

McAfee, Inc.  
Form 10-K/A  
May 24, 2005

**Table of Contents**

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

---

**Form 10-K/A  
(Amendment #1)**

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

**For the Fiscal Year Ended December 31, 2004**

**or**

**o 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: 001-31216**

**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**

**Securities registered pursuant to Section 12(b) of the Act:**

**None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, \$0.01 Par Value,  
together with associated Rights**

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A or any amendment to this Form 10-K/A.

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

The aggregate market value of the voting stock held by non-affiliates of the issuer as of the last business day of the Registrant's most recently completed second fiscal quarter (June 30, 2004) was approximately \$2.8 billion. The number of shares outstanding of the issuer's common stock as of February 28, 2005 was 163,500,000.

### EXPLANATORY NOTE

This Amendment to Form 10-K is being filed for the purpose of amending and restating contractual and lease obligation disclosures within Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, and Item 15, Exhibits and Financial Statement Schedules, of our Annual Report on Form 10-K filed on March 31, 2005. Specifically, the obligation disclosures within (1) the Contractual Obligations portion of the Liquidity and Capital Resources section of Management's Discussion and Analysis of Financial Condition and Results of Operations under Item 7, and (2) Note 11 to the Consolidated Financial Statements under Item 15 of our Annual Report on Form 10-K filed on March 31, 2005, have been amended to reflect a restatement of both our contractual obligation disclosure and our future minimum lease obligation disclosure, and we have provided enhanced disclosures related to leases in Note 11. These obligation disclosures in the Form 10-K as originally filed included both overstatements and understatements for individual obligations, which resulted in the aggregate obligation disclosures for the years 2005 through 2009 and thereafter being overstated by approximately \$50.0 million in Item 7 and \$52.9 million in Item 15. Other than as described above, no other changes or amendments have been made to Item 7 or Item 15. This Amendment to Form 10-K does not otherwise change or update the disclosures set forth in the Form 10-K as originally filed and does not otherwise reflect events occurring after the filing of the Form 10-K. For a description of our business and the risks related to our business, see our Annual Report on Form 10-K for the year ended December 31, 2004.

---

**MCAFEE INC.**  
**FORM 10-K/A**  
**For the fiscal year ended December 31, 2004**

### TABLE OF CONTENTS

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART II</u></b>   |             |
| <u>Item 7.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 3           |
| <u>Item 9a.</u> <u>Controls and Procedures</u>  | 27          |
| <b><u>PART IV</u></b>   |             |
| <u>Item 15.</u> <u>Exhibits and Financial Statement Schedules</u>   | 31          |
| <u>Signatures</u>   | 75          |
| <u>2005 Independent Director Cash Compensation Plan</u>   |             |
| <u>Subsidiaries</u>   |             |

Consent of Deloitte & Touche LLP

Consent of PricewaterhouseCoopers LLP

Certification of CEO and CFO Pursuant to Section 302

Certification of CEO and CFO Pursuant to Section 906

**Table of Contents****PART II****Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations****Forward-Looking Statements and Factors That May Affect Future Results**

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others things, those risk factors set forth in this section and elsewhere in this report. We identify forward-looking statements by words such as may, will, should, could, expects, plans, anticipates, believe, predicts, potential or continue or similar terms that refer to the future. 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. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

**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 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 2004 and 2003, our net revenue was \$910.5 million and \$936.3 million, and our net income was \$225.1 million and \$70.2 million, respectively. Our net revenue was impacted by a gradual recovery in the global economy which resulted in increased corporate IT spending in 2004. Additionally, the sales of our Sniffer and Magic businesses in 2004 resulted in a \$179.6 million reduction in revenues from 2003 to 2004. 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 (excluding Japan) and Latin America. In 2004, 39% of our net revenue was generated outside of North America, with North America and EMEA collectively accounting for 87% of our total net revenue. North America and EMEA have benefited from increased corporate IT spending. Our 2004 sales in EMEA totaling \$241.7 million were favorably impacted by the strengthening of the Euro during the year.

The following table illustrates the strengthening of foreign currencies in geographic regions outside of North America from which we derive a significant portion of our revenues:

|                                      | <b>Euro</b> | <b>Japanese Yen</b> |
|--------------------------------------|-------------|---------------------|
| 2003 Average Exchange Rate to \$1 US | .8854       | 115.98              |
| 2004 Average Exchange Rate to \$1 US | .8051       | 108.17              |
| <br>                                 |             |                     |
| % Change                             | 9%          | 7%                  |

*McAfee.* Our McAfee products include enterprise, small and medium sized businesses ( SMB ) and consumer products, with enterprise including our Enterecept host-based intrusion protection products which were acquired in connection with the Enterecept acquisition in April 2003. SMB sales remained relatively consistent from \$232.6 million for 2003 to \$228.9 million for 2004. Enterprise sales, excluding IntruShield, for 2004 were \$238.9 million, a \$13.0 million, or 6%, increase from \$225.9 million for 2003. The year over year increase reflects an increase in corporate IT spending in 2004, partially offset by the impact of our perpetual plus license model, which recognizes less revenue upfront and defers more revenue to future periods.

We continue to experience 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 2004, we added 4.7 million net new subscribers.

Revenue from our consumer security market increased \$122.6 million, or 70% from \$176.3 million in 2003 to \$298.9 million in 2004. At December 31, 2004, we had a total subscriber base of approximately 8.5 million consumer customers, compared to 3.7 million at December 31, 2003. Drivers of this subscriber growth include (i) numerous virus outbreaks during the second half of 2003 and through 2004, including variations of Sasser, MyDoom, Bagle and NetSky, and (ii) continued strategic relationships with channel partners, such as AOL and Dell. In October 2004, we announced a renewed relationship with AOL

**Table of Contents**

under which, among other things, AOL will offer our on-line PC anti virus services to AOL members as part of their AOL subscription and membership experience for both broadband and dial up members.

*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 2004, we had revenues of approximately \$43.7 million, compared to \$15.5 million in 2003. The \$28.2 million increase is due to the full year impact on revenues in 2004, as well as sequential quarter growth in 2004.

*Foundstone.* Our Foundstone network protection products, acquired by us in October 2004, are sold primarily to enterprises and small and medium sized businesses. We are in the process of integrating Foundstone's operations with ours and its products with our intrusion prevention technologies and systems management capabilities. Revenues from Foundstone were not significant in 2004.

*Sniffer Technologies.* We sold Sniffer in July 2004 for net cash proceeds of \$213.8 million. As there were only approximately six months of Sniffer revenue in 2004, there was a significant decline in revenue from \$210.2 million in 2003 to \$90.9 million in 2004. Additionally, there was a declining trend in Sniffer revenues in 2004 prior to the sale.

We have agreed to provide certain post-closing transitional services to Network General. We are reimbursed for our cost plus a profit margin and present these reimbursements as a reduction of operating expenses on a separate line in our income statement. For the year ended December 31, 2004, we have recorded approximately \$6.0 million for these transition services.

*Magic.* We sold the assets of our Magic Solutions service desk business to BMC Software, Inc. in January 2004 for cash proceeds of \$47.1 million, net of direct expenses. During 2004 and 2003, net revenue from Magic Solutions products totaled approximately \$2.9 million and \$63.2 million, respectively.

*McAfee Labs.* We entered into an agreement to sell the assets of McAfee Labs on December 21, 2004 for cash proceeds of \$1.5 million. During 2004 and 2003, net revenue from McAfee Labs totaled approximately \$6.4 million and \$11.0 million, respectively.

*Deferred revenue balances.* Our deferred revenue balance at December 31, 2004 was \$601.4 million, and at December 31, 2003 it was \$459.6 million, excluding approximately \$22.0 million relating to our Magic product line which was classified as liabilities related to assets held for sale. The increase from December 31, 2003 to December 31, 2004 was 31%. We believe 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 introduced this program in the United States in the first quarter of 2004. Under the perpetual plus licensing program more revenue is allocated to service and support due to a change in pricing structure, which was the primary reason for the increase in deferred revenue. The strengthening of foreign currencies against the U.S. dollar resulted in approximately \$18 million of the increase. These increases were partially offset by the sale of our Sniffer business in 2004, which had a deferred revenue balance at December 31, 2003 of approximately \$60.2 million.

*Cash, cash equivalents and investment balances.* Cash, cash equivalents and investment balances at December 31, 2004 and 2003 totaled \$924.7 million and \$766.3 million. During 2004, we generated approximately \$358.9 million in cash from operations. We used approximately \$39.4 million of cash for investing activities and \$369.9 million for financing activities. We received \$260.9 million for the sale of Sniffer and Magic, and paid \$84.7 million, net of cash assumed, for the acquisition of Foundstone, which is reflected in investing activities. Our primary utilizations of cash in 2004 were for the net purchases of

marketable securities of approximately \$210.6 million, the repurchase shares of common stock for \$221.8 million and the redemption of convertible debt for \$265.6 million.

In 2005, our management is 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) implementing cost controls and business streamlining measures required to improve operating margins; and (iv) continuing to grow our intrusion prevention business.

### **Critical Accounting Policies and Estimates**

In preparing our consolidated financial statements, we make estimates, assumptions and judgments that can have a significant impact on our net revenue, operating income and net income, as well as the value of certain assets and liabilities on our consolidated balance sheet. The application of our critical accounting policies requires an evaluation of a number of complex criteria and significant accounting judgments by us. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Senior management has discussed the development, selection and disclosure of these estimates with the audit



**Table of Contents**

committee of our board of directors. Actual results may differ, and could be material, from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. Management believes the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the consolidated financial statements. We have not materially changed our methodology for calculating the estimates below in the past three years.

Our critical accounting policies are as follows:

revenue recognition;

estimating valuation allowances and accrued liabilities, specifically sales returns and other allowances, the allowance for doubtful accounts, our facility restructuring accrual; and the assessment of the probability of the outcome of litigation against us;

accounting for income taxes; and

valuation of goodwill, intangibles and long-lived assets.

**Table of Contents*****Revenue Recognition***

As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates. These estimates affect the deferred revenue line item on our consolidated balance sheet and the net revenue line item on our consolidated statement of income. Estimates regarding revenue affect all of our operating geographies.

We apply the provisions of Statement of Position 97-2, *Software Revenue Recognition*, ( SOP 97-2 ) as amended by Statement of Position 98-9 *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* to all transactions involving the sale of software products and hardware transactions where the software is not incidental. For hardware transactions where software is not incidental, we do not bifurcate the fee and we do not apply separate accounting guidance to the hardware and software elements. For hardware transactions where no software is involved, we apply the provisions of Staff Accounting Bulletin 104 *Revenue Recognition* ( SAB 104 ). In addition, we apply the provisions of Emerging Issues Task Force Issue No. 00-03 *Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware* to our on-line software subscription services.

We license our software products on a one and two-year subscription basis or on a perpetual basis. Our two-year subscription licenses include the first year of maintenance and support. Our on-line subscription arrangements require customers to pay a fixed fee and receive service over a period of time, generally one or two years. Customers do not pay set-up fees. We recognize revenue from the sale of software licenses when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed or determinable and collection of the resulting receivable is reasonably assured. For all sales, except those completed over the Internet, we use either a binding purchase order or signed license agreement as evidence of an arrangement. For sales over the Internet, we use a credit card authorization as evidence of an arrangement. Sales through our distributors are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction by transaction basis.

Delivery generally occurs when product is delivered to a common carrier or upon delivery of the license key which is delivered primarily through email. At the time of the transaction, we assess whether the fee associated with our revenue transactions is fixed or determinable and whether or not collection is reasonably assured. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are 30 to 90 days from invoice date, we account for the fee as not being fixed or determinable. In these cases, we recognize revenue as the fees become due. With respect to rebate programs, we make estimates of amounts for promotional and rebate programs based on our historical experience, and reduce revenue by the amount of the estimates. We assess collection based on a number of factors, including past transaction history and credit-worthiness of direct customers. We do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash. For indirect customers, we monitor the financial condition and ability to pay for goods sold. If we do not identify potential collection problems with our indirect customers on a timely basis, we could incur a charge for bad debt that could be material to our consolidated financial statements.

For arrangements with multiple obligations (for example, undelivered maintenance and support), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to our company. This means that we defer revenue from the arrangement fee equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for both our two-year time based licenses and perpetual licenses are based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. This assessment generally includes analyses of the variability of renewal rates by product and region and determination of whether a majority of renewals supports our

estimated fair value of the maintenance and support obligations. In cases where renewal rates are not quoted in the initial sales contracts, our assessment is critical because if an estimated fair value cannot be established through separate sales then the fee for the entire arrangement (e.g. delivered software and undelivered maintenance and support obligations) is deferred until delivery occurs which for maintenance would be ratably over the service period. Fair value of services, such as training or consulting, is based upon separate sales by us of these services to other customers. Our arrangements do not generally include acceptance clauses. However, if an arrangement includes a specified acceptance provision, recognition occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

We recognize revenue for maintenance services ratably over the contract term. Our training and consulting services are billed based on hourly rates, and we generally recognize revenue as these services are performed. However, at the time of entering into a transaction, we assess whether or not any services included within the arrangement require us to perform significant work either to alter the underlying software or to build additional complex interfaces so that the software performs as the customer requests. If these services are included as part of an arrangement, we recognize the entire fee using the percentage of completion method. We estimate the percentage of completion based on our estimate of the total costs estimated to complete the project as a percentage of the costs incurred to date and the estimated costs to complete.

**Table of Contents*****Estimation of Sales Returns and Other Allowances, Allowance for Doubtful Accounts, Restructuring Accrual and Litigation***

*Sales Returns and Other Allowances.* In each accounting period, our management must make judgments and estimates of potential future product returns related to current period product revenue. We analyze and monitor current and historical return rates, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns and other allowances. We also budget for our sales incentives each quarter and determine amounts to be spent and we monitor amounts spent against our budgets. These estimates affect our net revenue line item on our statement of income and affect our net accounts receivable line item on our consolidated balance sheet. These estimates affect all of our operating geographies.

If our sales returns experience were to increase by an additional 1% of license revenues, our allowance for sales returns at December 31, 2004 would increase and net revenue and operating income for 2004 would decrease by approximately \$1.6 million.

*Allowance for Doubtful Accounts.* We also make estimates of the uncollectibility of our accounts receivables. Management specifically analyzes accounts receivable balances, current and historical bad debt trends, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We specifically reserve for any account receivable for which there are identified collection issues. Bad debts have historically been approximately 2% of our average accounts receivable. These estimates affect the provision for doubtful accounts line item on our statement of income and the net accounts receivable line item on the consolidated balance sheet. The estimation of uncollectible accounts affects all of our operating geographies.

|   | <b>December<br/>31,<br/>2004</b> | <b>December<br/>31,<br/>2003</b> |
|---|----------------------------------|----------------------------------|
|   | <b>(In millions)</b>             |                                  |
| Allowance for sales return and incentives | \$ 29.2                          | \$ 39.6                          |
| Allowance for doubtful accounts           | 2.5                              | 3.1                              |
| Total allowance                           | \$ 31.7                          | \$ 42.7                          |

At December 31, 2004, our accounts receivable balance was \$137.5 million, net of allowance for doubtful accounts of \$2.5 million, and our allowance for sales return and incentives amounts to \$29.2 million. At December 31, 2003, our accounts receivable balance was \$170.2 million, net of allowance for doubtful accounts of \$2.9 million (excluding the allowance related to Magic accounts receivable) and provision for sales returns and other allowances of \$39.6 million as of December 31, 2003. If an additional 1% of our gross accounts receivable were deemed to be uncollectible at December 31, 2004, our allowance for doubtful accounts and provision for bad debt expense would increase by approximately \$1.7 million.

*Restructuring Accrual.* During 2004, we permanently vacated several leased facilities, including an additional two floors in our Santa Clara headquarters building. As a result of these vacancies, we recorded \$8.7 million in restructuring accruals. In 2003, as part of a consolidation of activities into our Plano, Texas facility from our headquarters in Santa Clara, California, we recorded a restructuring charge of \$15.8 million. In 2004, we recorded adjustments to the 2004 and 2003 lease termination restructuring accruals of \$0.2 million and \$0.6 million, respectively. We recorded these facility restructuring charges in accordance with Statement of Financial Accounting Standard No. 146, *Accounting for Exit Costs Associated With Exit or Disposal Activities* ( SFAS 146 ). In order to

determine our restructuring charges and the corresponding liabilities, SFAS 146 required us to make a number of assumptions. These assumptions included estimated sublease income over the remaining lease period, estimated term of subleases, estimated utility and real estate broker fees, as well as estimated discount rates for use in calculating the present value of our liability. We developed these assumptions based on our understanding of the current real estate market in the respective locations as well as current market interest rates. The assumptions used are our management's best estimate at the time of the accrual, and adjustments are made on a periodic basis if better information is obtained. If, at December 31, 2004, our estimated sublease income were to decrease 10%, the restructuring reserve and related expense would have increased by approximately \$0.2 million.

The estimates regarding our restructuring accruals affect our current liabilities and other long term liabilities line items in our consolidated balance sheet, since these liabilities will be settled each year through 2013. These estimates affect our statement of income in the restructuring line item. At December 31, 2004, our North American operating segment was affected by these estimates.

*Litigation.* Management's current estimated range of liability related to litigation that is brought against us from time to time is based on claims for which our management can estimate the amount and range of loss. We recorded the minimum estimated liability related to those claims, where there is a range of loss as there is no better point of estimate. Because of the uncertainties related to an unfavorable outcome of litigation, and the amount and range of loss on pending litigation, management is often unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As litigation progresses, we continue to assess our potential liability and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. Estimates of litigation liability affect our accrued liability line item on our consolidated balance sheet and our general and administrative expense line item on our statement of income.

**Table of Contents*****Accounting for Income Taxes***

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess and make significant estimates regarding the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of income. Estimates related to income taxes affect the deferred tax asset and liability line items and accrued liabilities in our consolidated balance sheet and our income tax (benefit) expense line item in our statement of income. Income tax estimates affect all of our operating geographies.

The net deferred tax asset as of December 31, 2004 is \$421.1 million, net of a valuation allowance of \$65.8 million due to uncertainties related to our ability to utilize some of our deferred tax assets related to acquired companies, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire. The valuation allowance is based on our historical experience and estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations.

Tax returns are subject to audit by various taxing authorities. Although we believe that adequate accruals have been made for unsettled issues, additional benefits or expenses could occur in future years from resolution of outstanding matters. We continue to assess our potential tax liability included in accrued taxes in the consolidated financial statements, and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. We have classified a portion of our tax liability as noncurrent in the consolidated balance sheet based on the expected timing of cash payments to settle contingencies with taxing authorities.

***Valuation of Goodwill, Intangibles, and Long-lived Assets***

We account for goodwill and other indefinite-lived intangible assets in accordance with SFAS 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ). SFAS 142 requires, among other things, the discontinuance of amortization for goodwill and indefinite-lived intangibles and at least an annual test for impairment. An impairment review may be performed more frequently in the event circumstances indicate that the carrying value may not be recoverable. The goodwill impairment review involves a two-step process as described in Note 2 to the consolidated financial statements.

We are required to make estimates regarding the fair value of our reporting units when testing for potential impairment. We estimate the fair value of our reporting units using a combination of the income approach and the market approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. Under the market approach, we estimate the fair value based on market multiples of revenues or earnings for comparable companies. We estimate cash flows for these purposes using internal budgets based on recent and historical trends. We base these estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. We also make certain judgments about the selection of comparable companies used in the market approach in valuing our reporting units, as well as certain assumptions to allocate shared assets and liabilities to calculate the carrying value for each of our reporting units. If an impairment were present, these estimates would affect an impairment line item on our consolidated statement of income and would affect the goodwill in our consolidated balance sheet. As goodwill is allocated to all of our reporting units, any impairment could potentially affect each operating geography.

Based on our current impairment test, there would have to be a significant change in assumptions used in such calculation in order for an impairment to occur as of December 31, 2004.

We account for finite-lived intangibles and long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Under this standard we will record an impairment charge on finite-lived intangibles or long-lived assets to be held and used when we determine that the carrying value of intangibles and long-lived assets may not be recoverable.

Based upon the existence of one or more indicators of impairment, we measure any impairment of intangibles or long-lived assets based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Our estimates of cash flows require significant judgment based on our historical results and anticipated results and are subject to many of the factors, noted below as triggering factors, which may change in the near term.

Factors considered important, which could trigger an impairment review include, but are not limited to:

significant under performance relative to expected historical or projected future operating results;

**Table of Contents**

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant declines in our stock price for a sustained period; and

our market capitalization relative to net book value.

Goodwill amounted to \$439.2 million and \$443.6 million as of December 31, 2004 and 2003, respectively. We did not hold any other indefinite-lived intangibles as of December 31, 2004 or 2003. Net finite-lived intangible assets and long-lived assets amounted to \$198.8 million and \$217.6 million as of December 31, 2004 and 2003, respectively.

**Results of Operations***Years Ended December 31, 2004, 2003, and 2002**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 (in thousands, except percentages):

|                      | For the Year Ended December 31, |            |              | Percentage of |      |      |
|----------------------|---------------------------------|------------|--------------|---------------|------|------|
|                      | 2004                            | 2003       | 2002         | 2004          | 2003 | 2002 |
|                      | (In thousands)                  |            |              |               |      |      |
| Net revenue:         |                                 |            |              |               |      |      |
| Product              | \$ 294,163                      | \$ 513,610 | \$ 631,550   | 32%           | 55%  | 61%  |
| Services and support | 616,379                         | 422,726    | 411,494      | 68            | 45   | 39   |
| Total net revenue    | \$ 910,542                      | \$ 936,336 | \$ 1,043,044 | 100%          | 100% | 100% |

Net revenue decreased 3%, or \$25.8 million from 2003 to 2004. The decrease reflects (i) a \$119.3 million decrease in our Sniffer product line related to declining Sniffer revenues throughout 2004 and its sale in July 2004, and (ii) a \$60.3 million decrease due to the January 2004 sale of Magic, (iii) a decrease due to the introduction of our perpetual plus licensing model in 2003, offset by (iv) a \$28.2 million increase in our IntruShield product sales from our May 2003 IntruVert acquisition, (v) a \$103.9 million increase in our McAfee.com consumer business due to on-line subscriber growth, (vi) an increase in revenues in EMEA and Japan of approximately \$26.0 million due to a weakening U.S. Dollar, and (vii) increased corporate IT spending in 2004, which had a positive impact on our revenues. Net revenue decreased 10% or \$106.7 million from 2002 to 2003. The decline was due primarily to weaknesses in the United States and other economies and continued reductions in corporate spending. Many of our customers and potential customers: (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.

In 2003, we began introducing our perpetual plus licensing arrangements outside of North America. In the first quarter of 2004, we expanded our perpetual plus licensing arrangements to North America. 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 an increase in services and support revenue relative to product revenue due to higher renewal rates for support bundled in these arrangements and 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. The balance of deferred revenue has increased 31% from \$459.6 million at December 31, 2003 to \$601.4 million at December 31, 2004.

