants related to these convertible subordinated notes. We intend to redeem the Notes in accordance with the Indenture, on or after its call date of August 20, 2004, and accordingly, such notes have been classified as current liabilities in our condensed consolidated balance sheet at March 31, 2004.

In February 1998, we issued zero coupon convertible subordinated debentures due 2018 with an aggregate face amount at maturity of \$885.5 million and generating net proceeds to us of approximately \$337.6 million. Prior to December 31, 2002, we repurchased zero coupon debentures with an aggregate face amount of approximately \$527.0 million, at a total price of \$239.9 million. On February 13, 2003, we paid approximately \$177.1 million in cash to repurchase approximately \$358.0 million in face amount of the zero coupon debentures. On June 9, 2003, we redeemed the remaining zero coupon debentures with an aggregate face amount at maturity of \$0.5 million for a net price of \$0.2 million.

In April 2004, we renewed and expanded our \$16.5 million credit facility with a bank. The credit facility was increased \$2.0 million and is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between us and bank at the time of each specific transaction. The credit facility is intended to be used for short term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time.

## **Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. All of our subsidiaries are 100% owned by us and are fully consolidated into our condensed consolidated financial statements.

**Table of Contents**

**Item 4. Controls and Procedures**

*Information pertaining to controls and procedures has been updated for events and developments occurring subsequent to the filing of the original Form 10-Q with respect to the quarter ended March 31, 2004.*

Our management evaluated, with the participation of our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2004. Based on this evaluation, our CEO and CFO have concluded that, as of March 31, 2004, in light of the restatement of our financial results for the quarter ended March 31, 2004 and the related determination by our current auditors that the underlying issues giving rise to the restatement should be considered a material weakness (as described below), our disclosure controls and procedures were not effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. However, based on a subsequent evaluation performed in conjunction with our filing of our Report on Form 10-Q for the quarter ended June 30, 2004, our CEO and CFO have concluded that, as of June 30, 2004, our disclosure controls and procedures were effective for such purposes. Except as described below, there has been no change in our internal control over financial reporting during the quarter ended March 31, 2004 or June 30, 2004 or since the evaluation date, which materially affected, or is reasonably likely to affect, our internal control over financial reporting.

As more fully described in (i) our 2003 Annual Report on Form 10-K, we were required to restate our quarterly operating results for certain quarters in 2003, and (ii) this Form 10-Q/ A, we determined in July 2004, we were required to restate our financial results for the quarter ended March 31, 2004. The circumstances giving rise to these restatements were identified by McAfee and reported to our auditors.

Our former auditors, PricewaterhouseCoopers LLP, reported that the underlying control issues giving rise to the restatement of the 2003 quarterly operating results should be considered a material weakness under standards established by the Public Company Accounting Oversight Board. In conjunction with making the required corrections to address matters arising out of the restatement of our 2003 operating results, during the quarter ended March 31, 2004, we bolstered internal controls around the recognition of international revenues as part of our quarterly financial closing process and the manual journal entry process. At the end of the quarter ended March 31, 2004 we also instituted additional review procedures to verify that the internal controls were effective. We have also hired additional personnel, and are continuing to determine how to automate revenue recognition calculations so as to limit the number of manual adjustments, and engaging in additional testing of our control processes and procedures. Furthermore, we have implemented a software patch related to our international deferred revenue and are in the process of testing this patch and reviewing results.

In conjunction with the restatement of our operating results for the quarter ended March 31, 2004, our current auditors, Deloitte & Touche LLP, reported that the underlying issues giving rise to the restatement of our operating results for the quarter ended March 31, 2004 is a material weakness under standards established by the Public Company Accounting Oversight Board. In connection with the restatement of our operating results for the quarter ended March 31, 2004, we reviewed the circumstances giving rise to the restatement, and determined that the actions we have implemented or are in the process of implementing as part of our internal controls assessment for the internal controls reporting required under Sarbanes-Oxley Act of 2002, will correct the underlying circumstances giving rise to the restatement. The current actions management has or is implementing include the hiring of additional personnel in revenue accounting, establishing additional controls including increased review procedures, increased testing of internal controls to ensure internal controls are operating as designed, modifying our revenue accounting software and performing review and corrections of system data affecting our revenue accounting.

**Table of Contents**

**McAFEE, INC.**

**FORM 10-Q/ A,**

**March 31, 2004**

**SIGNATURES**

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

MCAFEE, INC.

By: */s/* STEPHEN C. RICHARDS

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Stephen C. Richards  
*Chief Operating Officer and  
Chief Financial Officer*

Date: August 6, 2004

**Table of Contents**

**INDEX TO EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002