**Table of Contents*****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:

|                                | For the Year Ended December 31, |            |              | Percentage of |      |      |
|--------------------------------|---------------------------------|------------|--------------|---------------|------|------|
|                                | 2004                            | 2003       | 2002         | 2004          | 2003 | 2002 |
|                                | (In thousands)                  |            |              |               |      |      |
| Net revenue:                   |                                 |            |              |               |      |      |
| North America                  | \$ 554,641                      | \$ 606,685 | \$ 653,532   | 61%           | 65%  | 63%  |
| EMEA                           | 241,724                         | 240,616    | 298,659      | 27            | 26   | 28   |
| Japan                          | 54,609                          | 40,519     | 39,369       | 6             | 4    | 4    |
| Asia-Pacific (excluding Japan) | 38,494                          | 29,014     | 33,595       | 4             | 3    | 3    |
| Latin America                  | 21,074                          | 19,502     | 17,889       | 2             | 2    | 2    |
| Total net revenue              | \$ 910,542                      | \$ 936,336 | \$ 1,043,044 | 100%          | 100% | 100% |

Net revenue outside of North America (United States and Canada) accounted for approximately 39%, 35% and 37% of net revenue for 2004, 2003 and 2002. Historically and for 2004, North America and EMEA has comprised between 87% and 91% of our business. In 2004, we saw a weakening of the U.S. dollar against many currencies, but most dramatically against the Euro. As a result of the weakening U.S. dollar, we experienced positive impacts on our net revenue in EMEA region.

In 2004, total net revenue in North America decreased 9% or \$52.0 million as compared to 2003 and decreased 7% or \$46.8 million from 2002 to 2003. The revenue decline from 2003 to 2004 was due to (i) a decline of \$92.4 million due to the July 2004 sale of Sniffer as well as declining Sniffer revenues in 2004, (ii) a decline of \$40.9 million due to the January 2004 sale of Magic, and (iii) a decrease in our enterprise revenues, excluding IntruShield, of approximately \$26.3 million, partially offset by (iv) an increase of \$99.9 million related to the increase in McAfee.com on-line subscriptions and (v) a \$15.9 million increase due to our IntruShield product. The economic growth and increased corporate IT spending had a positive impact on our revenues, while the introduction of the perpetual plus model in North America in 2004 resulted in an increase in the amount of revenue deferred to future periods. The revenue decline from 2002 to 2003 was due to the impact of an economic downturn as well as softness in corporate IT spending.

In EMEA, total net revenue remained consistent from 2003 to 2004, and decreased 19% or \$58.0 million from 2002 to 2003. For 2004, the Sniffer sale and declining revenues in 2004 resulted in an \$18.0 million decrease, the sale of Magic resulted in an \$18.4 million decrease and IntruShield resulted in a \$4.4 million increase. The strengthening of foreign currencies against the U.S. dollar resulted in an approximate \$22.0 million increase in revenues from 2003 to 2004, and we also benefited from increased corporate IT spending in 2004. The decline in revenue from 2002 to 2003 was due to the effects of the economic downturn and reduced corporate IT spending, as well as the introduction of the perpetual plus pricing model in the middle of 2003.

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. Revenues increased in each of these geographic regions primarily due to the strengthening of foreign currencies against the U.S. Dollar and increased corporate IT spending.

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.

**Table of Contents****Product Revenue**

The following table sets forth for the periods indicated each major category of our product revenue:

|                            | For the Year Ended December 31, |            |            | Percentage of Product Revenue |      |      |
|----------------------------|---------------------------------|------------|------------|-------------------------------|------|------|
|                            | 2004                            | 2003       | 2002       | 2004                          | 2003 | 2002 |
|                            | (In thousands)                  |            |            |                               |      |      |
| Term subscription licenses | \$ 39,682                       | \$ 113,696 | \$ 181,825 | 14%                           | 23%  | 29   |
| Perpetual licenses         | 118,301                         | 227,492    | 277,882    | 40                            | 44   | 44   |
| Hardware                   | 79,828                          | 99,502     | 93,359     | 27                            | 19   | 15   |
| Retail                     | 27,787                          | 45,993     | 63,236     | 9                             | 9    | 10   |
| Other                      | 28,565                          | 26,927     | 15,248     | 10                            | 5    | 2    |
| Total product revenue      | \$ 294,163                      | \$ 513,610 | \$ 631,550 | 100%                          | 100% | 100% |

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. The \$219.4 million, or 43% decrease from 2003 to 2004 is due to (i) the introduction of our perpetual plus licensing arrangements in the United States in the first quarter of 2004, and in EMEA and Asia-Pacific (excluding Japan) in the middle of 2003, resulting in reduced product revenues and increased services and support revenues, (ii) our continued shift in focus from retail boxed products to our on-line subscription model for consumers and SMBs, and (iii) the Sniffer sale in July 2004 and declining 2004 revenues, partially offset by the effects of the strengthening foreign currencies against the U.S. Dollar and increased corporate IT spending. The introduction of the perpetual plus licensing arrangement has resulted in revenue declines in the term subscription license and perpetual license revenues. Our hardware revenue decreased \$19.7 million, or 20%, due to the Sniffer sale in July 2004, which was partially offset by an increase in revenue from our IntruShield product due to our purchase of IntruVert in the second quarter of 2003. The \$18.2 million, or 40%, decrease in retail revenues is due to our shift to the on-line subscription model for consumers and SMB.

The \$117.9 million, or 19%, decrease in product revenue from 2002 to 2003 was due to (i) the introduction of our perpetual plus licensing arrangements in EMEA and Asia-Pacific (excluding Japan) in 2003, (ii) our continued shift in focus from retail boxed products to our on-line subscription model for consumers and SMBs, and (iii) the continued softness in corporate IT spending in 2003.

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 our license revenue in any quarter following the implementation of our perpetual plus licensing model worldwide. Furthermore, support pricing under the perpetual plus model is significantly higher than the subscription model. Thus, revenue is shifting out of the product revenue and into services and support revenue. We expect the remaining mix of product revenue to fluctuate as a percentage of revenue.

**Services and Support Revenue**

The following table sets forth for the periods indicated each major category of our services and support revenue:

|                         | For the Year Ended December 31, |            |            | Percentage of Services and Support Revenue |      |      |
|-------------------------|---------------------------------|------------|------------|--|------|------|
|                         | 2004                            | 2003       | 2002       | 2004                                       | 2003 | 2002 |
|                         | (In thousands)                  |            |            |  |      |      |
| Support and maintenance | \$ 436,299                      | \$ 313,731 | \$ 310,473 | 71%  | 74%  | 75%  |

Edgar Filing: McAfee, Inc. - Form 10-K/A

|                                    |            |            |            |      |      |      |
|------------------------------------|------------|------------|------------|------|------|------|
| Consulting                         | 19,157     | 27,421     | 36,740     | 3    | 7    | 9    |
| Training                           | 8,394      | 9,486      | 12,527     | 1    | 2    | 3    |
| On-line subscription arrangements  | 152,529    | 72,088     | 51,754     | 25   | 17   | 13   |
| Total services and support revenue | \$ 616,379 | \$ 422,726 | \$ 411,494 | 100% | 100% | 100% |

Services and support revenues include revenues from software support and maintenance contracts, consulting, training and on-line subscription arrangements. The \$193.7 million, or 46%, increase from 2003 to 2004 is due to (i) an increase in support and maintenance due to our perpetual plus licensing model and (ii) a \$80.4 million increase in our on-line subscription arrangements, (iii) the positive impact of foreign currencies strengthening against the U.S. Dollar, partially offset by (iv) a \$9.4 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 approximately 8.5 million subscribers at December 31, 2004, from 3.7 million subscribers at December 31, 2003. The increase in customers was due to our continued channel relationships with Dell, AOL and others, as well as an outbreak of computer viruses in the second half of 2003 continuing through 2004.

The \$11.2 million, or 3%, increase in service and support revenue from 2002 to 2003 was due to a \$20.3 million increase in our on-line subscription arrangements, partially offset by decreases in consulting and training revenues totaling \$12.4 million. The increase in our on-line subscription arrangements was due to an increase in our customer base to approximately 3.7 million subscribers at the end of 2003, as well as an increase in our McAfee ASaP on-line service for small-to-medium sized businesses. We saw decreases in our consulting and training revenues in each year because our customers typically first reduce consulting and training budgets when reducing overall corporate IT costs and projects.

**Table of Contents**

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 licenses 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. Additionally, support pricing under the perpetual plus model is significantly higher than the previous subscription model. In the event customers choose not to renew their support arrangements or renew such arrangements at other than the contractual rates, revenue recognition under the perpetual plus model could be impacted.

**Cost of Net Revenue; Gross Margin**

|                                      | For the Year Ended December 31, |            |            | Percentage of Cost of |      |      |
|--------------------------------------|---------------------------------|------------|------------|-----------------------|------|------|
|                                      | 2004                            | 2003       | 2002       | 2004                  | 2003 | 2002 |
|                                      | (In thousands)                  |            |            |                       |      |      |
| Cost of net revenue:                 |                                 |            |            |                       |      |      |
| Product                              | \$ 73,058                       | \$ 80,895  | \$ 101,019 | 49%                   | 54%  | 61%  |
| Services and support                 | 62,520                          | 57,362     | 60,539     | 42                    | 38   | 37   |
| Amortization of purchased technology | 13,331                          | 11,369     | 3,153      | 9                     | 8    | 2    |
| Total cost of net revenue            | \$ 148,909                      | \$ 149,626 | \$ 164,711 | 100%                  | 100% | 100% |
| Gross margin                         | \$ 761,633                      | \$ 786,710 | \$ 878,333 |                       |      |      |
| Gross margin percentage              | 84%                             | 84%        | 84%        |                       |      |      |

Our total cost of revenue remained consistent at \$148.9 million for 2004 and \$149.6 million for 2003 as revenues remained relatively consistent, with a slight decline of 3%. Our total cost of net revenue decreased \$15.1 million, or 9% due primarily to our 10% decrease in net revenue from 2002 to 2003.

*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, and, with respect to hardware-based anti-virus and security products and network fault and performance products, computer platforms and other hardware components. Our cost of product revenue decreased \$7.8 million from 2003 to 2004 and \$20.1 million from 2002 to 2003. The decrease from 2003 to 2004 is primarily due to the sale of Sniffer in July 2004, partially offset by IntruShield hardware due to a full year of activity in 2004. The decrease from 2002 to 2003 was due to lower costs of computer platforms and other hardware components as at the end of 2002 we began using a more competitive contract manufacturer which also utilized a greater number of standardized computer platforms and hardware components. We also benefited from the favorable impact of cost control measures. These costs have decreased as a percentage of total cost of net revenue from 2002 to 2004 due to the change in the mix of our revenues, with a shift from product revenues to service and support revenues over this period.

We anticipate that cost of product revenue will continue to fluctuate as a percent of cost of net revenue, due to various factors including product mix, material and labor costs and warranty costs.

*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, and costs related to the sale of on-line subscription arrangements, including revenue sharing arrangements and royalties paid to our on-line strategic partners. Cost of services and support revenue increased \$5.2 million from 2003 to 2004, and decreased \$3.2 million from 2002 to 2003. The increase from 2003 to 2004 is due to an increase in revenue sharing arrangements and royalties paid to

our on-line strategic partners, which was partially offset by reduced support and consulting headcount as a result of the sale of Magic in January 2004, as well as on-going cost reduction efforts. Cost of services and support have increased as a percentage of total cost of net revenue from 2002 through 2004 primarily as a result of the increase in revenue sharing arrangements and royalty payments to our on-line strategic partners. We anticipate that cost of service revenue will continue to fluctuate as a percentage of cost of net revenue.

*Amortization of Purchased Technology.* Amortization of purchased technology increased \$2.0 million, or 17%, from 2003 to 2004 and increased \$8.2 million, or 261%, from 2002 to 2003. The increases are due to our acquisitions of Entercept and IntruVert in 2003, for which we recorded purchased technology of \$21.7 million and \$18.2 million, respectively, and our acquisition of Foundstone in October 2004, for which we recorded purchased technology of \$27.0 million. Amortization for these items was \$9.0 million and \$5.2 million in 2004 and 2003, respectively. The increase in amortization related to the 2003 and 2004 acquisitions was partially offset by certain purchased technology assets becoming fully amortized in 2003. The purchased technology is being amortized over its estimated useful lives of four to seven years. Amortization of purchased technology is expected to be \$15.3 million in 2005.

*Gross Margins.* Our gross margins were stable at 84% from 2002 to 2004. The increase in cost of service and support revenue was offset by the decrease in cost of product revenue in 2004. The increase of amortization of purchased technology as a percentage of cost of net revenue in 2003 to 8% offset the improvement we experienced in our cost of product revenues from 2002 to 2003. Gross margins may fluctuate in the future due to various factors, including the mix of products sold, sales discounts, revenue sharing agreements, material and labor costs and warranty costs.

**Table of Contents****Operating Costs**

The following table sets forth for the periods indicated each major category of our operating expenses:

|  | For the Year Ended December 31, |            |            | Percentage of |      |      |
|--|---------------------------------|------------|------------|---------------|------|------|
|  | 2004                            | 2003       | 2002       | 2004          | 2003 | 2002 |
|  | (In thousands)                  |            |            |               |      |      |
| Research and development(1)  | \$ 172,717                      | \$ 184,606 | \$ 148,801 | 19%           | 20%  | 14%  |
| Marketing and sales(2)   | 354,380                         | 363,306    | 397,747    | 39            | 39   | 38   |
| General and administrative(3)  | 139,845                         | 129,920    | 119,393    | 15            | 14   | 11   |
| (Gain)loss on sale of assets and technology(4)                           | (240,336)                       | 788        | (9,301)    | (26)          |      | (1)  |
| Litigation (reimbursement) settlement                                    | (24,991)                        |            | 70,000     | (3)           |      | 7    |
| Restructuring charges  | 17,493                          | 22,667     | 1,116      | 2             | 2    |      |
| Amortization of intangibles  | 14,065                          | 15,637     | 10,742     | 2             | 2    | 1    |
| Severance/bonus costs related to Sniffer and Magic dispositions(5)       | 10,070                          |            |            | 1             |      |      |
| Reimbursement from transition services agreement                         | (5,997)                         |            |            | (1)           |      |      |
| Provision for (recovery from) doubtful accounts                          | 1,716                           | (1,216)    | (219)      |               |      |      |
| Acquisition related costs not subject to capitalization                  |                                 |            | 16,026     |               |      | 2    |
| In-process research and development                                      |                                 | 6,600      |            |               |      |      |
| Total operating costs, including the effects of stock-based compensation | \$ 438,962                      | \$ 722,308 | \$ 754,305 | 48%           | 77%  | 72%  |

- 
- (1) Includes stock-based compensation charge of \$6,518, \$5,157 and \$3,963 in 2004, 2003 and 2002, respectively.
- (2) Includes stock-based compensation charge of \$2,642, \$5,065 and \$1,980 in 2004, 2003 and 2002, respectively.
- (3) Includes stock-based compensation charge of \$4,085, \$2,285 and \$16,461 in 2004, 2003 and 2002, respectively.
- (4) Net of stock-based compensation charge of \$84 in 2004
- (5) Includes stock-based compensation charge of \$991 in 2004

*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. Research and development expenses decreased \$11.9 million, or 6%, from 2003 to 2004, and increased \$35.8 million, or 24%, from 2002 to 2003. The decrease from 2003 to 2004 reflects (i) a \$16.5 million decrease due to the Sniffer sale in July 2004, (ii) a \$6.7 million decrease related to the Magic sale in January 2004, and (iii) a decrease in expenses due to headcount reductions and the movement of research and development headcount to the Bangalore research facility, which has lower salary costs, partially offset by (iv) a \$9.2 million increase due to a full year impact of the IntruVert acquisition in 2003, (v) a \$2.1 million increase due to strengthening foreign currencies against the US Dollar in EMEA and Japan in 2004, (vi) a \$1.4 million increase in stock-based compensation, and (vii) a \$1.1 million increase due to the acquisition of



Foundstone in October 2004.

The \$35.8 million increase from 2002 to 2003 was due to \$9.7 million and \$3.2 million, respectively, related to our acquisitions IntruVert and Enterccept, and our acquisitions Deersoft, Inc. and Traxess, Inc.; \$4.6 million related to the 2003 opening of our research and development facility in Bangalore, India and \$9.0 million related to increased McAfee research and development expenditures; and \$8.0 million related to higher headcount.

Research and development expenses include stock-based compensation charges of \$6.5 million, \$5.2 million and \$4.0 million in 2004, 2003 and 2002, respectively. See *Stock Based Compensation* below for further discussion.

We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to remain relatively flat in future periods and continue to fluctuate as a percentage 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. Marketing and sales expenses decreased \$8.9 million, or 2%, from 2003 to 2004, and decreased \$34.4 million, or 9% from 2002 to 2003. The decrease from 2003 to 2004 reflects (i) a \$14.6 million decrease due to the Sniffer sale in July 2004, the Magic sale in January 2004 and the impact of headcount reductions in 2004, and (ii) a \$2.4 million decrease in stock-based compensation, partially offset by (iii) a \$6.4 million increase in expenses due to strengthening foreign currencies against the U.S. Dollar in EMEA and Japan in 2004, and (iv) a \$1.7 million increase due to the Foundstone acquisition in October 2004.

The decrease of \$34.4 million from 2002 to 2003 was primarily due to a corresponding 10% decrease in net revenue from 2002 to 2003. We also experienced lower sales and marketing expense in 2003 of approximately (i) \$10.6 million due to a reduction of salary,

## Table of Contents

benefit and commission expenses following a decrease in headcount of approximately 100 sales personnel, (ii) \$5.7 million from our reduced use of outside services and other cost saving measures, and (iii) \$2.1 million related to travel expense cost savings measures, which were partially offset by (iv) an increase in stock-based compensation expense of \$3.1 million. As a result of the change in the way we account for sales commissions, we had lower sales and marketing expense of approximately \$5.0 million.

Marketing and sales expenses include stock-based compensation charges of \$2.6 million, \$5.1 million and \$2.0 million for 2004, 2003 and 2002, respectively. See *Stock Based Compensation* below for further discussion.

We anticipate that marketing and sales expenses will decrease in absolute dollars, and 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. General and administrative expenses increased \$9.9 million, or 8%, from 2003 to 2004, and increased \$10.5 million, or 9%, from 2002 to 2003. The increase from 2003 to 2004 reflects (i) a \$11.1 million increase in costs incurred to comply with Section 404 of the Sarbanes-Oxley Act (SOX 404), (ii) \$2.9 million in consulting fees paid in connection with strategic planning, (iii) a \$4.3 million increase in depreciation expense due to a full year impact of significant hardware additions for back-office functions in 2003, (iv) a \$2.7 million increase due to strengthening foreign currencies against the US Dollar in EMEA and Japan in 2004, (v) a \$1.8 million increase in stock-based compensation expense, and (vi) a \$0.8 million increase due to the Foundstone acquisition in October 2004, partially offset by (vi) \$8.8 million in expenses incurred in 2003 related to financial statement restatements which did not occur in 2004, and a reduction in headcount and facilities costs related to restructurings in 2004 and 2003.

The increase from 2002 to 2003 is due to costs incurred in connection with our restatement of \$8.8 million and acquisition related bonuses of \$4.0 million. In 2003, our legal expenses increased approximately \$4.6 million in 2003 from 2002 due to an increase in outside legal services due to our on-going SEC and DOJ investigations. Our information technology department expenses increased approximately \$6.2 million due to increases in headcount and depreciation and equipment expense. We also had a full year of internal audit and four months of SOX 404 related expenses in 2003, resulting in an increase of approximately \$0.8 million and \$1.4 million, respectively, as compared to 2002. These increases were partially offset by a decrease in stock-based compensation charges of \$14.2 million from 2002 to 2003.

In 2004 and 2003, we recognized acquisition-related compensation of \$3.6 million and \$4.0 million, respectively, which represents amounts paid to Entercept, IntruVert and Foundstone employees currently providing services to us. We expect to recognize an additional \$4.4 million in expense related to these services in 2005, and an additional \$3.3 million through 2007.

General and administrative expenses include stock-based compensation charges of \$4.1 million, \$2.3 million and \$16.5 million in 2004, 2003 and 2002, respectively. See *Stock Based Compensation* below for further discussion.

We expect our general and administrative expenses to decrease as we continue to implement cost control measures and decrease as a percentage of net revenue.

*(Gain) loss on Sale of Assets and Technology.* In January 2004, we completed the sale of our Magic product line to BMC Software and, as a result, recognized a gain of approximately \$46.1 million. In July 2004, we completed the sale of our Sniffer product line to Network General and, as a result, recognized a gain of approximately \$197.4 million. These gains were partially offset by write-offs of property and equipment.

The loss on sale of assets and technology of \$0.8 million in 2003 consists of the write-off of property and equipment.

We recognized a \$6.7 million and \$2.6 million gain on the sale of the PGP Gauntlet businesses in February 2002, and the PGP Desktop/Encryption assets and technology in August 2002, respectively.

*Litigation Reimbursement/Settlement.* We agreed to settle a securities class action litigation in September 2003. The \$70.0 million litigation charge was recorded in 2002 because our agreement to settle, which established the liability to be probable and estimable, occurred prior to the publication of our 2002 consolidated financial statements in October 2003. We paid the \$70.0 million settlement in October 2003. During 2004, we received insurance reimbursements of approximately \$25.0 million from our insurance carriers for insurance coverage related to the class action lawsuit settled in October 2003.

**Table of Contents*****Restructuring Charges******2004 Restructuring***

During 2004, we recorded several restructuring charges related to the reduction of employee headcount. 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 America and EMEA operating segments, respectively. The workforce was reduced primarily due to our sale of Magic in January 2004. In the second quarter of 2004, we recorded a restructuring charge of approximately \$1.6 million related to the severance of approximately 80 employees in our sales, technical support and general and administrative functions. Approximately \$0.6 million of the restructuring charge was related to our EMEA operating segment and the remaining \$1.0 million was related to our North America operating segment. In the third quarter of 2004, we recorded a restructuring charge related to ten employees which totaled approximately \$0.9 million, all of which related to our North America operating segment. In the fourth quarter of 2004, we recorded a restructuring charge of \$1.3 million related to 111 employees, of which \$0.7 million, \$0.2 million, \$0.2 million and \$0.2 million related to our Latin America, North America, EMEA and Asia-Pacific (excluding Japan) operating segments, respectively. All employees have been terminated at December 31, 2004. The reductions in the second, third and fourth quarters are part of the previously announced cost-savings measures being implemented by us.

In September 2004, we announced the move of our European headquarters to Ireland, which is expected to be substantially completed by the first quarter of 2005. As a result of this relocation, approximately 80 employees in EMEA research and development, operations and finance were notified that their jobs would be moving to Ireland. We recorded restructuring charges of \$0.2 million and \$2.2 million in the third and fourth quarters of 2004, respectively. The costs will be substantially paid in the first half of 2005.

Also in September 2004, we permanently vacated an additional two floors in our Santa Clara headquarters building. We recorded a \$7.8 million accrual for the estimated lease related costs associated with the permanently vacated facility, offset by a \$1.3 million write off of deferred rent liability. 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 estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. We also recorded a non-cash charge of approximately \$0.8 million related to disposals of certain leasehold improvements. The restructuring charge of \$6.5 million and related cash outlay are based on management's current estimates.

In the fourth quarter of 2004, we permanently vacated several leased facilities and recorded a \$2.2 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with estimated costs associated with subleasing the vacated facility.

We adjusted the restructuring accruals related to severance costs and lease termination costs recorded in 2004. We recorded a \$0.3 million adjustment to reduce the EMEA severance accrual for amounts that were no longer necessary after paying out substantially all accrued amounts to the former employees. We also recorded a \$0.2 million reduction in lease termination costs due to changes in estimates related to the sublease income to be received over the remaining lease term of its Santa Clara headquarters building.

The following table summarizes our restructuring accrual established from January 1, 2004 through December 31, 2004 (in thousands):

| <b>Lease</b> | <b>Severance</b> |
|--------------|------------------|
|--------------|------------------|

|                            | <b>Termination</b> | <b>and<br/>Other</b> | <b>Other</b> | <b>Total</b> |
|----------------------------|--------------------|----------------------|--------------|--------------|
|                            | <b>Costs</b>       | <b>Benefits</b>      | <b>Costs</b> |              |
| Balance, January 1, 2004   | \$                 | \$                   | \$           | \$           |
| Restructuring accrual      | 8,685              | 7,932                | 480          | 17,097       |
| Cash payments              | (579)              | (4,175)              | (63)         | (4,817)      |
| Adjustment to liability    | (222)              | (275)                |              | (497)        |
| Accretion                  | 74                 |                      |              | 74           |
| Balance, December 31, 2004 | \$ 7,958           | \$ 3,482             | \$ 417       | \$ 11,857    |

### *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, 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 \$15.6 million accrual for estimated lease related

**Table of Contents**

costs associated with the permanently vacated facilities, offset by a \$1.9 million write-off of deferred rent liability. 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 estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. We also recorded a non-cash charge of approximately \$2.1 million related to asset disposals and discontinued use of certain leasehold improvements and furniture and equipment. The restructuring charge of \$15.8 million and related cash outlay are based on management's current estimates.

During the second and third quarters 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 restructuring charge related to headcount reductions was \$0.9 million and \$5.8 million in our North American and EMEA operating segments, respectively. 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 fourth quarters of 2003, we reversed a total of \$0.7 million of restructuring accrual in Europe that was no longer necessary after paying out substantially all accrued amounts to the former employees.

In 2004 and 2003, we adjusted the restructuring accrual related to lease termination costs previously recorded in 2003. The adjustments decreased the liability by approximately \$0.6 million and \$0.3 million due to changes in estimates related to the sublease income to be received over the remaining lease term. Also in 2004, we recorded a \$0.1 million adjustment to reduce the restructuring accrual for severance and benefits from our EMEA operating segment that would not be utilized.

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

|                            | <b>Lease<br/>Termination<br/>Costs</b> | <b>Severance<br/>and<br/>Other<br/>Benefits</b> | <b>Other<br/>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       |
| Cash payments              | (1,841)                                | (194)   |                        | (2,035)      |
| Adjustment to liability    | (623)                                  | (123)   |                        | (746)        |
| Accretion                  | 548                                    |   |                        | 548          |
| Balance, December 31, 2004 | \$ 12,301                              | \$  | \$                     | \$ 12,301    |

Our estimates of the excess facilities charge recorded during 2003 and 2004 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 charges in 2003 and 2004 were allocated to the North American operating segment.

*Restructuring Costs 2002.* As part of the plan to integrate certain activities of our PGP product group into our other product groups and to dispose of other product lines, we sold our Gauntlet business during the first quarter of 2002. In connection with this process, a restructuring charge of approximately \$1.1 million was recorded. The restructuring charge consists of costs of severance packages for 44 employees as well as related legal and outplacement services. All amounts were paid as of December 31, 2002.

*Amortization of Intangibles.* We expensed \$14.1 million, \$15.6 million and \$10.7 million of amortization related to intangibles in 2004, 2003, and 2002, respectively. Intangibles consist of identifiable intangible assets. The decrease in amortization of \$1.6 million in 2004 is the result of certain intangible assets becoming fully amortized in 2003 and 2004, partially offset by a \$0.5 million increase related to the acquisitions of IntruVert and Entercept in 2003 and Foundstone in 2004. The increase in amortization of \$4.9 million from 2002 to 2003 was primarily due to the full year impact in 2003 of amortization of intangible assets resulting from the acquisition of the McAfee.com minority interest in September 2002.

*Severance/Bonus Costs Related to Sniffer and Magic Dispositions.* In conjunction with the sale of the Sniffer product line, we incurred severance and bonuses to the former executives of Sniffer for their assistance in the transaction. The total bonuses and severance expensed was \$7.7 million in 2004, of which \$5.3 million has been paid, and the remaining \$2.4 million will be paid in the first quarter of 2006. Furthermore, we accelerated the vesting of these executives' stock options, which resulted in a stock-based compensation charge of approximately \$1.0 million.

**Table of Contents**

In conjunction with the Magic sale, we incurred bonus expense of approximately \$1.4 million for amounts paid to an executive.

*Reimbursement from Transition Services Agreement.* In conjunction with the Sniffer sale, we entered into a transition services agreement with Network General. Under this agreement, we provide certain back office services to Network General for a period of time, generally expected to be through June 2005. The reimbursements we have recognized under this agreement totaled approximately \$6.0 million in 2004.

*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 \$1.7 million in 2004. The recovery of doubtful accounts was \$1.2 million and \$0.2 million in 2003 and 2002, respectively.

*Acquisition Related Costs not Subject to Capitalization.* Acquisition costs not subject to capitalization consist primarily of expenses incurred by McAfee.com related to our exchange offer for all outstanding publicly held shares of McAfee.com class A common stock. As of December 31, 2002, these charges totaled \$16.0 million, or 2%, of net revenue. No additional costs were incurred after 2002.

*In-Process Research and Development.* In 2003, we expensed \$5.7 million of in-process research and development related to IntruVert. The ongoing project at IntruVert at the time of the purchase included the development of the Infinity model of IntruShield sensor. Infinity is a lower end model of the IntruShield sensor product family that is targeted towards remote offices and branch offices of large enterprises as well as small/medium businesses. At the date we acquired IntruVert, we estimated that, on average, 86% of the development effort had been completed and that the remaining 14% of the development effort would take approximately 2 1/2 months to complete and would cost \$0.3 million. The efforts required to complete the development of these projects principally related to finalization of coding, and completion of prototyping, verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The product was completed in the third quarter of 2003 and is being shipped to customers. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of our more effective distribution channel. These cash flows were discounted back to their net present value using a discount rate of 20% (which represents a premium of approximately 4% over our weighted average cost of capital) and excluding the value attributable to the use of the in-process technologies in future products.

In 2003, we expensed \$0.9 million of in-process research and development related to Entercept. The ongoing projects at Entercept at the time of the purchase consisted of a Linux version of their current product. At the date we acquired Entercept, we estimated that, on average, 31% of the development effort had been completed and that the remaining 69% of the development effort would take approximately eight months to complete and would cost \$0.3 million. The efforts required to complete the development of these projects principally related to additional design efforts, finalization of coding, and completion of prototyping, verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The product was released in the fourth quarter of 2004. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of the our more effective distribution channel. These cash flows were discounted back to their net present value using a discount rate of 35% (which represents a premium of approximately 19% over our weighted average cost of capital) and excluding the value attributable to the use of the in-process technologies in future products.



*Interest and Other Income.* Interest and other income was \$15.9 million in 2004, \$15.9 million in 2003 and \$27.3 million in 2002. Interest and other income remained consistent from 2003 to 2004 primarily due to an increase in cash and marketable securities of \$158.4 million from 2003 to 2004, partially offset by a \$1.3 million loss in 2004 on the interest rate swap we entered into in 2002. Interest and other income decreased from 2002 to 2003 due to a decrease of cash and marketable securities of \$247.5 million from 2002 to 2003 and an overall decrease in average yields on our marketable securities. In 2003, we used cash of approximately \$217.1 million to purchase Entercept and IntruVert and \$177.3 million to redeem the remaining portion of our outstanding zero coupon debentures.

*Interest and Other Expenses.* Interest and other expense was \$5.3 million in 2004, \$7.5 million in 2003 and \$25.1 million in 2002. Interest and other expense decreased from 2003 to 2004 due to the redemption and conversion of the convertible debt in August 2004. The \$17.6 million decrease in interest and other expenses from 2002 to 2003 was due to an \$8.8 million reduction related to the repurchase in 2003 of the remaining zero coupon debentures and a \$9.2 million reduction related to the realization of a full year of effect of the interest rate swap we entered into in July 2002.

*(Loss) gain on repurchase of convertible debt.* In 2004 and 2003, we recognized losses of \$15.1 million and \$2.7 million, respectively, on the redemption of all our remaining convertible debt. In 2003, we redeemed debt which had an aggregate face amount at maturity of \$358.0 million for approximately \$177.1 million resulting in a loss on redemption of \$2.7 million. In August 2004, we

**Table of Contents**

redeemed all of our outstanding \$345.0 million 5.25% convertible notes for approximately \$265.6 million in cash and the issuance of approximately 4.6 million of our common shares. The \$15.1 million loss was the result of the write-off of unamortized debt issuance costs, fair value adjustment of the debt and a 1.3125% premium paid for redemption.

*(Loss) gain on Investments, Net.* In 2004, we recognized a loss on the sale marketable securities of \$1.7 million. In 2003 and 2002, we recognized gains of \$3.1 million and \$3.8 million, respectively. Our investments are classified as available for sale and we may sell securities from time to time to move funds into investments with more lucrative investment yields, thus resulting in gains and losses on sale.

*Impairment of Strategic and Other Investments.* In 2002, we recorded impairment charges of \$0.2 million related to an other than temporary decline in the value of our venture and strategic investments. No such impairment charges were incurred in 2004 and 2003 as all of our investments had no carrying value.

*Provision for (benefit from) Income Taxes.* The provision for (benefit from) income taxes was \$91.4 million, \$16.8 million (including \$3.6 million included in the cumulative effect of change in accounting principle) and \$(0.3) million in 2004, 2003 and 2002, respectively. Tax expense was 28.9%, 18.1% (excluding \$3.6 million included in the cumulative effect of change in accounting principle) and 0% of income before income taxes and minority interest for 2004, 2003 and 2002, 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.

*Cumulative Effect of Change in Accounting Principle.* In 2003, we changed our method of accounting for recognizing commission expenses to sales personnel, and recorded a one-time credit of \$13.9 million, \$10.3 million net of tax. Prior to January 1, 2003, we expensed sales commissions as incurred. Commissions are now directly related to sales transactions and are deferred and recognized ratably over the same period as the revenue is recognized and recorded.

**Stock-Based Compensation**

We recognized stock-based compensation expense of \$14.3 million, \$12.5 million and \$22.4 million in 2004, 2003 and 2002, respectively, which is included in research and development, marketing and sales, general and administrative expenses and severance costs related to Sniffer disposition in the consolidated statements of income. Our stock-based compensation charges are comprised of the following for the years presented (in thousands):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b> |
| Exchange of McAfee.com options                                  | \$ 6,669                        | \$ 3,369    | \$ 16,101   |
| Former employees  | 1,216                           | 1,125       | 10,118      |
| New and existing executives and employees                       | 1,928                           | 424         | 1,478       |
| Extended life of vested options of terminated employees         | 1,164                           | 3,720       |             |
| Extended vesting term of options                                |                                 |             | 193         |
| Extended period of Employee Stock Purchase Plan                 |                                 | 3,869       |             |
| Shares purchased outside Employee Stock Purchase Plan and other |                                 |             | 62          |
| Repriced options  | 3,343                           |             | (5,548)     |
| Total stock-based compensation                                  | \$ 14,320                       | \$ 12,507   | \$ 22,404   |

Described below are the events giving rise to the stock-based compensation charges in 2004. These stock-based compensation charges are described in greater detail in Note 16 to our consolidated financial statements. We expect significant future stock-based compensation charges related to the exchange of McAfee.com options and repriced employee stock options, with the amount of these charges being impacted by fluctuations in our stock price.

*Exchange of McAfee.com options.* For 2004, 2003 and 2002, we recorded stock-based compensation of approximately \$6.7 million, \$3.4 million and \$16.1 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 \$28.93, \$15.04 and \$16.09, respectively. As of December 31, 2004, we had outstanding exchanged options to acquire approximately 0.4 million shares subject to this variable accounting. Further increases in our stock price may result in significant additional stock-based compensation expense related to these options.

*Former employees.* As a result of the Sniffer sale in July 2004, we modified the stock option agreements of several Sniffer executives by accelerating the vesting of their unvested options. We recorded a stock-based compensation charge of approximately \$1.0 million in 2004.

**Table of Contents**

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 continued to vest after termination and their exercise period was extended an additional 90 days, we recorded a one-time stock-based compensation charge of approximately \$0.1 million in 2004.

In October 2002, we terminated the employment of four former McAfee.com executives. These executives held McAfee.com exchanged options, which are subject to variable accounting. Upon termination, the options were modified in accordance with a change in control provision, which resulted in stock-based compensation charges of \$1.1 million and \$9.9 million in 2003 and 2002, respectively.

*New and existing executives and employees.* In September 2004, our chief financial officer and chief operating officer announced that he was retiring effective December 31, 2004. Under the terms of his transition agreement, all of his options vested on December 31, 2004. We recorded stock-based compensation expense due to the acceleration of vesting of \$1.3 million in 2004.

In connection with the acquisition of Foundstone in October 2004, we granted stock options to Foundstone employees which are subject to vesting provisions as the employees provide service to us. The total stock-based compensation charge was \$2.3 million, of which approximately \$0.2 million was recognized in 2004, and an additional \$0.5 million was reversed due to terminated employees. An additional \$1.4 million will be recognized through 2008, which is subject to a reduction based on employees terminating prior to full vesting of their options.

In January 2002, our board of directors granted 50,000 shares of restricted stock to our chief executive officer. The fair value of the restricted stock grant was \$1.4 million and is being recognized as stock-based compensation expense over the vesting period through January 2005. We recorded stock-based compensation expense of \$0.4 million, \$0.4 million and \$0.5 million in 2004, 2003 and 2002, respectively.

In January 2001, we entered into an employment agreement with our chief executive officer which provided for the grant of 400,000 shares of restricted stock that vested over a two year period from the date of grant. The fair value of the restricted stock was \$2.0 million, of which the remaining \$1.0 million was recognized as stock-based compensation expense in 2002.

*Extended life of vested options held by terminated employees.* As part of the purchase of Foundstone in October 2004, we granted stock options to Foundstone employees, certain of which terminated their employment after the acquisition. The terminated employees had 90 days to exercise their stock options from the date of termination, otherwise the options would expire. We determined in December 2004 that we would not be able to file the required public company reports with the SEC that would allow the option holders to exercise their options within the 90 day period. In December 2004, we extended the expiration date of the options approximately one month, resulting in a new measurement date for the options. We recorded a one-time stock-based compensation charge of \$1.0 million in 2004 due to the extension of the expiration date.

During a significant portion of 2003, we suspended exercises of stock options until our required public company reports were filed with the SEC. The period during which stock option exercises were suspended is known as the black-out period. Due to the blackout period, we have 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, we have recorded stock-based compensation charges on the dates the options should have terminated based on the intrinsic value of the option on the modification date and the option price. In 2004 and 2003, we recorded stock-based compensation charges of approximately \$0.1 million and \$3.7 million, respectively.

*Extended period of Employee Stock Purchase Plan.* During the blackout period in 2003, we suspended all stock purchases under our 2002 Employee Stock Purchase Plan ( 2002 Purchase Plan ). Due to the blackout period, we extended the purchase period for shares in the 2002 Purchase Plan that would otherwise have been purchased on July 31, 2003. Accordingly, in 2003 we recorded a one-time stock-based compensation charge of approximately \$3.9 million.

*Repriced Options.* In April 1999, we offered to substantially all of our employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price equivalent to the fair market value of our stock at the time of grant. Options to purchase a total of 9.5 million shares were cancelled and the same number of new options were granted. These new options vest at the same rate that they would have vested under previous option plans and are subject to variable accounting. Stock-based compensation expense will be recorded in the event our stock price closes above \$20.375 at the end of period. We have and will continue to remeasure compensation cost for these repriced options until these options are exercised, cancelled or forfeited without replacement. Depending upon movements in the market value of our common stock, this accounting treatment may result in additional stock-based compensation charges or reversals in future periods.

During 2004 and 2002, we incurred charges (credits) to earnings of approximately \$3.3 million and (\$6.5) million, respectively, based on closing stock prices of \$28.93 and \$16.09, respectively. We did not record any stock-based compensation for the repriced

**Table of Contents**

options in 2003 as our stock price was below \$20.375 as of December 31, 2002 and throughout 2003. As of December 31, 2004, 0.3 million options were outstanding and subject to variable accounting.

We also incurred an initial stock-based compensation charge in connection with the initial issuance of the repriced options. Approximately \$1.0 million was recorded in 2002.

*Impact of Recent Accounting Pronouncement on Stock-Based Compensation.* In December 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS 123R, *Share Based Payment* ( SFAS 123R ) which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the consolidated statements of income. The accounting provisions of SFAS 123R are effective for reporting periods beginning after June 15, 2005. We are required to adopt SFAS 123R in the third quarter of 2005. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. See Note 2 for the pro forma net income and net income per share amounts, for fiscal 2002 through fiscal 2004, as if we had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although we have not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, we are evaluating the requirements under SFAS 123R and expect the adoption to have a significant adverse impact on the consolidated results of operations.

**Acquisition***Foundstone, Inc.*

On October 1, 2004, we acquired 100% of the outstanding capital shares of Foundstone, Inc., a provider of risk assessment and vulnerability services and products for \$82.5 million in cash and \$3.1 million of direct expenses, totaling \$85.6 million. Total consideration paid for the acquisition was \$90.4 million including \$4.8 million for the fair value of vested stock options assumed in the acquisition. We acquired Foundstone to enhance our network protection product line. The results of operations of Foundstone have been included in our consolidated financial statements since the date of acquisition.

Under the transaction, we recorded approximately \$27.0 million for developed technology, \$1.0 million for acquired product rights, including revenue related order backlog and contracts, \$0.6 million for trade names/trademarks and non-compete arrangements, \$59.2 million for goodwill (none of which is deductible for tax purposes), \$2.6 million for net deferred tax liabilities and \$5.1 million of tangible assets, net of liabilities. The intangible assets acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to 6.5 years or a weighted average period of 6.4 years. We accrued \$0.3 million in severance costs for employees terminated at the time of the acquisition, of which less than \$0.1 million remains as an accrual as of December 31, 2004.

**Liquidity and Capital Resources**

|  | <b>2004</b>           | <b>2003</b>  | <b>2002</b>  |
|--|-----------------------|--------------|--------------|
|  | <b>(In thousands)</b> |              |              |
| Cash, cash equivalents and investments             | \$ 924,681            | \$ 766,257   | \$ 1,013,709 |
| Net cash provided by operating activities          | \$ 358,913            | \$ 156,304   | \$ 195,093   |
| Net cash used in investing activities              | \$ (39,373)           | \$ (374,480) | \$ (183,646) |
| Net cash (used in)provided by financing activities | \$ (369,867)          | \$ (146,579) | \$ 43,736    |

*Overview*

We ended 2004 with cash, cash equivalents and investments totaling \$924.7 million, as compared to \$766.3 million at the end of 2003. The increase was due primarily to our sale of Sniffer in July 2004 for cash proceeds of \$213.8 million, net of direct expenses; our sale of Magic Solutions in January 2004 for cash proceeds of \$47.1 million, net of direct expenses; the receipt of \$113.8 million in proceeds from stock issued under options and employee stock purchase plans; the receipt of \$25.0 million in reimbursements from our insurance carriers related to the securities class action lawsuit; and an increase in deferred revenue, net of dispositions of businesses, of \$161.9 million. The receipts of cash were partially offset by our use of \$265.6 million to repurchase the remaining balance of convertible debt; our use of \$221.8 million to repurchase shares of our common stock; our use of \$210.6 million for the net purchase of marketable securities; and our use of \$84.7 million to purchase Foundstone. A more detailed discussion of changes in our liquidity follows.

***Operating Activities***

Net cash provided by operating activities in 2004, 2003 and 2002 was primarily the result of our net income of \$225.1 million, \$70.2 million and \$128.3 million, respectively, which is adjusted for non-cash items such as depreciation and amortization, non-cash restructuring charges, acquired in-process research and development, stock-based compensation, tax benefits from the exercise of

## **Table of Contents**

employee stock options and changes in various assets and liabilities such as accounts payable, deferred revenue, 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 71 days, 92 days and 69 days at December 31, 2004, 2003 and 2002, respectively. We calculate accounts receivable DSO on a gross basis by dividing the gross 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 to vary from period to period because of changes in quarterly revenue and the effectiveness of our collection efforts. In 2004, 2003 and 2002, we have not made any significant changes to our payment terms for our customers, which are generally net 30.

Our balances in accounts payable, accrued liabilities and accrued taxes and other liabilities increased from \$402.1 million at December 31, 2003 to \$435.1 million at December 31, 2004, causing a \$6.1 million increase in cash from operating activities, net of acquisitions, dispositions and non-cash items. The increase is primarily due to an increase in accrued taxes payable. Our operating cash flows will be impacted in the future based on the timing of payments to our vendors for accounts payable and to taxing authorities. 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 and management's assessment of our cash inflows. In 2004, 2003 and 2002, we have not made 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 December 31, 2004, approximately \$327.8 million of our cash and cash equivalents were held outside the United States. 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. We have provided for U.S. federal income taxes on these amounts for consolidated financial statement purposes, except for foreign earnings that are considered indefinitely reinvested outside the United States. The American Jobs Creations Act of 2004 ( AJCA ) introduced a limited time 85% dividends received reduction on the repatriation of certain foreign earnings to a U.S. taxpayer, provided certain criteria are met. We are analyzing the impact of the AJCA and may repatriate to the United States some or all of our offshore earnings currently characterized as indefinitely reinvested outside the United States. The range of possible amounts we are considering for repatriation under this provision is between \$0 and \$500 million, and the range of potential additional income taxes is between \$0 and \$30 million.

Our working capital, defined as current assets minus current liabilities, was \$259.9 million and \$415.8 million at December 31, 2004 and December 31, 2003, respectively. The cause of the decrease in working capital of approximately \$155.9 million is primarily due to the \$132.8 million increase in the current portion of deferred revenue. Our new perpetual plus licensing model results in less revenue recognition up-front, therefore causing increases in our deferred revenue. Additionally, the strengthening of foreign currencies against the U.S. dollar resulted in an increase in deferred revenue of approximately \$18 million. The remainder of the decrease in working capital is primarily due to an increase in the current portion of accrued taxes payable from 2003 to 2004.

We are currently under an SEC and DOJ investigation. 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 December 31, 2004, 2003 and 2002 is as follows (in thousands). The detail of these line items can be seen in our consolidated statement of cash flows:

| <b>Activity</b>  | <b>2004</b> | <b>2003</b>  | <b>2002</b>  |
|--|-------------|--------------|--------------|
| Cash payments for acquisitions, net                              | \$ (84,650) | \$ (217,256) | \$ (118,308) |
| Cash payments for property and equipment                         | (25,374)    | (60,027)     | (59,427)     |
| Net (purchases) proceeds of investments in marketable securities | (210,588)   | (97,861)     | 8,668        |
| Decrease(increase) in restricted cash                            | 19,930      | 664          | (21,734)     |
| Proceeds from sale of assets and technology                      | 261,309     |              | 7,155        |
| Net cash used in investing activities                            | \$ (39,373) | \$ (374,480) | \$ (183,646) |

## **Table of Contents**

### *Acquisitions*

In 2004, we paid cash for our acquisition of Foundstone in the amount of \$84.7 million, net of cash assumed. In 2003, we paid cash for our acquisitions of Entercept and IntruVert in the amount of \$124.8 million and \$92.3 million, respectively. We purchased IntruVert and Entercept to enhance our network intrusion prevention products. In September 2002, to, among other things, reduce customer and brand confusion, we acquired the outstanding minority interest in McAfee.com for a combination of shares our common stock and \$98.4 million total cash payments. In 2002, we also purchased several smaller entities for cash in the amount of \$19.1 million in order to enhance our products and improve distribution in Latin America.

We may buy or make investments in complementary companies, products and technologies. Our available cash and equity and debt securities may be used to acquire or invest in companies or products, possibly resulting in significant acquisition-related charges to earnings and dilution to our stockholders.

We have also made divestitures previously. In July and January 2004, we completed the sales of our Sniffer and Magic businesses, respectively, as part of our continued focus on security and security related products. In 2004, we received cash proceeds of approximately \$213.8 million for the Sniffer sale and approximately \$47.1 million for the Magic sale.

### *Property and Equipment*

We added \$25.4 million of equipment during 2004 to update hardware for our employees and enhance various back office systems and purchases of equipment for our Bangalore research and development facility. We added \$60.0 million of equipment during 2003 to update hardware for our employees and enhance various back office systems, including our new customer relationship management system which we deployed in early 2004. In 2002, we added \$59.4 million of property and equipment, including approximately \$17.0 million related to the construction of our regional office in Plano, Texas. Our property and equipment additions have been funded from operations.

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.

### *Investments*

We (made net purchases of) and received net proceeds from sales/maturities of our marketable securities of \$(210.6) million, \$(97.9 million), and \$8.7 million in 2004, 2003 and 2002, 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 corporate bonds and U.S. government agency securities to maturity; however, 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 or sale of our investments has no material impact on our overall liquidity.

### *Restricted Cash*

At December 31, 2003, we had on deposit approximately \$20.2 million 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 required us to 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. The swap agreement terminated in October 2004. The December 31, 2004 restricted cash balance of \$0.6 million consists primarily of cash collateral related to our workers' compensation insurance coverage.

***Financing Activities***

The primary uses of cash for financing activities in 2004 were the use of \$265.6 million of cash to repurchase our convertible debt, and the use of \$221.8 million for the repurchase common stock. In 2003 and 2002, we also repurchased debt using \$177.3 million and \$66.2 million of cash, respectively.

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. We received cash proceeds from these plans in the amount of \$113.8 million, \$35.4 million and \$109.9 million in 2004, 2003 and 2002, respectively. While we expect to continue to receive these proceeds in future periods, the timing and amount of such proceeds are difficult to predict and are 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.

**Table of Contents**

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, resulting in no cash received by us. The decrease in cash proceeds from the exercise of stock options and employee stock purchase plans from 2002 to 2003 was primarily the result of the blackout period in most of 2003 due to our restatement. 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 and increased in 2004.

We have a \$17.0 million credit facility with a bank. The credit facility 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 the 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. No balances are outstanding as of December 31, 2004.

**Contractual Obligations**

Subsequent to the issuance of our Form 10-K, we determined that our contractual obligations as of December 31, 2004 had been improperly calculated. As a result, the amounts in the table below have been restated from amounts previously reported. The restated summary of our contractual obligations at December 31, 2004 is as follows (in thousands):

|                                | <b>Total</b>      | <b>Payments Due by Period</b> |                  |                  | <b>More Than 5 Years</b> |
|--------------------------------|-------------------|-------------------------------|------------------|------------------|--------------------------|
|                                |                   | <b>Less Than 1 Year</b>       | <b>1-3 Years</b> | <b>3-5 Years</b> |                          |
| <b>Contractual Obligations</b> |                   |                               |                  |                  |                          |
| Operating leases(1)            | \$ 100,578        | \$ 20,025                     | \$ 25,424        | \$ 17,680        | \$ 37,449                |
| Other commitments(2)           | 23,720            | 10,464                        | 10,741           | 2,515            |                          |
| Purchase obligations(3)        | 3,277             | 3,277                         |                  |                  |                          |
| <b>Total</b>                   | <b>\$ 127,575</b> | <b>\$ 33,766</b>              | <b>\$ 36,165</b> | <b>\$ 20,195</b> | <b>\$ 37,449</b>         |

- 
- (1) Operating leases are for office space and office equipment. The operating lease commitments above reflect contractual and reasonably assured rent escalations under the lease arrangements. The majority of our lease contractual obligations relate to the following three leases: \$51.2 million for the Santa Clara, California facility lease, \$20.5 million for the Slough, United Kingdom facility lease and \$5.2 million for the Cork, Ireland facility lease.
- (2) Other commitments are minimum commitments on telecom contracts and contractual commitments for naming rights and advertising services.
- (3) We generally issue purchase orders to our contract manufacturers with delivery dates from four to six weeks from the purchase order date. In addition, we regularly provide such contract manufacturers with rolling six-month forecasts of product requirements for planning and long-lead time parts procurement purposes only. We are committed to accept delivery of materials pursuant to our purchase orders subject to various contract provisions which allow us to delay receipt of such order or allow us to cancel orders beyond certain agreed lead times. Such cancellations may or may not include cancellation costs payable by us. If we are unable to

adequately manage our contract manufacturers and adjust such commitments for changes in demand, we may incur additional inventory expenses related to excess and obsolete inventory.

### **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 consolidated financial statements.

### **Convertible Debt**

On August 17, 2001, we issued 5.25% convertible subordinated notes ( Notes ) 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 had a maturity date of August 15, 2006, unless earlier redeemed by us at our option or converted at the holder's option. Interest was 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 could be converted into our common stock at any time, unless previously redeemed, at a conversion price of \$18.07 per share. We had the option to redeem all or a portion of the Notes for cash at a repurchase price of 101.3125% of the principal amount at any time between August 20, 2004 and August 14, 2005. On August 20, 2004, we redeemed the outstanding balance for approximately \$265.6 million in cash. Prior to the redemption date, approximately \$83.4 million in aggregate principal was converted into approximately 4.6 million shares of our common stock. We recorded a loss on redemption of the Notes of

## **Table of Contents**

approximately \$15.1 million due to the write-off of unamortized debt issuance costs, fair value adjustment of the debt and the premium paid for redemption.

We had interest rate swap agreements with two banks to hedge the interest rate risk on the Notes. The Swap agreements had a maturity date of August 15, 2006, subject to early termination provisions if on or after August 20, 2004 and prior to August 15, 2006 the average closing price of our common stock equals or exceeds \$22.59 per share for a five-day period. We left the swap agreements intact after the Notes were redeemed in August 2004. On October 27, 2004, the swap agreements automatically terminated under the terms of the agreements as our five-day average stock price equaled the \$22.59 threshold.

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 redeem 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.

## **Stock Repurchases**

In 2004 and 2003, we repurchased 12.6 million and 0.4 million shares of our common stock in the open market for \$221.8 million and \$4.7 million, respectively. As of December 31, 2004, we were authorized to repurchase an additional \$123.6 million of our common stock from time to time through August 2006, depending upon market conditions, share price and other factors.

We repurchased approximately 2.0 million shares of our common stock in the open market for \$47.4 million in March 2005.

## **Financial Risk Management**

The following discussion about our risk management activities includes forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements.

### ***Foreign Currency Risk***

As a global concern, we face exposure to movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. Our primary exposures are related to non U.S. dollar-denominated sales and operating expenses in Japan, Canada, Australia, Europe, Latin America, and Asia. At the present time, we hedge only those currency exposures associated with certain assets and liabilities denominated in nonfunctional currencies and do not generally hedge anticipated foreign currency cash flows. Our hedging activity is intended to offset the impact of currency fluctuations on certain nonfunctional currency assets and liabilities. The success of this activity depends upon estimates of transaction activity denominated in various currencies, primarily the Japanese Yen, Canadian dollar, Australian dollar, the Euro, and the British Pound. To the extent that these estimates are overstated or understated during periods of currency volatility, we could experience unanticipated currency gains or losses.

To reduce exposures associated with nonfunctional net monetary asset positions in various currencies, we enter into spot, forward and swap foreign exchange contracts. Our foreign exchange contracts typically range from one to three months in original maturity. In general, we have not hedged anticipated foreign currency cash flows nor do we enter into forward contracts for trading purposes. We do not use any derivatives for speculative purposes. Our existing

forward contracts do not qualify for hedge accounting and accordingly are marked to market at the end of each reporting period with any unrealized gain or loss being recognized in the consolidated statements of income. Net realized gains and losses arising from settlement of our forward foreign exchange contracts were not significant in 2004, 2003, and 2002.

The forward contracts outstanding and their fair values are presented below as of December 31 (in thousands):

|                        | 2004              |               | 2003              |               |
|------------------------|-------------------|---------------|-------------------|---------------|
|                        | Carrying<br>Value | Fair<br>Value | Carrying<br>Value | Fair<br>Value |
| Euro                   | \$ 116            | \$ 116        | \$ 490            | \$ 490        |
| British Pound Sterling | 288               | 288           | 54                | 54            |
| Brazilian Real         | 420               | 420           |                   |               |
| Singapore Dollar       |                   |               | (16)              | (16)          |
| Japanese Yen           | 1                 | 1             |                   |               |
| Australian Dollar      | 4                 | 4             | 75                | 75            |
| Canadian Dollar        | 39                | 39            | 255               | 255           |
|                        | \$ 868            | \$ 868        | \$ 858            | \$ 858        |

**Table of Contents*****Interest Rate Risk***

In July 2002, we 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 Note due 2006 (Notes) (See Note 7 to the consolidated financial statements).

The notional amount of the Transactions was \$345.0 million to match the entire principal amount of the Notes. We received 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, we paid 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 were to 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 five-day average closing price of our common stock were to equal or exceed \$22.59. On October 27, 2004, the Transactions automatically terminated as our five-day average common stock price equaled \$22.59.

The Transactions qualified and were designated as a fair value hedge under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* to 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 was recognized at fair value on the consolidated balance sheet with an offsetting entry to the consolidated income statement. In addition, changes in fair value of the Notes due to changes in the benchmark interest rate were recognized as a basis adjustment to the carrying amount of the Notes with an offsetting entry to the consolidated 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 were recognized as interest and other expense. The net gain recorded as of December 31, 2003 was approximately \$5.6 million. There was no net gain or loss as of December 31, 2004 as the Transactions terminated in October 2004.

To test effectiveness of the hedges, regression analysis was 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 were calculated at least quarterly 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 our stock prices. For the year ended December 31, 2003, the hedge was highly effective and therefore, the ineffective portion did not have a material impact on earnings.

In support of our obligation under the Transactions, we were 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 was presented as restricted cash in our consolidated financial statements at December 31, 2003.

***Cash Management Risk***

We maintain balances in cash, cash equivalents and investment securities. We maintain our investment securities in portfolio holdings of various issuers, types and maturities including money market, government, agency and corporate bonds. These securities are classified as available-for-sale, and consequently are recorded on the consolidated balance sheet at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income. These securities are not leveraged and are held for purposes other than trading.

The following tables present the hypothetical changes in fair values in the securities held at December 31, 2004 that are sensitive to the changes in interest rates. The modeling technique used measures the change in fair values arising from hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS), 100 BPS and 150 BPS over six and twelve-month time horizons. Beginning fair values represent the market principal plus accrued



interest and dividends at December 31, 2004. Ending fair values are the market principal plus accrued interest, dividends and reinvestment income at six and twelve month time horizons.

The following table estimates the fair value of the portfolio at a six-month time horizon (in millions):

| Issuer                                | Valuation of Securities Given an Interest Rate Decrease of X Basis Points |          | No Change in Interest Rate | Valuation of Securities Given an Interest Rate Increase of X Basis Points |          |          |
|---------------------------------------|---|----------|----------------------------|---|----------|----------|
|                                       | 100 BPS   | 50 BPS   |                            | 50 BPS  | 100 BPS  | 150 BPS  |
| U.S. Government notes and bonds       | \$ 288.8  | \$ 287.3 | \$ 285.8                   | \$ 285.4  | \$ 283.9 | \$ 282.4 |
| Municipal bonds                       | 4.9   | 4.9      | 4.9                        | 4.9   | 4.9      | 4.9      |
| Corporate notes, bonds and preferreds | 422.1   | 421.1    | 420.1                      | 419.1   | 418.1    | 417.1    |
| Total                                 | \$ 715.8  | \$ 713.3 | \$ 710.8                   | \$ 709.4  | \$ 706.9 | \$ 704.4 |

**Table of Contents**

The following table estimates the fair value of the portfolio at a twelve-month time horizon (in millions):

| <b>Issuer</b>                         | <b>Valuation of Securities Given an Interest Rate Decrease of X Basis Points</b> |                 | <b>No Change in Interest Rate</b> | <b>Valuation of Securities Given an Interest Rate Increase of X Basis Points</b> |                 |                 |
|---------------------------------------|--|-----------------|-----------------------------------|--|-----------------|-----------------|
|                                       | <b>100 BPS</b>   | <b>50 BPS</b>   |                                   | <b>50 BPS</b>  | <b>100 BPS</b>  | <b>150 BPS</b>  |
| U.S. Government notes and bonds       | \$ 292.9   | \$ 291.6        | \$ 290.3                          | \$ 289.1   | \$ 287.8        | \$ 286.5        |
| Municipal bonds                       | 5.0  | 5.0             | 5.0                               | 5.0  | 5.0             | 5.0             |
| Corporate notes, bonds and preferreds | 428.3  | 427.5           | 426.6                             | 425.8  | 425.0           | 424.2           |
| <b>Total</b>                          | <b>\$ 726.2</b>  | <b>\$ 724.1</b> | <b>\$ 721.9</b>                   | <b>\$ 719.9</b>  | <b>\$ 717.8</b> | <b>\$ 715.7</b> |

**Recent Accounting Pronouncements Update**

See Note 2 of the consolidated financial statements for a full description of recent accounting pronouncements, including the expected dates of adoption and effects on financial condition, results of operations and cash flows.

## **Table of Contents**

### **Item 9A. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

Our management evaluated, with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), the effectiveness of the design and operation 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 (the Exchange Act)) as of the end of the period covered by this annual report on Form 10-K/A. Based on this evaluation, and because of the material weaknesses in our internal control over financial reporting described below, our management, including our CEO and CFO, has concluded that, as of December 31, 2004, our disclosure controls and procedures were ineffective to ensure that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

#### **Management's Report on Internal Control over Financial Reporting**

Our management, with the participation of our CEO and CFO, is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) of the Exchange Act. Our internal controls are designed to provide reasonable assurance to our management and members of our Board of Directors regarding the preparation and fair presentation of published financial statements in accordance with generally accepted accounting principles of the United States of America (GAAP).

As part of our compliance efforts relative to Section 404 of the Sarbanes-Oxley Act of 2002, our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth in the *Internal Control - Integrated Framework* by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In performing the assessment, our management has identified three material weaknesses in internal control over financial reporting existing as of December 31, 2004.

#### **Accounting for Income Taxes**

While preparing the annual provision for 2004 income taxes, we identified certain unreconciled differences in our tax reserve accounts dating back to calendar years 2002 and 2003. After further analysis, we determined that no adjustments were required to prior or current year financial statements. However, in reaching this conclusion, our management noted that there was a lack of historic analysis and documentation, ineffective account reconciliation procedures, and insufficient tax accounting personnel which did not allow the timely calculation of the year end tax provisions. Given the significance of the tax account balances and the absence of sufficient mitigating controls, these deficiencies which existed as of December 31, 2004 represent a material weakness in internal control over financial reporting on the basis that there is more than a remote likelihood that a material misstatement in our interim or annual financial statements due to errors in accounting for income taxes could occur and would not be prevented or detected by our internal control over financial reporting.

#### **Revenue Accounting**

In August 2004, we restated our results for the first quarter of 2004 as a result of revenue accounting misstatements that resulted from the improper system set up of a limited number of product stock keeping units. Subsequent to this event, we took action to remediate our revenue accounting controls. During the fourth quarter 2004 review and audit process, we noted that certain revenue accounting controls relating to (a) the analysis of transactions in certain

geographies and (b) the deferral and amortization of the appropriate amounts of post contract support had not operated as designed and adjustments were recorded in the consolidated financial statements for the year ended December 31, 2004 to correct the identified errors. Our management has concluded that given the magnitude of the revenue adjustments recorded and the potential for misstatements to occur as a result of internal control deficiencies in revenue accounting existing as of December 31, 2004, there is more than a remote likelihood that a material misstatement in our interim or annual financial statements could occur and would not be prevented or detected by our internal control over financial reporting.

## **Table of Contents**

### **Financial Close and Reporting Process**

During the 2004 year end review and audit process, we identified a series of adjustments relating to complex transactions and balance sheet reconciliations and were unable to complete the financial close process in a timely manner due to a lack of sufficient accounting personnel. Given the number of adjustments identified, the significance of the financial closing and reporting process to the preparation of reliable financial statements, and the potential for errors to significant account balances to occur as of December 31, 2004, our management has concluded that there is more than a remote likelihood that a material misstatement in our interim or annual financial statements could occur and would not be prevented or detected by our internal control over financial reporting.

As a result of the material weaknesses described above, management's conclusion is that, as of December 31, 2004, the Company did not maintain effective internal control over financial reporting based upon the criteria set forth in COSO's *Internal Control - Integrated Framework*.

Deloitte & Touche LLP, an independent registered public accounting firm, has issued an attestation report on management's assessment of our internal control over financial reporting. That report appears below.

On October 1, 2004, we completed the acquisition of all of Foundstone, Inc., as discussed elsewhere in this report under Business Overview, Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 4 to our consolidated financial statements. Therefore, in making management's assessment of the effectiveness of our internal control over financial reporting, we have excluded Foundstone, whose financial statements reflect total assets and revenues constituting 0.6% and 0.3%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004, from our report on internal control over financial reporting as management did not have sufficient time to make an assessment of Foundstone's internal controls using the COSO criteria in accordance with Section 404 of the Sarbanes-Oxley Act.

### **Changes in Internal Control over Financial Reporting**

We undertook significant efforts in 2004 to establish a framework to improve internal controls over financial reporting. We committed considerable resources to the design, implementation, documentation and testing of our internal controls. Additional efforts were required to remediate and re-test certain internal control deficiencies. Our management believes that these efforts have improved our internal control over financial reporting.

While these steps have helped address some of the internal control deficiencies noted above, they have not been sufficient to remedy the control issues that existed as of December 31, 2004. We are taking the following steps to remediate these material weaknesses:

Increasing the number of internal general ledger and tax accounting personnel trained in reporting under accounting principles generally accepted in the United States (GAAP)

Improving the documentation, communication and periodic review of our accounting policies throughout our domestic and international locations for consistency and application with GAAP at each of our operating locations

Improving the interim and annual review and reconciliation process for certain key account balances

Enhancing the training and education for our international finance and accounting personnel and new hire additions to the worldwide finance team

Implementing more stringent policies and procedures regarding revenue accounting and change management of our product catalogue

Directing more internal audit time and attention to sales order processing and revenue accounting activities

Increasing diligence regarding user access and change management to our network, databases and applications

Automating certain controls that are currently performed manually

Simplifying and integrating systems

**Table of Contents**

**Inherent Limitation on the Effectiveness of Internal Controls**

The effectiveness of any system of internal control over financial reporting, including McAfee's, is subject to inherent limitations, including the exercise of judgment in designing, implementing, operating, and evaluating the controls and procedures, and the inability to eliminate misconduct completely. Accordingly, any system of internal control over financial reporting, including McAfee's, can only provide reasonable, not absolute assurances. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. We intend to continue to monitor and upgrade our internal controls as necessary or appropriate for our business, but cannot assure you that such improvements will be sufficient to provide us with effective internal control over financial reporting.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Stockholders of McAfee, Inc. (formerly known as Network Associates, Inc.):**

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting ( Management's Report ), that McAfee, Inc. and subsidiaries (the Company ) did not maintain effective internal control over financial reporting as of December 31, 2004, because of the effect of the material weaknesses identified in management's assessment based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in Management's Report, management excluded from their assessment the internal control over financial reporting at Foundstone, Inc. which was acquired on October 1, 2004 and whose financial statements reflect total assets and revenues constituting 0.6% and 0.3%, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2004. Accordingly, our audit did not include the internal control over financial reporting at Foundstone, Inc. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management's assessment:



**Table of Contents**

The Company's controls over the calculation of the income tax provision, taxes payable and deferred income tax amounts did not operate effectively as of December 31, 2004. In particular, (1) the Company did not have a sufficient number of personnel with adequate expertise in income tax accounting matters, (2) historical analyses were not maintained in sufficient detail and (3) account reconciliations, which are necessary to detect whether income tax amounts are calculated properly and recorded in the proper period, were not completed and reviewed in time to permit timely reporting of financial results. Due to the potential that a material misstatement could occur related to the income tax amounts and the absence of mitigating controls, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

The Company's controls over the recognition of revenue for software contracts did not operate effectively as of December 31, 2004. In particular, controls to properly apply the provisions of AICPA Statement of Position 97-2, *Software Revenue Recognition* (as amended) to (1) analyze the terms of new contracts from a certain geographic region and (2) defer and amortize the appropriate amount applicable to post contract support, did not operate effectively and audit adjustments to defer revenue that had been improperly recognized were recorded by the Company for the quarter ended December 31, 2004. Such adjustments in the aggregate were material to the interim financial statements for that period and the potential misstatement could have been material to the annual financial statements. In addition, based on (1) the amount of the misstatements identified and the potential for additional misstatements related to the revenue recognized, (2) the elevated risk of misstatement associated with revenue recognition and (3) the absence of mitigating controls, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

The Company's controls over the period-end financial closing and reporting process are inadequate and constitute a material weakness in the design of internal control over financial reporting. Specifically, the Company lacks sufficient resources with the appropriate level of technical accounting expertise within the accounting function and therefore was unable to accurately perform certain of the designed controls over the December 31, 2004 financial closing and reporting process on a timely basis, evidenced by a significant number of adjustments which were necessary to present the financial statements for the year ended December 31, 2004 in accordance with generally accepted accounting principles. Based on (1) the misstatements identified and (2) the significance of the financial closing and reporting process to the preparation of reliable financial statements, there is a more than remote likelihood that a material misstatement of the interim and annual financial statements would not have been prevented or detected.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2004 of the Company and this report does not affect our report on such consolidated financial statements and financial statement schedule.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2004, of the Company and our report dated March 30, 2005 (May 19, 2005 as to the effects of the

restatement described in Note 11) expressed an unqualified opinion on such consolidated financial statements and financial statement schedule.

DELOITTE & TOUCHE LLP

San Jose, California

March 30, 2005

**Table of Contents**

**Part IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a)(1) *Financial Statements:*

|  | <b>Page<br/>Number</b> |
|--|------------------------|
| <u>Reports of Independent Registered Public Accounting Firms</u>   | 32                     |
| <u>Consolidated Balance Sheets:</u>                                |                        |
| <u>December 31, 2004 and 2003</u>                                  | 34                     |
| <u>Consolidated Statements of Income and Comprehensive Income:</u> |                        |
| <u>Years ended December 31, 2004, 2003 and 2002</u>                | 35                     |
| <u>Consolidated Statements of Stockholders' Equity:</u>            |                        |
| <u>Years ended December 31, 2004, 2003 and 2002</u>                | 37                     |
| <u>Consolidated Statements of Cash Flows:</u>                      |                        |
| <u>Years ended December 31, 2004, 2003, and 2002</u>               | 38                     |
| <u>Notes to Consolidated Financial Statements</u>                  | 39                     |

(a)(2) *Financial Statement Schedule*

The following financial statement schedule of McAfee, Inc. for the years ended December 31, 2004, 2003, and 2002 is filed as part of this Form 10-K and should be read in conjunction with McAfee, Inc.'s Consolidated Financial Statements.

Schedule II Valuation and Qualifying Accounts on Page 126

Schedules not listed above have been omitted because they are not applicable or are not required or because the required information is included in the Consolidated Financial Statements or Notes thereto.

(a)(3) *Exhibits:* See Index to Exhibits on Page 123. The Exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as part of this report.

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of  
McAfee, Inc. (formerly Network Associates, Inc.):

We have audited the accompanying consolidated balance sheet of McAfee, Inc. and subsidiaries (the Company) as of December 31, 2004, and the related consolidated statements of income and comprehensive income, stockholders equity, and cash flows for the year then ended. Our audit also included the financial statement schedule listed in the Index at Item 15(a)(2) for the year ended December 31, 2004. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such 2004 consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2004, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such 2004 financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 30, 2005 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an adverse opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

San Jose, California  
March 30, 2005 (May 19, 2005 as to Note 11)

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders  
of McAfee, Inc. (formerly Networks Associates, Inc.):

In our opinion, the consolidated balance sheet as of December 31, 2003 and the related consolidated statements of income and comprehensive income, of shareholders' equity and of cash flows for each of the two years in the period ended December 31, 2003 present fairly, in all material respects, the financial position, results of operations and cash flows of McAfee, Inc. and its subsidiaries at December 31, 2003 and for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15 (a) (2) for each of the two years in the period ended December 31, 2003 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 3 to the consolidated financial statements, the Company changed its method of accounting for sales commissions effective January 1, 2003.

/s/ PricewaterhouseCoopers LLP

Dallas, Texas  
February 26, 2004

**Table of Contents**

**MCAFEE, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

|  | <b>December 31,</b><br><b>2004            2003</b><br><b>(In thousands, except<br/>share data)</b> |              |
|--|--|--------------|
| <b>ASSETS</b>  |  |              |
| Current assets:  |  |              |
| Cash and cash equivalents  | \$ 291,155   | \$ 333,651   |
| Short-term marketable securities   | 232,929  | 174,499      |
| Accounts receivable, net of allowance for doubtful accounts of \$2,536 and \$2,863, respectively | 137,520  | 170,218      |
| Prepaid expenses, income taxes and other current assets  | 103,687  | 97,616       |
| Deferred income taxes  | 200,459  | 160,550      |
| Assets held for sale   |  | 24,719       |
| <br>   |  |              |
| Total current assets   | 965,750  | 961,253      |
| Long-term marketable securities  | 400,597  | 258,107      |
| Restricted cash  | 617  | 20,547       |
| Property and equipment, net  | 91,715   | 111,672      |
| Deferred income taxes  | 220,604  | 199,196      |
| Intangible assets, net   | 107,133  | 105,952      |
| Goodwill   | 439,180  | 443,593      |
| Other assets   | 12,080   | 20,178       |
| <br>   |  |              |
| Total assets   | \$ 2,237,676   | \$ 2,120,498 |
| <br><b>LIABILITIES</b>   |  |              |
| Current liabilities:   |  |              |
| Accounts payable   | \$ 32,891  | \$ 32,099    |
| Accrued liabilities  | 197,368  | 147,281      |
| Deferred revenue   | 475,621  | 342,795      |
| Liabilities related to assets held for sale  |  | 23,310       |
| <br>   |  |              |
| Total current liabilities  | 705,880  | 545,485      |
| Deferred revenue, less current portion   | 125,752  | 116,762      |
| Convertible debt   |  | 347,397      |
| Accrued taxes and other long term liabilities  | 204,796  | 222,765      |
| <br>   |  |              |
| Total liabilities  | 1,036,428  | 1,232,409    |
| <br>   |  |              |
| Commitments and contingencies (Notes 11, 12 and 20)  |  |              |
| <b>STOCKHOLDERS EQUITY</b>   |  |              |
| Preferred stock, \$0.01 par value:   |  |              |
| Authorized: 5,000,000 shares; Issued and outstanding: none in 2004 and 2003                      |  |              |
| Common stock, \$0.01 par value:  |  |              |

Edgar Filing: McAfee, Inc. - Form 10-K/A

Authorized: 300,000,000 shares; Issued:162,266,174 shares and 162,071,798 shares for 2004 and 2003, respectively;

Outstanding: 162,266,174 shares and 161,721,798 for 2004 and 2003, respectively

Treasury stock, at cost: no shares in 2004 and 350,000 shares in 2003

Additional paid-in capital

Deferred stock-based compensation

Accumulated other comprehensive income

Accumulated deficit

Total stockholders' equity

Total liabilities and stockholders' equity

|              |              |
|--------------|--------------|
| 1,623        | 1,621        |
|              | (4,707)      |
| 1,178,855    | 1,087,625    |
| (1,777)      | (598)        |
| 27,361       | 34,027       |
| (4,814)      | (229,879)    |
| 1,201,248    | 888,089      |
| \$ 2,237,676 | \$ 2,120,498 |

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

**Table of Contents****MCAFEE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

|  | <b>Years Ended December 31,</b>              |             |             |
|--|--|-------------|-------------|
|  | <b>2004</b>                                  | <b>2003</b> | <b>2002</b> |
|  | <b>(In thousands, except per share data)</b> |             |             |
| Net revenue:   |  |             |             |
| Product  | \$ 294,163                                   | \$ 513,610  | \$ 631,550  |
| Services and support   | 616,379                                      | 422,726     | 411,494     |
| Total net revenue  | 910,542                                      | 936,336     | 1,043,044   |
| Cost of net revenue:   |  |             |             |
| Product  | 73,058                                       | 80,895      | 101,019     |
| Services and support   | 62,520                                       | 57,362      | 60,539      |
| Amortization of purchased technology   | 13,331                                       | 11,369      | 3,153       |
| Total cost of net revenue  | 148,909                                      | 149,626     | 164,711     |
| Operating costs:   |  |             |             |
| Research and development(1)  | 172,717                                      | 184,606     | 148,801     |
| Marketing and sales(2)   | 354,380                                      | 363,306     | 397,747     |
| General and administrative(3)  | 139,845                                      | 129,920     | 119,393     |
| (Gain) loss on sale of assets and technology(4)  | (240,336)                                    | 788         | (9,301)     |
| Litigation (reimbursement) settlement  | (24,991)                                     |             | 70,000      |
| Restructuring charges  | 17,493                                       | 22,667      | 1,116       |
| Amortization of intangibles  | 14,065                                       | 15,637      | 10,742      |
| Severance/bonus costs related to Sniffer and Magic disposition(5)  | 10,070                                       |             |             |
| Reimbursement from transition services agreement   | (5,997)                                      |             |             |
| Provision for (recovery of) doubtful accounts, net   | 1,716  | (1,216)     | (219)       |
| Acquisition related costs not subject to capitalization  |  |             | 16,026      |
| In-process research and development  |  | 6,600       |             |
| Total operating costs  | 438,962                                      | 722,308     | 754,305     |
| Income from operations   | 322,671                                      | 64,402      | 124,028     |
| Interest and other income  | 15,889                                       | 15,917      | 27,324      |
| Interest and other expenses  | (5,315)                                      | (7,543)     | (25,085)    |
| (Loss) gain on repurchase of convertible debt  | (15,070)                                     | (2,727)     | 26          |
| (Loss) gain on investments, net  | (1,704)                                      | 3,076       | 3,838       |
| Impairment of strategic and other investments  |  |             | (198)       |
| Income before provision for (benefit from) income taxes, minority interest and cumulative effect of change in accounting principle | 316,471                                      | 73,125      | 129,933     |
| Provision for (benefit from) income taxes  | 91,406                                       | 13,220      | (274)       |
| Income before minority interest and cumulative effect of change in accounting principle  | 225,065                                      | 59,905      | 130,207     |



Edgar Filing: McAfee, Inc. - Form 10-K/A

|  |            |           |            |
|--|------------|-----------|------------|
| Minority interest in income of consolidated subsidiaries   |            |           | (1,895)    |
| Income before cumulative effect of change in accounting principle  | 225,065    | 59,905    | 128,312    |
| Cumulative effect of change in accounting principle, net of taxes of \$3,590   |            | 10,337    |            |
| Net income   | \$ 225,065 | \$ 70,242 | \$ 128,312 |
| Other comprehensive income:  |            |           |            |
| Unrealized losses on marketable securities, net of reclassification adjustment for losses recognized on marketable securities during the period and income tax | \$ (2,129) | \$ (709)  | \$ (2,667) |
| Foreign currency translation (loss) gain   | (4,537)    | 10,578    | 10,744     |
| Comprehensive income   | \$ 218,399 | \$ 80,111 | \$ 136,389 |
| Basic net income per share:  |            |           |            |
| Income before cumulative effect of change in accounting principle  | \$ 1.40    | \$ 0.37   | \$ 0.86    |
| Cumulative effect of change in accounting principle, net of taxes  |            | 0.07      |            |
| Net income per share basic   | \$ 1.40    | \$ 0.44   | \$ 0.86    |
| Shares used in per share calculation basic   | 160,714    | 160,338   | 149,441    |
| Diluted net income per share:  |            |           |            |
| Income before cumulative effect of change in accounting principle  | \$ 1.31    | \$ 0.36   | \$ 0.80    |
| Cumulative effect of change in accounting principle, net of taxes  |            | 0.07      |            |
| Net income per share diluted   | \$ 1.31    | \$ 0.43   | \$ 0.80    |
| Shares used in per share calculation diluted   | 177,099    | 164,489   | 176,249    |

(1) Includes stock-based compensation charge of \$6,518, \$5,157 and \$3,963 in 2004, 2003 and 2002, respectively.

(2) Includes stock-based compensation charge of \$2,642, \$5,065 and \$1,980 in 2004, 2003 and 2002, respectively.

**Table of Contents**

- (3) Includes stock-based compensation charge of \$4,085, \$2,285 and \$16,461 in 2004, 2003 and 2002, respectively.
- (4) Net of stock-based compensation charge of \$84 in 2004.
- (5) Includes stock-based compensation charge of \$991 in 2004.

|   | <b>Year Ended<br/>December 31,<br/>2002</b> |
|---|---|
| Pro forma amounts assuming the change in accounting principle is applied retroactively: |   |
| Net income  | \$ 121,513                                  |
| Basic income per share  | \$ 0.81                                     |
| Diluted income per share  | \$ 0.76                                     |

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

**Table of Contents****MCAFEE, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

|   | Common Stock<br>Shares | Common Stock<br>Amount | Treasury<br>Stock | Additional<br>Paid-In<br>Capital<br>(In thousands) | Deferred<br>Stock-Based<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>Income (Loss)<br>Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |            |
|---|------------------------|------------------------|-------------------|--|---|--|---------------------------------|------------|
| Balances,<br>December 31,<br>2001   | 140,681                | \$ 1,406               | \$                | \$ 752,439   | \$                                      | \$ 16,081  | \$ (428,433)                    | \$ 341,493 |
| Issuance of<br>common stock<br>upon exercise of<br>stock options  | 8,197                  | 82                     |                   | 99,664   |   |  |                                 | 99,746     |
| Issuance of<br>common stock<br>upon exercise of<br>stock options by<br>McAfee.com                                     |                        |                        |                   | 3,633  |   |  |                                 | 3,633      |
| Issuance of<br>common stock<br>from Employee<br>Stock Purchase<br>Plans   | 743                    | 8                      |                   | 6,524  |   |  |                                 | 6,532      |
| Issuance of<br>common stock for<br>acquisition of<br>minority interest<br>in McAfee.com,<br>net of cost of<br>\$1,956 | 8,307                  | 83                     |                   | 119,397  |   |  |                                 | 119,480    |
| Deferred<br>stock-based<br>compensation   |                        |                        |                   | 31,955   | (31,955)                                |  |                                 |            |
| Amortization of<br>deferred<br>stock-based<br>compensation and<br>other<br>compensation<br>charge                     |                        |                        |                   | (3,815)  | 26,219                                  |  |                                 | 22,404     |
| Reclassification of<br>cash payable in<br>excess of exercise<br>price related to<br>exchange of                       |                        |                        |                   | (4,190)  |   |  |                                 | (4,190)    |

|  |         |       |           |         |         |           |  |         |
|--|---------|-------|-----------|---------|---------|-----------|--|---------|
| McAfee.com options   |         |       |           |         |         |           |  |         |
| Tax benefits from exercise of non-qualified stock options  |         |       | 45,962    |         |         |           |  | 45,962  |
| Stock options issued in connection with acquisition  |         |       | 357       |         |         |           |  | 357     |
| Minority interest attributed to McAfee.com   |         |       | (1,638)   |         |         |           |  | (1,638) |
| Foreign currency translation   |         |       |           |         | 10,744  |           |  | 10,744  |
| Net decrease in unrealized gains on investments  |         |       |           |         | (2,667) |           |  | (2,667) |
| Net income   |         |       |           |         |         | 128,312   |  | 128,312 |
| Balances, December 31, 2002  | 157,928 | 1,579 | 1,050,288 | (5,736) | 24,158  | (300,121) |  | 770,168 |
| Issuance of common stock upon exercise of stock options  | 2,548   | 26    | 19,610    |         |         |           |  | 19,636  |
| Issuance of common stock from Employee Stock Purchase Plans  | 1,596   | 16    | 15,765    |         |         |           |  | 15,781  |
| Repurchase of common stock   | (350)   |       | (4,707)   |         |         |           |  | (4,707) |
| Deferred stock-based compensation  |         |       | (643)     | 643     |         |           |  |         |
| Amortization of deferred stock-based compensation and other stock-based compensation charge            |         |       | 8,012     | 4,495   |         |           |  | 12,507  |
| Reclassification of cash payable in excess of exercise price related to exchange of McAfee.com options |         |       | (5,407)   |         |         |           |  | (5,407) |

Edgar Filing: McAfee, Inc. - Form 10-K/A

|  |          |       |           |           |         |        |           |           |
|--|----------|-------|-----------|-----------|---------|--------|-----------|-----------|
| Foreign currency translation   |          |       |           |           |         | 10,578 |           | 10,578    |
| Net decrease in unrealized gains on investments  |          |       |           |           |         | (709)  |           | (709)     |
| Net income   |          |       |           |           |         |        | 70,242    | 70,242    |
| Balances, December 31, 2003  | 161,722  | 1,621 | (4,707)   | 1,087,625 | (598)   | 34,027 | (229,879) | 888,089   |
| Issuance of common stock upon exercise of stock options  | 9,152    | 92    |           | 105,638   |         |        |           | 105,730   |
| Issuance of common stock from Employee Stock Purchase Plans  | 775      | 8     |           | 8,055     |         |        |           | 8,063     |
| Issuance of common stock upon exercise of warrants   | 184      | 2     |           | (2)       |         |        |           |           |
| Issuance of common stock upon conversion of debt   | 4,616    | 46    |           | 83,364    |         |        |           | 83,410    |
| Repurchase of common stock   | (12,623) |       | (221,816) |           |         |        |           | (221,816) |
| Retirement of treasury stock   |          | (130) | 226,523   | (226,393) |         |        |           |           |
| Deferred stock-based compensation  |          |       |           | 6,443     | (6,443) |        |           |           |
| Shares returned from trust   | (1,560)  | (16)  |           | 16        |         |        |           |           |
| Amortization of deferred stock-based compensation and other stock-based compensation charge            |          |       |           | 6,804     | 7,516   |        |           | 14,320    |
| Reclassification of cash payable in excess of exercise price related to exchange of McAfee.com options |          |       |           | (3,154)   |         |        |           | (3,154)   |
|  |          |       |           | 3,779     |         |        |           | 3,779     |

|  |         |          |    |              |            |           |            |    |              |
|--|---------|----------|----|--------------|------------|-----------|------------|----|--------------|
| Contribution of proceeds from sale of common stock held in trust   |         |          |    |              |            |           |            |    |              |
| Tax benefits from exercise of non-qualified stock options  |         |          |    | 72,622       |            |           |            |    | 72,622       |
| Stock options issued in connection with acquisition  |         |          |    | 7,039        | (2,252)    |           |            |    | 4,787        |
| Release of deferred tax valuation allowance related to acquisition accounted for as a pooling of interests |         |          |    | 27,019       |            |           |            |    | 27,019       |
| Foreign currency translation   |         |          |    |              |            | (4,537)   |            |    | (4,537)      |
| Net decrease in unrealized gains on investment   |         |          |    |              |            | (2,129)   |            |    | (2,129)      |
| Net income   |         |          |    |              |            |           | 225,065    |    | 225,065      |
| Balances, December 31, 2004  | 162,266 | \$ 1,623 | \$ | \$ 1,178,855 | \$ (1,777) | \$ 27,361 | \$ (4,814) | \$ | \$ 1,201,248 |

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

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

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b> |
|   | <b>(In thousands)</b>           |             |             |
| Cash flows from operating activities:   |                                 |             |             |
| Net income  | \$ 225,065                      | \$ 70,242   | \$ 128,312  |
| Adjustments to reconcile net income to net cash provided by operating activities:       |                                 |             |             |
| Cumulative effect of change in accounting principle, net                                |                                 | (10,337)    |             |
| Depreciation and amortization   | 66,699                          | 62,830      | 53,684      |
| Non-cash restructuring charge   | 9,624                           | 14,534      |             |
| Acquired in-process research and development  |                                 | 6,600       |             |
| Premium amortization of marketable securities   | 4,614                           | 7,114       |             |
| Provision for (recovery of) doubtful accounts   | 1,716                           | (1,216)     | (219)       |
| Non-cash interest and other expense on convertible debt                                 | 1,224                           | 3,162       | 12,025      |
| Stock-based compensation charges  | 14,320                          | 12,507      | 22,404      |
| Deferred income taxes   | (21,503)                        | (25,368)    | (65,208)    |
| Loss (gain) on sale of investments  | 1,704                           | (3,076)     | (3,838)     |
| Impairment of strategic and other investments   |                                 |             | 198         |
| Minority interest   |                                 |             | 1,895       |
| Loss (gain) on repurchase of zero coupon convertible debenture                          | 15,070                          | 2,727       | (26)        |
| (Gain) loss on sale of assets and technology  | (238,923)                       | 788         | (9,301)     |
| Tax benefit from exercise of nonqualified stock options                                 | 72,622                          |             | 45,962      |
| Change in fair value of interest rate swap, net of change in the fair value of the debt | 382                             | (5,646)     | (1,402)     |
| Changes in assets and liabilities, net of acquisitions:                                 |                                 |             |             |
| Accounts receivable   | 44,524                          | (6,676)     | (15,805)    |
| Prepaid expenses, income taxes and other assets   | (6,267)                         | (17,624)    | 9,699       |
| Accounts payable, accrued taxes and other liabilities                                   | 6,109                           | (78,452)    | 77,993      |
| Deferred revenue  | 161,933                         | 124,195     | (61,280)    |
| Net cash provided by operating activities   | 358,913                         | 156,304     | 195,093     |
| Cash flows from investing activities:   |                                 |             |             |
| Purchase of marketable securities   | (1,243,990)                     | (1,120,561) | (773,093)   |
| Proceeds from sale and maturity of marketable securities                                | 1,033,402                       | 1,022,700   | 781,761     |
| Decrease (increase) in restricted cash  | 19,930                          | 664         | (21,734)    |
| Purchase of minority interest in McAfee.com   |                                 |             | (98,447)    |
| Purchases of acquired technology  |                                 | (178)       | (807)       |
| Acquisitions, net of cash acquired  | (84,650)                        | (217,078)   | (19,054)    |
| Purchase of property and equipment and leasehold improvements, net                      | (25,374)                        | (60,027)    | (59,427)    |
| Sale of Secure Computing shares and collar  |                                 |             | 5,105       |
| Proceeds from sale of assets and technology   | 261,309                         |             | 2,050       |
| Net cash used in investing activities   | (39,373)                        | (374,480)   | (183,646)   |

Edgar Filing: McAfee, Inc. - Form 10-K/A

Cash flows from financing activities:

|  |            |            |            |
|--|------------|------------|------------|
| Proceeds from issuance of common stock under stock option plan and stock purchase plans              | 113,793    | 35,417     | 109,911    |
| Contribution of proceeds from sale of common stock held in trust                                     | 3,779      |            |            |
| Repurchase of common stock   | (221,816)  | (4,707)    |            |
| Repurchase of convertible debt   | (265,623)  | (177,289)  | (66,175)   |
| Net cash (used in) provided by financing activities  | (369,867)  | (146,579)  | 43,736     |
| Effect of exchange rate fluctuations   | 7,831      | 24,180     | 6,211      |
| Net (decrease) increase in cash and cash equivalents   | (42,496)   | (340,575)  | 61,394     |
| Cash and cash equivalents at beginning of period   | 333,651    | 674,226    | 612,832    |
| Cash and cash equivalents at end of period   | \$ 291,155 | \$ 333,651 | \$ 674,226 |
| Non cash investing and financing activities:   |            |            |            |
| Unrealized losses on marketable investments, net   | \$ (2,129) | \$ (709)   | \$ (2,667) |
| Issuance of common stock for acquisition of minority interest in McAfee.com, net of costs of \$1,956 | \$         | \$         | \$ 119,480 |
| Fair value of assets acquired in business combinations   | \$ 110,394 | \$ 247,958 | \$         |
| Liabilities assumed in business combinations   | \$ 20,037  | \$ 25,465  | \$         |
| Realization of deferred tax assets of acquired company   | \$ 27,019  | \$         | \$         |
| Issuance of common stock upon conversion of debt   | \$ 83,410  | \$         | \$         |
| Stock options issued in connection with acquisition  | \$ 7,039   | \$         | \$ 357     |
| Supplemental disclosure of cash flow information:  |            |            |            |
| Cash paid during the year for interest   | \$ 6,349   | \$ 10,434  | \$ 20,666  |
| Cash paid during the year for income taxes   | \$ 31,393  | \$ 20,864  | \$ 18,547  |

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



**Table of Contents**

**MCAFEE, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Business**

McAfee, Inc. (formerly Network 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 (excluding Japan) and Latin America.

In January 2004, the Company sold its Magic Solutions product line (Magic), and in July 2004, the Company sold its Sniffer product line (Sniffer).

In October 2004, the Company purchased Foundstone, Inc. (Foundstone), a provider of risk assessment and vulnerability services and products.

In December 2004, the Company entered into an agreement to sell its McAfee Labs assets. The sale is expected to close in the first half of 2005.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying consolidated financial statements include the accounts of McAfee, Inc. and its wholly owned subsidiaries. On September 13, 2002, the Company repurchased the 25% minority interest in its McAfee.com subsidiary. Therefore, since the date of acquisition, no minority interest exists in McAfee.com and accordingly the Company's consolidated net income beginning in 2002 includes the full amount of McAfee.com results from this date. All significant intercompany accounts and transactions have been eliminated.

Certain reclassifications have been made to the prior year's consolidated financial statements to conform to the current year's presentation. These reclassifications had no effect on the prior year's stockholders' equity or results of operations.

***Minority Interest***

Minority interest in income of consolidated subsidiaries in the consolidated statement of income for 2002 represents the minority stockholders' share of the income of McAfee.com. As of December 31, 2002 and for all subsequent periods, the Company's consolidated subsidiaries were all wholly owned and there were no minority interests.

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principals generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Significant estimates include those required in the valuation of intangible assets acquired in purchase combinations, impairment analysis of goodwill and intangibles, property and equipment, allowances for doubtful accounts, sales returns and allowances, vendor specific

objective evidence of the fair value of the various elements of the Company's multiple element software transactions, valuation allowances for deferred tax assets, tax accruals, and warranty obligation accrual. Although the Company believes that adequate accruals have been made for unsettled issues, additional gains or losses could occur in future years from resolutions of outstanding matters. Actual results could differ materially from original estimates.

**Table of Contents**

***Certain Risks and Concentrations***

The Company has historically derived a majority of its net revenue from its McAfee anti-virus software products and its Sniffer network fault identification and application performance management products. The Company sold its Sniffer business in July 2004, which accounted for \$90.9 million and \$210.2 million of revenues in 2004 and 2003, respectively, which represented 10% and 22% of total revenue for those periods, respectively. McAfee anti-virus software products and support renewals are expected to continue to account for an even more significant portion of the Company's net revenues after the sale of Sniffer. The markets in which the Company operates are highly competitive and rapidly changing. Significant technological changes, changes in customer requirements, or the emergence of competitive products with new capabilities or technologies could adversely affect operating results. As a result of this revenue concentration, the Company's business could be harmed by a decline in demand for, or in the prices of, these products as a result of, among other factors, any change in pricing model, a maturation in the markets for these products, increased price competition or a failure by the Company to keep up with technological change.

The Company sells a significant amount of its products through intermediaries such as distributors, resellers and others. The Company's top ten distributors represented 49% to 63% of net sales per quarter during 2004, 2003 and 2002. During 2004, 2003 and 2002, one customer accounted for 22%, 24% and 25%, respectively, of the total net revenue for each year. During 2004 and 2002, another customer accounted for 11% and 10%, respectively, of the net revenue. At December 31, 2004 and 2003, one distributor had an accounts receivable balance which comprised 23% and 22%, respectively, of the Company's total accounts receivable balance. The Company's distributor agreements may be terminated by either party without cause. If one of the Company's significant distributors terminates its distribution agreement, the Company could experience a significant interruption in the sale and distribution of its products. The distributors may sell other vendor's products that are complementary to, or compete with, its products. While the Company encourages its distributors to focus on the Company's products through market and support programs, these distributors may give greater priority to products of other suppliers, including competitors.

Some of the Company's distributors may experience financial difficulties, which could adversely impact collection of accounts receivable. The Company regularly reviews the collectibility and credit-worthiness of its distributors to determine an appropriate allowance for doubtful accounts. The Company's bad debt allowance was \$2.5 million at December 31, 2004 and \$2.9 million at December 31, 2003. The Company's uncollectible accounts could exceed its current or future allowances. The Company determines its allowance for doubtful accounts by assessing the collectibility of individual accounts receivable over a specified aging and amount and provides an amount equal to the historical percentage of write-off experience of the remaining accounts receivable. Accounts receivable are written off on a case by case basis, considering the probability that any amounts can be collected.

Some of the Company's products incorporate licensed software and the Company must be able to obtain reasonably priced licenses and successfully integrate this software with its hardware. In addition, some of the Company's products may include open source software. The Company's ability to commercialize products or technologies incorporating open source software may be restricted because, among other reasons, open source license terms may be ambiguous and may result in unanticipated obligations regarding its products.

The Company maintains the majority of cash balances and all of its short-term investments with seven financial institutions. The Company invests with financial institutions with high quality credit and, by policy, limits the amount of deposit exposure to any one financial institution.

The Company receives certain of its critical components from sole suppliers. Additionally, the Company relies on a limited number of contract manufacturers and suppliers to provide manufacturing services for its products. The inability of any contract manufacturer or supplier to fulfill supply requirements of the Company could materially impact future operating results.

***Foreign Currency Translation***

The Company considers the local currency to be the functional currency for its international subsidiaries. Assets and liabilities denominated in foreign currencies are translated using the exchange rate on the consolidated balance sheet date. Revenues and expenses are translated at average exchange rates prevailing during the year. Translation adjustments resulting from this process are charged or credited to accumulated other comprehensive income. Where the United States Dollar is the functional currency of the subsidiary, all remeasurement adjustments are recorded in the consolidated statement of income.

Foreign currency transaction gains and losses, which to date have not been material, are included in the consolidated statements of income.

***Derivatives***

The Company follows the guidance in Statement of Financial Accounting Standard ( SFAS ) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, in accounting for derivatives. The standard requires the Company to recognize all

**Table of Contents**

derivatives on the consolidated balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through the consolidated statement of income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value is immediately recognized in earnings. The Company's use of derivative financial instruments is discussed in Note 7.

***Cash and Cash Equivalents***

Cash equivalents are comprised of highly liquid debt instruments with original maturities or remaining maturities at date of purchase of 90 days or less.

***Restricted Cash***

Restricted cash balances were \$0.6 million and \$20.5 million at December 31, 2004 and 2003, respectively. The restricted cash balance at December 31, 2004 consists of deposits restricted related to the Company's workers compensation insurance coverage. The restricted cash balance at December 31, 2003 consists primarily of collateral for an interest rate swap arrangement that terminated in 2004.

***Marketable Securities***

All marketable securities are classified as available-for-sale securities. Available-for-sale securities are carried at fair value with resulting unrealized gains and losses, net of related taxes, reported as a component of accumulated other comprehensive income. Premium and discount on debt securities recorded at the date of purchase are amortized and accreted, respectively, to interest income using the effective interest method. Short-term marketable securities are those with remaining maturities at the consolidated balance sheet date of one year or less. Long-term marketable securities have remaining maturities at the consolidated balance sheet date of greater than one year. Realized gains and losses on sales of all such investments are reported in earnings and computed using the specific identification cost method.

The Company assesses the value of its available-for-sale marketable securities on a regular basis to assess whether an other-than-temporary decline in the fair value has occurred. Factors which the Company uses to assess whether an other than temporary decline has occurred include, but are not limited to, the period of time which the fair value is below original cost, significant changes in the operating performance, financial condition or business model, and changes in market conditions. Any other than temporary decline in value is reported in earnings and a new cost basis for the marketable security established. The Company did not record any other than temporary declines in marketable securities for 2004, 2003 or 2002.

***Inventory***

Inventory, which consists primarily of finished goods, is stated at lower of cost or market and is included in other current assets. Cost is computed using standard cost, which approximates cost on a first in, first out basis. Inventory of \$5.1 million at December 31, 2004 and \$15.9 million at December 31, 2003 is included in other current assets.

***Property and Equipment***

Property and equipment are presented at cost less accumulated depreciation and amortization (see Note 8). Depreciation and amortization of property and equipment are computed using the straight-line method over the estimated useful lives as follows:

building interior seven years;  
exterior twenty years;

office furniture and equipment  
three to seven years; and

computer hardware and software  
three to five years;

leasehold improvements the  
shorter of the lease term,  
including assumed lease renewal  
periods that are reasonably  
assured or the estimated useful  
life of the asset.

The costs associated with projects eligible for capitalization are accumulated on the consolidated balance sheet until the project is substantially complete and is placed into service. Capitalized interest is calculated on all eligible projects in progress. Interest capitalization begins when three conditions have been met (1) expenditures have occurred, (2) activities necessary to prepare the asset have begun, and (3) interest cost has been incurred. For 2004 and 2003, the Company recorded \$0.1 million and \$0.3 million of capitalized interest, respectively.

## **Table of Contents**

When assets are disposed, the Company removes the asset and accumulated depreciation from its records and recognizes the related gain or loss in results of operations.

Repairs and maintenance expenditures, which are not considered improvements and do not extend the useful life of property and equipment, are expensed as incurred.

### ***Internal Use Software***

The Company follows the guidance in Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Software development costs, including costs incurred to purchase third party software, are capitalized beginning when the Company has determined factors are present, including among others, that technology exists to achieve the performance requirements, buy versus internal development decisions have been made and the Company's management has authorized the funding for the project. Capitalization of software costs ceases when the software is substantially complete and is ready for its intended use and is amortized over its estimated useful life of three years using the straight-line method.

When events or circumstances indicate the carrying value of internal use software might not be recoverable, the Company assesses the recoverability of these assets by determining whether the amortization of the asset balance over its remaining life can be recovered through undiscounted future operating cash flows. The amount of impairment, if any, is recognized to the extent that the carrying value exceeds the projected discounted future operating cash flows and is recognized as a write down of the asset. In addition, when it is no longer probable that computer software being developed will be placed in service, the asset will be recorded at the lower of its carrying value or fair value, if any, less direct selling costs.

### ***Goodwill***

The Company follows the guidance of SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS 142 ) in accounting for its goodwill and intangible assets. The Company adopted SFAS 142 as of January 1, 2002, and as required, ceased amortizing goodwill. In lieu of amortization, an impairment review of goodwill is performed on at least an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company's reporting units below their carrying value. The Company's reporting units are consistent with the operating geographies discussed in Note 19.

### ***Finite-Lived Intangibles, Long-Lived Assets and Assets Held for Sale***

Purchased technology and other identifiable intangible assets are carried at cost less accumulated amortization. The Company amortizes other identifiable intangibles on a straight-line basis over their estimated useful lives. The range of estimated useful lives of the Company's identifiable intangibles is one to seven years (see Note 10).

The Company accounts for finite-lived intangibles and long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Under this standard, the Company reviews finite-lived intangibles or long-lived assets to be held and used for impairment whenever events or changes in circumstances indicate that the carrying value such assets may not be recoverable.

Based upon the existence of one or more potential indicators of impairment, recoverability is assessed based upon an estimate of undiscounted cash flows resulting from the use of the assets and its eventual disposition. Measurement of an impairment loss is based on a projected discounted cash flow method using a discount rate determined by management to be commensurate with the risk inherent in the Company's current business model. Finite-lived intangibles and long-lived assets to be disposed of are reported at the lower of carrying amount of fair value less the costs to sell.

The Company announced plans to sell its McAfee Labs assets ( McAfee Labs ) in December 2004. The assets and liabilities related to this disposal group are not significant as of December 31, 2004. The Company sold its Magic assets in January 2004. This disposal group met the criteria stated in SFAS 144 to be held for sale in December 2003, and consequently, depreciation on the equipment related to Magic ceased, and all assets and liabilities related to Magic were presented as held for sale in the consolidated balance sheet at December 31, 2003.

***Fair Value of Financial Instruments***

Carrying amounts of the Company's financial instruments including accounts receivable, accounts payable and accrued liabilities approximate fair value due to their short maturities. The fair values of the Company's investments in marketable securities are disclosed in Note 6. The fair value of the Company's derivative instruments is disclosed in Note 7. The fair value of the Company's convertible debt instruments is disclosed in Note 13.



## **Table of Contents**

### ***Revenue Recognition***

The Company's revenue is derived from primarily two sources (i) product revenue, which includes software license, hardware, retail and royalty revenue and (ii) services and support revenue which includes software license maintenance and support, training, consulting, and on-line subscription revenue.

The Company licenses its software products under one and two-year term or perpetual licenses. The two-year licenses include the first year of maintenance and support. The Company sells its products and services via its direct sales force, through domestic and foreign distributors and via the Internet. Under the Company's on-line subscription arrangements, which do not include any upfront setup fees, customers pay a fixed fee and receive service over a period of time, generally one year.

The Company applies the provisions of Statement of Position 97-2, *Software Revenue Recognition*, (SOP 97-2) as amended by Statement of Position 98-9 *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions* to all transactions involving the sale of software products and hardware transactions where the software is not incidental. For hardware transactions where software is not incidental, the Company does not bifurcate the fee and apply separate accounting guidance to the hardware and software elements. For hardware transactions where no software is involved, the Company applies the provisions of Staff Accounting Bulletin 104 *Revenue Recognition*. In addition, the Company applies the provisions of Emerging Issues Task Force Issue No. 00-03 *Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware* to its on-line subscription software transactions.

Product revenue from the license of the Company's software products and sale of hardware products where the software is and is not incidental is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed or determinable, and collection of the resulting receivable is reasonably assured, and, if applicable, upon acceptance when acceptance criteria are specified or upon expiration of the acceptance period. Maintenance and support revenue for providing product updates and customer support is deferred and recognized ratably over the service period. On-line subscription revenue is recognized ratably over the service period, which is generally one year. Training and consulting revenue is recognized as services are performed and billable according to the terms of the service arrangement. Revenue on one-year time-based subscription licenses is recognized ratably over the contract term. Royalty revenue is generally recognized upon receipt of periodic royalty reports received from customers, which generally coincides with receipt of cash.

For all sales except those completed via the Internet, the Company uses either a binding purchase order or signed license agreement as evidence of an arrangement. For sales over the Internet, the Company uses a credit card authorization as evidence of an arrangement. Sales through distributors are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction by transaction basis.

Fees due under an arrangement are generally deemed not to be fixed or determinable if a significant portion of the fee is due beyond the Company's normal payment terms that are 30 to 90 days from the date of invoice. Fees due under an arrangement with distributors and resellers are generally deemed not to be fixed or determinable if a significant portion of the fee is due beyond the date when the products have been sold by the distributor or reseller to the customers. In these cases, revenue is not recognized until the fees become due. The Company assesses collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. The Company does not request collateral from its customers. If the Company determines that collection of a fee is not reasonably assured, the fee is deferred and revenue recognized at the time collection becomes reasonably assured, which is generally upon receipt of cash.

The Company's distributors are permitted to purchase software licenses at the same time they fill customer orders and to pay for hardware and retail products only when these products are resold to the distributors' customers. In

addition, the distributors have an unlimited right of return up until the point of sale. After sale, the Company must approve any returns from end-users. As a result, the Company recognizes revenue from sales to distributors and resellers when products have been sold by the distributors or resellers to their customers (sell-through or sell-out method). In addition, the Company makes an estimate of returns from end users and amounts for promotional and rebate programs based on its historical experience. The provisions are recorded as a reduction of revenue.

For arrangements with multiple obligations (e.g. undelivered maintenance and support bundled with term and perpetual licenses), the Company allocates revenue to each component of the arrangement using the residual value method based on evidence of the fair value of the undelivered elements, which is specific to the Company. The vendor specific objective evidence of fair values for the ongoing maintenance and support obligations for both term and perpetual licenses are based upon the prices paid for the separate renewal of these services by the customer or upon substantive renewal rates stated in the contractual arrangements. Vendor specific objective evidence of the fair value of other services, primarily consulting and training services, is based upon separate sales of these services.

**Table of Contents*****Government Contracts***

McAfee Labs performs a significant portion of the Company's research and development activities with government agencies. The Company enters into research and development contracts with government agencies under various pricing arrangements. Government contracting revenue is classified as services and support revenue in the accompanying consolidated statements of income and comprehensive income. Under government contracts, the Company is subject to audit by the Defense Contract Audit Agency ( DCAA ) which could result in the renegotiation of amounts previously billed.

Revenue from cost-plus-fixed-fee contracts is recognized on the basis of reimbursable contract costs incurred during the period, plus a percentage of the fixed fee. Revenue from time and material contracts is recognized on the basis of hours utilized, plus other reimbursable contract costs incurred during the period. Revenue from firm-fixed-price contracts is recognized on the percentage of completion method. Under this method, individual contract revenues are recorded based on the percentage relationship that contract costs incurred bear to costs incurred plus management's estimate of costs to complete. Losses, if any, are accrued when their occurrence becomes known and the amount of the loss is reasonably determinable. During 2004, 2003, and 2002, the Company recognized revenue of approximately \$6.4 million, \$11.0 million, and \$17.3 million, respectively, associated with government contracts. The Company entered into an agreement for the sale of its McAfee Labs assets in December 2004.

***Research and Development***

Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Research and development costs include salaries and benefits of researchers, supplies, and other expenses incurred with research and development efforts. Development costs are capitalized beginning when a product's technological feasibility has been established and ending when the product is available for general release to customers. Technological feasibility is reached when the product reaches the working model stage. To date, products and enhancements have generally reached technological feasibility and have been released for sale at substantially the same time and all research and development costs have been expensed.

***Advertising Costs***

Advertising production costs are expensed as incurred. Media (television and print) placement costs are expensed in the period the advertising appears. Total advertising and promotional expenses were \$9.0 million, \$7.9 million, and \$13.6 million for 2004, 2003 and 2002, respectively.

***Stock-based Compensation***

As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25 ( APB 25 ), *Accounting for Stock Issued to Employees*, and Financial Accounting Standards Board ( FASB ) Interpretation No. 44 ( FIN 44 ), *Accounting for Certain Transactions Involving Stock-Based Compensation, an interpretation of APB Opinion No. 25* and related interpretations in accounting for its stock-based compensation plans. Accordingly, with respect to fixed-plan awards, the Company measures the excess, if any, of the market value of its common stock on the date of the award over the exercise price of options granted as deferred compensation expense (intrinsic method) and recognizes any such excess over the vesting period using the straight-line method. With respect to variable-plan awards resulting from award modifications or award terms where the amount of shares and the exercise price are not fixed at the date of grant, the Company records stock-based deferred compensation for the excess, if any, of the market value of its common stock at the end of each reporting period (or date of exercise, forfeiture or cancellation without replacement, if earlier) over the fair value of its common stock on the date of the award or modification. The resulting deferred compensation charge to earnings will be recorded over the remaining vesting term using the accelerated method of amortization. When variable plan options become fully vested, any remaining deferred compensation is recognized.

The Company accounts for options awarded to non-employees (consultants) at fair value using the Black-Scholes option pricing model. The resulting fair value is recognized in expense upon performance.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation. The Company recognizes pro forma expense for FAS 123 purposes under the accelerated method of amortization.

**Table of Contents**

For pro forma purposes, the compensation costs for the 1997 Plan, the Stock Option Plan for Outside Directors, the 2000 Nonstatutory Stock Option Plan and the 2002 and 1994 Employee Stock Purchase Plans ( ESPPs ) has been determined based on fair value at the grant date for awards from 1998 through 2004 consistent with the provisions of SFAS 123 using assumptions defined in Note 15, the Company's net income and net income per share would have been as follows (in thousands):

|   | <b>Year Ended December 31,</b> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <b>2004</b>                    | <b>2003</b> | <b>2002</b> |
| Net income, as reported   | \$ 225,065                     | \$ 70,242   | \$ 128,312  |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax | (25,632)                       | (55,848)    | (76,721)    |
| Add back: stock-based compensation expense, net of tax, included in reported net income                                     | 9,182                          | 7,504       | 13,442      |
| Pro forma net income  | \$ 208,615                     | \$ 21,898   | \$ 65,033   |
| Net income per share:   |                                |             |             |
| Basic as reported   | \$ 1.40                        | \$ 0.44     | \$ 0.86     |
| Basic pro forma   | \$ 1.30                        | \$ 0.14     | \$ 0.44     |
| Diluted as reported   | \$ 1.31                        | \$ 0.43     | \$ 0.80     |
| Diluted pro forma   | \$ 1.25                        | \$ 0.13     | \$ 0.41     |

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

***Income Taxes***

The Company accounts for income taxes in accordance with the liability method of accounting for income taxes. Under the liability method, deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The provision for income taxes is comprised of the current tax liability and the change in deferred tax assets and liabilities. The Company establishes a valuation allowance to the extent that it is more likely than not that deferred tax assets will not be recoverable against future taxable income.

***Net Income Per Share***

Basic net income per share is computed using the weighted-average common shares outstanding during the period. Diluted net income per share is computed using the weighted average common shares and potentially dilutive shares outstanding during the period. Potentially dilutive common shares include incremental common shares issuable upon exercise of stock options, stock purchase warrants, restricted stock, and potential dilution upon conversion of the convertible debt. Diluted loss per share is computed using the weighted average number of common shares and excludes potentially dilutive shares outstanding, as their effect is anti-dilutive.

***Warranty***

The Company offers a warranty on its software and hardware products and records a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and the Company's estimate of the level of future costs.

***Comprehensive Income (Loss)***

Unrealized gains (losses) on available-for-sale securities and foreign currency translation adjustments are included in the Company's components of comprehensive income (loss), which are excluded from net income.

**Table of Contents**

For 2004, 2003 and 2002 other comprehensive income (loss) is comprised of the following items (in thousands):

|   | <b>Before<br/>Income<br/>Tax</b> | <b>Income<br/>Tax</b> | <b>Net of<br/>Income<br/>Tax</b> |
|---|----------------------------------|-----------------------|----------------------------------|
| <b>2004</b>   |                                  |                       |                                  |
| Unrealized loss on marketable securities and investments, net                                     | \$ (5,253)                       | \$ 2,102              | \$ (3,151)                       |
| Reclassification adjustment for net loss on marketable securities<br>recognized during the period | 1,704                            | (682)                 | 1,022                            |
| Foreign currency translation loss   | (4,537)                          |                       | (4,537)                          |
| Total other comprehensive loss  | \$ (8,086)                       | \$ 1,420              | \$ (6,666)                       |
| <b>2003</b>   |                                  |                       |                                  |
| Unrealized gain on marketable securities and investments, net                                     | \$ 1,894                         | \$ (757)              | \$ 1,137                         |
| Reclassification adjustment for net gain on marketable securities<br>recognized during the period | (3,076)                          | 1,230                 | (1,846)                          |
| Foreign currency translation gain   | 10,578                           |                       | 10,578                           |
| Total other comprehensive income  | \$ 9,396                         | \$ 473                | \$ 9,869                         |
| <b>2002</b>   |                                  |                       |                                  |
| Unrealized loss on marketable securities and investments, net                                     | \$ (805)                         | \$ 322                | \$ (483)                         |
| Reclassification adjustment for net gain on marketable securities<br>recognized during the period | (3,838)                          | 1,535                 | (2,303)                          |
| Impairment recognized   | 198                              | (79)                  | 119                              |
| Foreign currency translation gain   | 10,744                           |                       | 10,744                           |
| Total other comprehensive income  | \$ 6,299                         | \$ 1,778              | \$ 8,077                         |

Accumulated other comprehensive income is comprised of the following (in thousands):

|   | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|---|-------------|-------------|-------------|
| Unrealized (loss) gain on available-for-sale securities | \$ (1,384)  | \$ 745      | \$ 1,454    |
| Cumulative translation adjustment                       | 28,745      | 33,282      | 22,704      |
| Total   | \$ 27,361   | \$ 34,027   | \$ 24,158   |

**Recent Accounting Pronouncements and Guidance***Stock-based Compensation*

In December 2004, the FASB issued SFAS 123R, *Share Based Payment* ( SFAS 123R ) which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the consolidated statements of income. The accounting provisions of SFAS 123R are effective for reporting periods beginning after June 15, 2005. The Company is required

to adopt SFAS 123R in the third quarter of fiscal 2005. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. See *Stock-based Compensation* above for the pro forma net income and net income per share amounts, for fiscal 2002 through fiscal 2004, as if the Company had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although the Company has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have a significant adverse impact on the consolidated results of operations.

#### *Income Taxes*

In December 2004, the FASB issued Staff Position ( FSP ) FAS 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creations Act of 2004* ( AJCA ) ( FSP 109-2 ). The AJCA introduces a limited time 85% dividends received deduction on the repatriation of certain foreign earnings to a U.S. taxpayer (repatriation provision), provided certain criteria are met. FSP 109-2 provides accounting and disclosure guidance for the repatriation provision. Although FSP 109-2 is effective immediately, the Company does not expect to be able to complete its evaluation of the repatriation provision until after Congress or the Treasury Department provides additional clarifying language on key elements of the provision. In January 2005, the Treasury Department began to issue the first of a series of clarifying guidance documents related to this provision. The Company expects to complete its evaluation of the effects of the repatriation provision by the end of fiscal 2005. The range of possible amounts that the Company is considering for repatriation under this provision is between \$0 and \$500 million. While the Company estimates that the related potential range of additional income tax is between \$0 and \$30 million, this estimation is subject to change following technical correction legislation that the Company believes is forthcoming from Congress. The amount of additional income tax would be reduced by the part of the eligible dividend that is attributable to foreign earnings on which a deferred tax liability had been previously accrued.



**Table of Contents***Inventory*

In December 2004, the FASB issued SFAS 151, *Inventory Costs, an Amendment of ARB No. 43, Chapter 4*. SFAS 151 clarifies the accounting for inventory when there are abnormal amounts of idle facility expense, freight, handling costs, and wasted materials. Under existing pronouncements, items such as idle facility expense, excessive spoilage, double freight, and re-handling costs may be so abnormal as to require treatment as current period charges rather than recorded as adjustments to the value of the inventory. SFAS 151 requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. In addition, SFAS 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Earlier application is permitted for inventory costs incurred during fiscal years beginning after the date SFAS 151 is issued. The adoption of SFAS 151 is not expected to have a material effect on the Company's consolidated financial position or results of operations as the Company does not manufacture any of its products.

*The Meaning of Other-Than-Temporary Impairment*

In March 2004, the FASB issued Emerging Issues Task Force Issue No. 03-1 ( EITF 03-1 ), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provided new guidance for assessing impairment losses on investments. Additionally, EITF 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF 03-1; however the disclosure requirements remain effective for annual periods ending after June 15, 2004 (see Note 6). The Company does not believe that the adoption of EITF 03-01 will have a material impact on its financial position, results of operations or cash flows, however, the Company will evaluate the impact of EITF 03-1 once final guidance is issued.

**3. Cumulative Effect of Change in Accounting Principle**

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 believed that expensing the commissions as incurred did 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. The cumulative effect of the change in accounting principle resulted in a one-time credit of \$10.3 million, net of taxes of \$3.6 million, that was recorded in 2003.

The following table illustrates 2002 after considering the retroactive application of the adopted principle:

|   | <b>Actual</b> | <b>Pro Forma<br/>for<br/>Commission<br/>Change</b> |
|---|---------------|--|
| Operating expenses  | \$ 763,606    | \$ 774,938   |
| Income before cumulative effect of change in accounting principle | \$ 128,312    | \$ 121,513   |
| Per common share basic  | \$ 0.86       | \$ 0.81  |
| Per common share diluted  | \$ 0.80       | \$ 0.76  |

|                          |  |            |    |         |
|--------------------------|--|------------|----|---------|
| Net income               |  | \$ 128,312 | \$ | 121,513 |
| Per common share basic   |  | \$ 0.86    | \$ | 0.81    |
| Per common share diluted |  | \$ 0.80    | \$ | 0.76    |

#### 4. Business Combinations and Other Acquisitions

##### *Foundstone, Inc.*

On October 1, 2004, the Company acquired 100% of the outstanding capital shares of Foundstone, Inc., ( Foundstone ), a provider of risk assessment and vulnerability services and products for \$82.5 million in cash and \$3.1 million of direct expenses, totaling \$85.6 million. Total consideration paid for the acquisition was \$90.4 million including \$4.8 million for the fair value of vested stock options assumed in the acquisition. The Company acquired Foundstone to enhance its network protection product line. The Company acquired Foundstone to deliver enhanced risk classification of prioritized assets, automated shielding and risk remediation using intrusion prevention technology, and automated enforcement and compliance. The results of operations of Foundstone have been included in these consolidated financial statements since the date of acquisition.

Under the transaction, the Company recorded approximately \$27.0 million for developed technology, \$1.0 million for acquired product rights, including revenue related order backlog and contracts, \$0.6 million for trade names/trademarks and non-compete arrangements, \$59.2 million for goodwill (none of which is deductible for tax purposes), \$2.6 million for net deferred tax liabilities and \$5.1 million of tangible assets, net of liabilities. The intangible assets acquired in the acquisition, excluding goodwill, are being

**Table of Contents**

amortized over their estimated useful lives of two to 6.5 years or a weighted average period of 6.4 years. The Company accrued \$0.3 million in severance costs for employees terminated at the time of the acquisition, of which less than \$0.1 million remains as an accrual as of December 31, 2004.

As part of the Foundstone acquisition, the Company assumed a portion of outstanding vested and unvested Foundstone stock option options. The fair value of the Company's stock options exchanged was \$7.0 million, of which \$4.8 million was reflected as part of the purchase price and \$2.3 million was reflected as unearned compensation to be recognized by the Company through 2008 as employment services are provided.

The Company cancelled the Foundstone stock options it did not assume, such options being held by four executives, in exchange for a cash payment equal to the intrinsic value of the cancelled stock options based on the purchase price per share. Forty percent of this amount was placed into escrow accounts for the four executives (Key Employee Escrow), along with 40% of the proceeds for the purchase of shares from the four executives. The four executives also received retention bonus payments, which were placed into Key Employee Escrow accounts. The Key Employee Escrow amounts are subject to vesting provisions from the date of acquisition through October 1, 2007. The Company recorded the \$5.6 million paid into Key Employee Escrow as prepaid compensation, which is being recognized as expense over the vesting period. The Company recognized expense of approximately \$0.3 million in 2004. In January 2005, the vesting schedule was amended such that a greater portion of the escrow amount vests within one year of the close of the transaction. The Company expects to record approximately \$2.9 million in expense for escrow amounts vesting in 2005.

Management determined the preliminary purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived 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 acquisition of Foundstone:

|                                  | <b>(In<br/>thousands)</b> |
|----------------------------------|---------------------------|
| Technology                       | \$ 27,000                 |
| Other intangible assets          | 1,600                     |
| Goodwill                         | 59,235                    |
| Cash                             | 920                       |
| Other assets                     | 12,918                    |
| Deferred tax assets              | 8,721                     |
| <b>Total assets acquired</b>     | <b>110,394</b>            |
| Liabilities                      | 8,740                     |
| Deferred tax liabilities         | 11,297                    |
| <b>Total liabilities assumed</b> | <b>20,037</b>             |
| <b>Net assets acquired</b>       | <b>\$ 90,357</b>          |

The following unaudited pro forma financial information presents the combined results of the Company and Foundstone as if the acquisitions had occurred at the beginning of 2004 and 2003 (in thousands except per share amounts):

|   | <b>Year Ended December 31,</b> |             |
|---|--------------------------------|-------------|
|   | <b>2004</b>                    | <b>2003</b> |
|   | <b>(Unaudited)</b>             |             |
| Net revenue   | \$ 927,595                     | \$ 954,136  |
| Income before cumulative effect of change in accounting principle | \$ 212,610                     | \$ 46,838   |
| Net income  | \$ 212,610                     | \$ 57,175   |
| Basic net income per share  | \$ 1.32                        | \$ 0.36     |
| Shares used in per share calculation basic                        | 160,714                        | 160,338     |
| Diluted net income per share                                      | \$ 1.24                        | \$ 0.35     |
| Shares used in per share calculation diluted                      | 177,099                        | 164,489     |

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.

***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 intrusion detection product line, improve its 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 consolidated financial statements since the date of acquisition.

**Table of Contents**

The Company recorded approximately \$5.7 million for acquired in-process research and development which was fully expensed at the time of acquisition 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 acquisition 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 also accrued approximately \$0.3 million in duplicative site costs for lease space no longer being utilized and permanently vacated related to the IntruVert acquisition, which has been fully paid as of December 31, 2004.

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. The Company recorded expense of approximately \$1.4 million and \$1.1 million in 2004 and 2003, respectively. Payments under the stock option plan are being paid monthly through the Company's payroll, and will total approximately \$4.1 million. The Company recorded expense of approximately \$1.4 million and \$0.8 million in 2004 and 2003, respectively, and will record an additional \$2.0 million through the first quarter of 2007. Cash payments that were fully vested at the date of acquisition were 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 intrusion detection 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 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 acquisition was a Linux version of their current product. The project was completed in the fourth quarter of 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 for permanently vacated facilities at the acquisition date. The accrual will be fully utilized by 2006, the end of the original lease term. The Company made payments of \$0.7 million in 2003, and in the fourth quarter of 2003, the Company entered into a sublease for the vacated facility, and therefore, adjusted the accrual and related goodwill by the value of the sublease, which was \$1.1 million. 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                    | (1,106)  |
| Adjustments                      | (1,137)  |

Balance, December 31, 2004

\$ 594

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 totaling \$2.4 million have been expensed monthly as salary expense as the employees were providing services to the Company. The Company recorded expense related to these payments of \$0.6 million and \$1.8 million in 2004 and 2003, respectively.

**Table of Contents**

Management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques and the assistance of valuation consultants. The following table summarizes the final fair values of the assets acquired and liabilities assumed in the acquisitions:

|  | <b>IntruVert<br/>Networks,<br/>Inc.</b> | <b>Entercept<br/>Security<br/>Technologies,<br/>Inc.</b> | <b>Total Assets<br/>Acquired and<br/>Liabilities<br/>Assumed</b> |
|--|---|--|--|
|  | <b>(In thousands)</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                                  | 99,565   | 171,163  |
| Other assets                                   | 4,984                                   | 3,517  | 8,501  |
| <b>Total assets acquired</b>                   | <b>108,104</b>                          | <b>139,170</b>   | <b>247,274</b>   |
| Current liabilities                            | 2,649                                   | 4,739  | 7,388  |
| Deferred tax liabilities                       | 7,839                                   | 9,555  | 17,394   |
| <b>Total liabilities assumed</b>               | <b>10,488</b>                           | <b>14,294</b>  | <b>24,782</b>  |
| <b>Net assets acquired</b>                     | <b>\$ 97,616</b>                        | <b>\$ 124,876</b>  | <b>\$ 222,492</b>  |
| In-process research and development (expensed) | \$ 5,700                                | \$ 900   | \$ 6,600   |
| <b>Total acquisition cost</b>                  | <b>\$ 103,316</b>                       | <b>\$ 125,776</b>  | <b>\$ 229,092</b>  |

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 and 2002 (in thousands except per share amounts):

|   | <b>Year Ended December 31,</b> |              |
|---|--------------------------------|--------------|
|   | <b>2003</b>                    | <b>2002</b>  |
|   | <b>(Unaudited)</b>             |              |
| Net revenue   | \$ 939,953                     | \$ 1,052,474 |
| Income before cumulative effect of change in accounting principle | \$ 49,721                      | \$ 93,367    |
| Net income  | \$ 60,058                      | \$ 93,367    |
| Basic net income per share  | \$ 0.38                        | \$ 0.62      |

|                                      |         |         |         |
|--------------------------------------|---------|---------|---------|
| Shares used in per share calculation | basic   | 160,338 | 149,441 |
| Diluted net income per share         |         | \$ 0.37 | \$ 0.59 |
| Shares used in per share calculation | diluted | 164,489 | 157,156 |

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.

### ***McAfee.com***

In September 2002, the Company repurchased the 25% minority interest in its McAfee.com subsidiary for \$219.9 million in cash and stock. The Company issued 8.3 million shares of its common stock valued at \$14.62 per share, which corresponds to the average market price of the Company's common stock two days before and after the date the terms of the acquisition were agreed and announced. The acquisition was an effort to reduce or eliminate customer, market and brand confusion due to the similarity in its products, names and web addresses and to reduce or eliminate actual and potential conflicts between the companies and their sales forces, and related senior management distraction, due to confusion over market boundaries. This acquisition increased the Company's ownership of McAfee.com to 100% and was accounted for using the purchase method of accounting. As part of the acquisition, McAfee.com was merged with and into the Company. The results of operations of McAfee.com have always been included in the consolidated income before minority interest of the Company. Prior to the acquisition, the minority interest in the McAfee.com income was excluded from the Company's consolidated net income.

Since the date of acquisition on September 13, 2002, no minority interest exists in McAfee.com and accordingly the consolidated net income includes the full amount of McAfee.com results from this date. The aggregate purchase price was allocated to tangible and identified intangible assets acquired and liabilities assumed based on estimates of fair value. Identifiable intangible assets totaled \$50.7 million and are amortized using an estimated useful life identified for each type of intangible ranging from two to seven years, or a weighted average period of 6.7 years. The excess of the aggregate purchase price over the fair value of the identifiable net assets acquired of approximately \$145.8 million has been recognized as goodwill of which none is deductible for tax purposes.



**Table of Contents**

The following table summarizes the final fair values of the assets acquired and liabilities assumed.

|                               | <b>(In<br/>thousands)</b> |
|-------------------------------|---------------------------|
| Deferred tax assets           | \$ 25,767                 |
| Technology                    | 1,401                     |
| Other intangible assets       | 49,335                    |
| Goodwill                      | 145,756                   |
| Minority interest             | 21,044                    |
| <br>Total assets acquired     | <br>243,303               |
| Current liabilities           | 2,065                     |
| Deferred tax liabilities      | 21,345                    |
| <br>Total liabilities assumed | <br>23,410                |
| <br>Net assets acquired       | <br>\$ 219,893            |

The following unaudited pro forma financial information presents the combined results of the Company and McAfee.com as if the acquisition had occurred at the beginning of 2002, after giving effect to certain adjustments, including amortization of identifiable intangible assets (in thousands, except per share amounts):

|  | <b>(Unaudited)</b> |
|--|--------------------|
| Net revenue                                  | \$ 1,043,044       |
| Net income                                   | \$ 141,334         |
| Basic net income per share                   | \$ 0.91            |
| Shares used in per share calculation basic   | 155,245            |
| Diluted net income per share                 | \$ 0.84            |
| Shares used in per share calculation diluted | 183,150            |

The above unaudited pro forma financial information includes adjustments for interest income on cash disbursed for the acquisition, amortization of identifiable intangible assets and adjustments for the expenses incurred by McAfee.com related to the Company's exchange offer for all McAfee.com outstanding publicly held shares.

**5. Sale of Businesses*****McAfee Labs***

In December 2004, the Company entered into an agreement for the sale of its McAfee Labs assets to SPARTA, Inc. ( SPARTA ) for \$1.5 million. The transaction is expected to close in the first half of 2005. The assets and liabilities

of McAfee Labs are not presented as held for sale since the purchase agreement requires the Company to be involved under certain contracts that are in progress at the close of the transaction until SPARTA obtains government approval as the contractor. As the Company will continue to be involved in the operations of the McAfee Labs business in 2005, its results of operations are included in income from operations in the consolidated statements of income. The cash flows resulting from this continued involvement are not expected to be material to the Company's consolidated financial statements.

The assets and liabilities of McAfee Labs are present in the Company's North American operating region. Revenues related to McAfee Labs were approximately \$6.4 million, \$11.0 million and \$17.3 million for 2004, 2003 and 2002, respectively.

***Sniffer Technologies***

In July 2004, the Company completed its sale of the Sniffer product line to Network General Corporation (the Buyer) for \$213.8 million in cash, net of approximately \$4.0 million in direct costs. The Company recorded a gain on sale of \$197.4 million in 2004. Sniffer does not represent a separate component of the Company as its operations and cash flows cannot be sufficiently separated from the rest of the Company, consequently, its results of operations are included in income from continuing operations in the consolidated statements of income.

**Table of Contents**

The following is a detail of assets and liabilities that were sold to or assumed by the Buyer upon the close of the transaction:

|                          | <b>(In<br/>thousands)</b> |
|--------------------------|---------------------------|
| Assets:                  |                           |
| Prepaid expenses         | \$ 2,227                  |
| Inventory                | 6,759                     |
| Equipment, net           | 2,396                     |
| Goodwill                 | 50,547                    |
| <b>Total assets</b>      | <b>\$ 61,929</b>          |
| Liabilities:             |                           |
| Accrued liabilities      | \$ 2,069                  |
| Deferred revenue         | 43,477                    |
| <b>Total liabilities</b> | <b>\$ 45,546</b>          |

The assets and liabilities of Sniffer were located primarily in the Company's North America and EMEA operating segments. Sniffer assets and liabilities in the Company's other reporting units were not material. Revenues related to Sniffer were \$90.9 million and \$210.2 million in 2004 and 2003, respectively.

In conjunction with the sale of Sniffer, the Company entered into a transition services agreement with the Buyer. Under this agreement, the Company provides certain transitional services, including initial order processing, use of facilities, transaction processing services and certain other back office functions for the Buyer. The Company is reimbursed for its costs plus a margin. Operating expenses under this agreement are included in general and administrative expenses, while reimbursements for such expenses are included in the caption "Reimbursement from transition services agreement" on the accompanying consolidated statements of income. The Company recorded approximately \$6.0 million of reimbursements under the transition services agreement.

Also in conjunction with the sale of the Sniffer product line, the Company paid severance and bonuses to the former executives of Sniffer for their assistance in the transaction. The total bonuses and severance accrued was \$7.7 million in 2004, of which \$5.3 million has been paid as of December 31, 2004, and the remaining \$2.4 million will be paid in the first quarter of 2006. Furthermore, the Company accelerated the vesting of these executive's stock options, which resulted in a stock-based compensation charge of approximately \$1.0 million.

***Magic Solutions***

In December 2003, the Company entered into an agreement for the sale of its Magic Solutions product line ( "Magic" ) to BMC Software for \$47.1 million in cash. The Company completed the transaction on January 30, 2004, and recorded a gain of \$46.1 million. At December 31, 2003, the carrying values of assets and liabilities related to Magic sale were presented as held for sale on the consolidated balance sheet. Magic does not represent a separate component of the Company as its operations and cash flows cannot be sufficiently separated from the rest of the Company, consequently, its results of operations are included in income from continuing operations in the consolidated statements of income.

The following were the components of Magic at December 31, 2003:

|   | <b>(In<br/>thousands)</b> |
|---|---------------------------|
| <b>Assets:</b>                              |                           |
| Accounts receivable                         | \$ 12,991                 |
| Prepaid expenses                            | 888                       |
| Inventory                                   | 20                        |
| Equipment, net                              | 1,023                     |
| Goodwill                                    | 9,797                     |
| <br>  |                           |
| Assets held for sale                        | \$ 24,719                 |
| <br>  |                           |
| <b>Liabilities:</b>                         |                           |
| Accounts payable                            | \$ 215                    |
| Accrued liabilities                         | 1,050                     |
| Deferred revenue                            | 22,045                    |
| <br>  |                           |
| Liabilities related to assets held for sale | \$ 23,310                 |

The assets and liabilities of Magic were located primarily in the Company's North American and EMEA operating regions. Magic assets and liabilities in the Company's other operating regions were not material. Revenues related to Magic were approximately \$2.9 million and \$63.2 million in 2004 and 2003, respectively.

In conjunction with the Magic sale, the Company paid a \$1.4 million bonus to an executive related to the transaction.

**Table of Contents****PGP Product Group**

In October 2001, the Board of Directors of the Company approved a plan to integrate the activities of the Company's PGP product group into its other product groups. In addition to the integration plan, the Company began to look for a buyer for the PGP desktop encryption and Gauntlet firewall product. In February 2002, the Company announced the sale of Gauntlet firewall/VPN business to Secure Computing. As a result of the transaction, the Company received common shares of Secure Computing in exchange for the Gauntlet business. The Company recorded a gain on sale of the business of \$6.7 million. In August 2002, the Company announced the sale of the PGP business to PGP Corporation, a new venture funded company unrelated to the Company, for \$2.0 million in cash and assumed liabilities. As a result of the transaction, the Company recorded a gain on sale of the business of \$2.6 million.

**6. Marketable Securities and Cash and Cash Equivalents**

Marketable securities, which are classified as available-for-sale, are summarized as follows as of December 31 (in thousands):

|  | <b>2004</b>                             |                                       |  |                                 |
|--|---|---------------------------------------|--|---------------------------------|
|  | <b>Purchase/<br/>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Aggregate<br/>Fair Value</b> |
| U.S. Government debt securities                  | \$ 274,594                              | \$ 40                                 | \$ (1,021)                             | \$ 273,613                      |
| Corporate debt securities                        | 340,037                                 | 138                                   | (1,458)                                | 338,717                         |
| Municipal debt securities                        | 4,850                                   |                                       |  | 4,850                           |
| Time deposits                                    | 16,350                                  |                                       | (4)                                    | 16,346                          |
|  | <b>\$ 635,831</b>                       | <b>\$ 178</b>                         | <b>\$ (2,483)</b>                      | <b>\$ 633,526</b>               |
|  |   |                                       |  |                                 |
|  | <b>2003</b>                             |                                       |  |                                 |
|  | <b>Purchase/<br/>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Aggregate<br/>Fair Value</b> |
| U.S. Government debt securities                  | \$ 190,567                              | \$ 401                                | \$ (76)                                | \$ 190,892                      |
| Corporate debt securities and money market funds | 484,156                                 | 607                                   | (180)                                  | 484,583                         |
| Equity securities                                | 118                                     | 293                                   |  | 411                             |
|  | <b>\$ 674,841</b>                       | <b>\$ 1,301</b>                       | <b>\$ (256)</b>                        | <b>\$ 675,886</b>               |

At December 31, 2004, \$232.9 million of marketable debt securities had scheduled maturities of less than one year and are classified as current assets. Marketable securities of \$400.6 million have maturities ranging from greater than one year to less than three years and are classified as non current assets.

The following table summarizes the components of the cash and cash equivalents balance at December 31 (in thousands):

|  | <b>2004</b> | <b>2003</b> |
|--|-------------|-------------|
| Cash and money market funds, at cost which approximates fair value | \$ 262,216  | \$ 325,360  |

|   |            |            |
|---|------------|------------|
| Corporate debt securities, primarily commercial paper | 28,939     | 8,291      |
| Total cash and cash equivalents                       | \$ 291,155 | \$ 333,651 |

The Company recognizes realized gains(losses) upon the sale of investments using the specific identification method. The following table summarizes the gross realized gains (losses) for the years ending December 31 (in thousands):

|                          |             |             |             |
|--------------------------|-------------|-------------|-------------|
|                          | <b>2004</b> | <b>2003</b> | <b>2002</b> |
| Realized gains           | \$ 922      | \$ 3,753    | \$ 4,670    |
| Realized losses          | (2,626)     | (677)       | (832)       |
| Net realized (loss) gain | \$ (1,704)  | \$ 3,076    | \$ 3,838    |

In accordance with EITF 03-1, the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2004 (in thousands):

|                                 | <b>Less Than 12 Months</b> |                                | <b>More Than 12 Months</b> |                                | <b>Total</b>      |                                |
|---------------------------------|----------------------------|--------------------------------|----------------------------|--------------------------------|-------------------|--------------------------------|
|                                 | <b>Fair Value</b>          | <b>Gross Unrealized Losses</b> | <b>Fair Value</b>          | <b>Gross Unrealized Losses</b> | <b>Fair Value</b> | <b>Gross Unrealized Losses</b> |
| U.S. Government debt securities | \$ 242,316                 | \$ (1,056)                     | \$ 2,625                   | \$ (33)                        | \$ 244,941        | \$ (1,089)                     |
| Corporate debt securities       | 185,359                    | (1,076)                        | 48,241                     | (318)                          | 233,600           | (1,394)                        |
|                                 | \$ 427,675                 | \$ (2,132)                     | \$ 50,866                  | \$ (351)                       | \$ 478,541        | \$ (2,483)                     |

**Table of Contents**

Market values were determined for each individual security in the investment portfolio. The declines in value of these investments are primarily related to changes in interest rates and are considered to be temporary in nature. The Company invests in government securities and debt instruments with high credit ratings, and believes that the financial position of the issuers of these securities are indicators that the securities are not impaired as of December 31, 2004.

**7. Derivatives*****Forward Exchange Contracts***

The Company conducts business globally. As a result, it is exposed to movements in foreign currency exchange rates. The Company enters into forward exchange contracts to reduce exposures associated with nonfunctional currency monetary assets and liabilities such as accounts receivable and accounts payable denominated in Euros, British Pound Sterling, Japanese Yen, and Singapore, Canadian and Australian dollars. The forward contracts typically range from one to three months in original maturity. In general, the Company does not hedge anticipated foreign currency cash flows nor does the Company enter into forward contracts for trading purposes. The Company does not use any foreign exchange derivatives for trading or speculative purposes.

The forward contracts do not qualify for hedge accounting and accordingly are marked to market at the end of each reporting period with any unrealized gain or loss being recognized in the statement of income as interest and other income.

The forward contracts outstanding and their fair values are presented below as of December 31 (in thousands):

|                        | 2004           |            | 2003           |            |
|------------------------|----------------|------------|----------------|------------|
|                        | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Euro                   | \$ 116         | \$ 116     | \$ 490         | \$ 490     |
| British Pound Sterling | 288            | 288        | 54             | 54         |
| Brazilian Real         | 420            | 420        |                |            |
| Singapore Dollar       |                |            | (16)           | (16)       |
| Japanese Yen           | 1              | 1          |                |            |
| Australian Dollar      | 4              | 4          | 75             | 75         |
| Canadian Dollar        | 39             | 39         | 255            | 255        |
|                        | \$ 868         | \$ 868     | \$ 858         | \$ 858     |

***Interest Rate Swaps***

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 (the Notes) (see Note 13).

The notional amount of the Transactions was \$345.0 million to match the entire principal amount of the Notes. The Company received 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 paid 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 had a termination date of 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 five-day average closing price of the Company s common stock were to equal or exceed \$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 Transactions 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 December 31, 2003 was approximately \$5.6 million and the estimated fair value of the Transactions was \$9.4 million at December 31, 2003.

The Notes were fully repaid in August 2004, and the Transactions were left intact and became a speculative investment, with gains and losses being recorded in the consolidated statement of income. On October 27, 2004, the Transactions automatically terminated as the Company s five-day average common stock price was equal to \$22.59. The Company recorded a loss of \$3.2 million in 2004 for the period of time from the repayment of the Notes through the termination of the Transactions.



**Table of Contents**

To test effectiveness of the hedge, regression analysis was 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 were calculated at least quarterly 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 until the repayment of the Notes 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 was 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 consolidated balance sheet as of December 31, 2003. The swap agreement terminated in October 2004, consequently, there is no restricted cash balance at December 31, 2004 for the Transactions.

**Collar**

In March 2002, the Company purchased a one-year collar consisting of 300,354 purchased put options with a strike price of \$17.31 and the same number of written call options with a strike price of \$22.04. Underlying both the put and call options were the Secure Computing shares. The Company designated the purchased collar as a fair value hedge of the Secure Computing available-for-sale securities received in the sales of Gauntlet assets (see Note 5) in accordance with SFAS 133. At the inception of the hedge, the Company assessed that the collar was highly effective based upon expected changes in the collar's intrinsic value. In July 2002, the Company sold its shares in Secure Computing and closed its collar. As a result the Company recorded a net gain of \$0.3 million, which is recorded as a gain of \$0.4 million from the sale of the collar offset by a loss of \$0.1 million from the sale of Secure Computing securities for 2002.

**8. Consolidated Balance Sheet Detail (in thousands):**

|                                   | <b>December 31,</b> |             |
|-----------------------------------|---------------------|-------------|
|                                   | <b>2004</b>         | <b>2003</b> |
| Property and equipment:           |                     |             |
| Building                          | \$ 19,828           | \$ 19,822   |
| Furniture and fixtures            | 18,728              | 27,469      |
| Computers and equipment           | 154,005             | 198,737     |
| Leasehold improvements            | 21,421              | 26,179      |
| Construction in progress          | 2,034               | 23,505      |
|                                   | 216,016             | 295,712     |
| Accumulated depreciation          | (129,363)           | (189,102)   |
|                                   | 86,653              | 106,610     |
| Land                              | 5,062               | 5,062       |
| Total property and equipment, net | \$ 91,715           | \$ 111,672  |

Depreciation expense for 2004, 2003, and 2002 was \$39.3 million, \$35.8 million, and \$39.8 million, respectively.

**December 31,**

|                                   | <b>2004</b> | <b>2003</b> |
|-----------------------------------|-------------|-------------|
| Accrued liabilities:              |             |             |
| Accrued income taxes, short term  | \$ 70,778   | \$ 10,123   |
| Accrued compensation              | 53,146      | 51,183      |
| Accrued marketing costs           | 2,806       | 3,622       |
| Accrued legal and accounting fees | 9,231       | 6,946       |
| Accrued interest                  |             | 6,843       |
| Other accrued expenses            | 61,407      | 68,564      |
|                                   | \$ 197,368  | \$ 147,281  |

|   | <b>December 31,</b> |             |
|---|---------------------|-------------|
|   | <b>2004</b>         | <b>2003</b> |
| Accrued income taxes and other long-term liabilities: |                     |             |
| Accrued income taxes, long term                       | \$ 188,734          | \$ 209,287  |
| Other   | 16,062              | 13,478      |
|   | \$ 204,796          | \$ 222,765  |

Long-term accrued income taxes represent tax accruals for which the Company believes any related cash flows would occur after December 31, 2005.

**Table of Contents****9. Restructurings*****2004 Restructurings***

During 2004, the Company recorded several restructuring charges related to the reduction of employee headcount. 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 the Company's North America and EMEA operating segments, respectively. The workforce size was reduced primarily due to the Company's sale of Magic in January 2004 (see Note 5). In the second quarter of 2004, the Company recorded a restructuring charge of approximately \$1.6 million related to the severance of approximately 80 employees in the Company's sales, technical support and general and administrative functions. Approximately \$0.6 million of the restructuring charge was related to the EMEA operating segment and the remaining \$1.0 million was related to the North America operating segment. In the third quarter of 2004, the Company recorded a restructuring charge related to ten employees which totaled approximately \$0.9 million, all of which related to the North America operating segment. In the fourth quarter of 2004, the Company recorded a restructuring charge of \$1.3 million related to 111 employees, of which \$0.7 million, \$0.2 million, \$0.2 million and \$0.2 million related to the Latin America, North America, EMEA and Asia-Pacific (excluding Japan) operating segments, respectively. All employees have been terminated at December 31, 2004. The reductions in the second, third and fourth quarters are part of the previously announced cost-savings measures being implemented by the Company.

In September 2004, the Company announced the move of the European headquarters to Ireland, which is expected to be substantially completed by the first quarter of 2005. In the third and fourth quarters of 2004, the Company recorded restructuring charges of \$0.2 million and \$2.2 million, respectively, related to the severance of approximately 80 employees, all of which was related to the EMEA operating segment. The costs will be substantially paid in the first half of 2005.

Also in September 2004, the Company permanently vacated an additional two floors in its Santa Clara headquarters building. The Company recorded a \$7.8 million accrual for the estimated lease related costs associated with the permanently vacated facility, partially offset by a \$1.3 million write-off of deferred rent liability. 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 estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The Company also recorded a non-cash charge of approximately \$0.8 million related to disposals of certain leasehold improvements. The restructuring charge of \$6.5 million and related cash outlay are based on management's current estimates.

In the fourth quarter of 2004, the Company permanently vacated several leased facilities and recorded a \$2.2 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, along with estimated costs associated with subleasing the vacated facility.

During 2004, the Company adjusted the restructuring accruals related to severance costs and lease termination costs recorded in 2004. The Company recorded a \$0.3 million adjustment to reduce the EMEA severance accrual for amounts that were no longer necessary after paying out substantially all accrued amounts to the former employees. The Company also recorded a \$0.2 million reduction in lease termination costs due to changes in estimates related to the sublease income to be received over the remaining lease term of its Santa Clara headquarters building.

The following table summarizes the Company's restructuring accruals established in 2004 (in thousands):

**Lease**

|                            | <b>Termination<br/>Costs</b> | <b>Severance<br/>and<br/>Other<br/>Benefits</b> | <b>Other<br/>Costs</b> | <b>Total</b> |
|----------------------------|------------------------------|---|------------------------|--------------|
| Balance, January 1, 2004   | \$                           | \$  | \$                     | \$           |
| Restructuring accrual      | 8,685                        | 7,932   | 480                    | 17,097       |
| Cash payments              | (579)                        | (4,175)   | (63)                   | (4,817)      |
| Adjustment to liability    | (222)                        | (275)   |                        | (497)        |
| Accretion                  | 74                           |   |                        | 74           |
| Balance, December 31, 2004 | \$ 7,958                     | \$ 3,482  | \$ 417                 | \$ 11,857    |

As of December 31, 2004, \$5.8 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of \$6.1 million has been classified as other long term liabilities, and will be paid through March 31, 2013. Lease termination costs are net of estimated sublease income of \$5.2 million at December 31, 2004.

**Table of Contents****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 regional headquarters facility in Plano, Texas. The facility houses employees working in finance, 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 the Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, the Company recorded a \$15.6 million accrual for estimated lease related costs associated with the permanently vacated facilities, partially offset by a \$1.9 million write off of deferred rent liability. 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 estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The Company also recorded a non-cash charge of approximately \$2.1 million related to asset disposals and discontinued use of certain leasehold improvements and furniture and equipment. The total restructuring charge of \$15.8 million and related cash outlay are based on management's current estimates. This restructuring charge was allocated to the Company's North American segment.

During the second and third quarters 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 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. 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 \$0.7 million of restructuring accrual in EMEA that was no longer necessary after paying out substantially all accrued amounts to the former employees.

In 2004 and 2003, the Company adjusted the restructuring accrual related to lease termination costs previously recorded in 2003. The adjustments decreased the liability by approximately \$0.6 million and \$0.3 million in 2004 and 2003, respectively, due to changes in estimates related to the sublease income to be received over the remaining lease term. Also in 2004, the Company recorded a \$0.1 million adjustment to reduce the restructuring accrual for severance and benefits from its EMEA operating segment that would not be utilized.

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

|                          | <b>Lease<br/>Termination<br/>Costs</b> | <b>Severance<br/>and<br/>Other<br/>Benefits</b> | <b>Other<br/>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          |

Edgar Filing: McAfee, Inc. - Form 10-K/A

|                            |           |       |           |
|----------------------------|-----------|-------|-----------|
| Balance, December 31, 2003 | 14,217    | 317   | 14,534    |
| Cash payments              | (1,841)   | (194) | (2,035)   |
| Adjustment to liability    | (623)     | (123) | (746)     |
| Accretion                  | 548       |       | 548       |
| Balance, December 31, 2004 | \$ 12,301 | \$    | \$ 12,301 |

As of December 31, 2004, \$1.3 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of \$11.0 million has been classified as other long term liabilities and will be paid through March 31, 2013. Lease termination costs are net of estimated sublease income of \$10.9 million at December 31, 2004.

The Company's estimate of the excess facilities charges recorded during 2003 and 2004 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 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 actual lease exit costs or sublease income differ from amounts currently expected.

As part of the plan to integrate certain activities of the Company's PGP product group into its other product groups and to dispose of other product lines, the Company sold its Gauntlet business during the first quarter of 2002. In connection with this process, a restructuring charge of approximately \$1.1 million was recorded. The restructuring charge consists of costs of severance packages for 44 employees as well as related legal and outplacement services. All amounts were paid at December 31, 2002.

**Table of Contents****10. Goodwill and 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 impairment review requires a two-step process.

The Company performs its annual goodwill impairment review as of October 1, of its fiscal year. In 2004, 2003, and 2002, these analyses have indicated 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. The Company will continue to test for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company's reporting units below their carrying amounts. An interim impairment analysis was performed in the second quarter of 2004 to coincide with the sale of the Company's Sniffer product line.

Goodwill information is as follows (in thousands):

|                                | January 1, 2003   |                   |                             |                 | December 31, 2003 |                  |                             |               | December 31, 2004 |             |                             |  |
|--------------------------------|-------------------|-------------------|-----------------------------|-----------------|-------------------|------------------|-----------------------------|---------------|-------------------|-------------|-----------------------------|--|
|                                | Goodwill Acquired | Adjustments       | Effects of Foreign Exchange |                 | Goodwill Acquired | Adjustments      | Effects of Foreign Exchange |               | Goodwill Acquired | Adjustments | Effects of Foreign Exchange |  |
| North America                  | \$ 232,122        | \$ 137,636        | \$ (6,671)                  | \$ 1,238        | \$ 364,325        | \$ 59,235        | \$ (59,007)                 | \$ 571        | \$ 365,124        |             |                             |  |
| EMEA                           | \$ 25,424         | \$ 21,477         | \$ (2,830)                  | \$ 289          | \$ 44,360         | \$               | \$ (2,930)                  | \$ 221        | \$ 41,651         |             |                             |  |
| Japan                          | \$ 12,071         | \$ 4,678          | \$ (1)                      | \$              | \$ 16,748         | \$               | \$ (351)                    | \$            | \$ 16,397         |             |                             |  |
| Asia-Pacific (excluding Japan) | \$ 2,301          | \$ 3,814          | \$ (28)                     | \$              | \$ 6,087          | \$               | \$ (520)                    | \$            | \$ 5,567          |             |                             |  |
| Latin America                  | \$ 2,016          | \$ 3,905          | \$ 5,454                    | \$ 698          | \$ 12,073         | \$               | \$ (1,724)                  | \$ 92         | \$ 10,441         |             |                             |  |
| <b>Total</b>                   | <b>\$ 273,934</b> | <b>\$ 171,510</b> | <b>\$ (4,076)</b>           | <b>\$ 2,225</b> | <b>\$ 443,593</b> | <b>\$ 59,235</b> | <b>\$ (64,532)</b>          | <b>\$ 884</b> | <b>\$ 439,180</b> |             |                             |  |

Goodwill was acquired during 2004 as a result of the purchase of Foundstone, and during 2003 as part of the purchases of Entercept and Intruvert (see Note 4).

For 2004, the adjustments column consists primarily of a reduction of \$50.5 million due to the sale of Sniffer in 2004 (see Note 5), \$13.6 million in adjustments related to the realization of net deferred tax assets from the Cybermedia, BySupport and IntruVert acquisitions and \$0.4 million related to purchase price adjustments. For 2003, the adjustments column reflects a \$6.2 million increase due to purchase price adjustments related to the BySupport acquisition in 2002, and a \$9.8 million decrease due to the reclassification of Magic goodwill to assets held for sale. The goodwill adjustments related to each of the businesses were allocated based on the relative percentage of their respective estimated fair values to the Company's fair value by reporting unit.

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

**December 31, 2004**

**December 31, 2003**

|                          | <b>Weighted<br/>Average<br/>Useful<br/>Life</b> | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization<br/>(Including<br/>Effects<br/>of Foreign<br/>Currency<br/>Exchange)</b> | <b>Net<br/>Carrying<br/>Amount</b> | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization<br/>(Including<br/>Effects<br/>of Foreign<br/>Currency<br/>Exchange)</b> | <b>Net<br/>Carrying<br/>Amount</b> |
|--------------------------|---|--------------------------------------|--|------------------------------------|--------------------------------------|--|------------------------------------|
| Other Intangible assets: |   |                                      |  |                                    |                                      |  |                                    |
|                          | 6.0   |                                      |  |                                    |                                      |  |                                    |
| Purchased technologies   | years   | \$ 139,509                           | \$ (74,400)  | \$ 65,109                          | \$ 116,037                           | \$ (64,439)  | \$ 51,598                          |
| Trademarks, patents      |   |                                      |  |                                    |                                      |  |                                    |
| customer base, and       | 6.4   |                                      |  |                                    |                                      |  |                                    |
| other intangibles        | years   | 90,335                               | (48,311)   | 42,024                             | 103,431                              | (49,077)   | 54,354                             |
|                          | 6.1   |                                      |  |                                    |                                      |  |                                    |
|                          | years   | \$ 229,844                           | \$ (122,711)   | \$ 107,133                         | \$ 219,468                           | \$ (113,516)   | \$ 105,952                         |

The aggregate amortization expenses for the intangible assets listed above totaled \$27.4 million, \$27.0 million, and \$13.9 million for 2004, 2003, and 2002, respectively.

|  | <b>2004</b>           | <b>2003</b> |
|--|-----------------------|-------------|
|  | <b>(In thousands)</b> |             |
| Intangible assets, beginning of year   | \$ 219,468            | \$ 177,255  |
| Add: Purchased technologies (amortized over one to seven years)                    | 27,000                | 40,523      |
| Add: Trademarks, patents and other intangibles (amortized over one to seven years) | 1,600                 | 4,704       |
| Add: Change in value due to foreign exchange                                       | 2,122                 | 2,738       |
|  | 250,190               | 225,220     |
| Less: Transfers to goodwill  |                       | (5,752)     |
| Dispositions   | (20,346)              |             |
| Intangible Assets, end of year   | \$ 229,844            | \$ 219,468  |

The additions in 2004 are a result of the Foundstone acquisition. The dispositions consist of the sale of the Magic and Sniffer product lines in 2004. The additions in 2003 consist of the IntruVert and Enterecept acquisitions. The transfers to goodwill in 2003 are a result of purchase accounting adjustments for BySupport.



**Table of Contents**

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

|               |            |
|---------------|------------|
| Fiscal Years: |            |
| 2005          | \$ 27,585  |
| 2006          | 24,896     |
| 2007          | 21,954     |
| 2008          | 16,586     |
| 2009          | 10,727     |
| Thereafter    | 5,385      |
|               | \$ 107,133 |

**11. Restated Commitments**

The Company leases most of its facilities under operating leases, which expire at various times ranging from the year 2005 through 2017. The Company's operating leases for facilities typically include renewal periods which are at the option of the Company, and annual contractual escalations in lease payments. Several of the Company's significant leases are subject to rent increases to market rates based on periodic rent reviews (typically every 5 years). The Company owns its regional office in Plano, Texas. A description of the Company's significant operating leases is as follows:

|   | <b>Lease Expiration</b> | <b>Renewal Option</b>             |
|---|-------------------------|-----------------------------------|
| Corporate Headquarters, Santa Clara, California | March 2013              | None                              |
| European Headquarters, Cork, Ireland            | December 2014           | One 5-year and one 6-year renewal |
| Amsterdam, The Netherlands                      | June 2008               | 5-year renewal                    |
| Slough, England                                 | December 2017           | None                              |
| Paris, France                                   | April 2006              | None                              |
| Tokyo, Japan                                    | February 2006           | None                              |

In addition, the Company has leased certain office equipment with various lease expiration dates through 2007.

Subsequent to the issuance of the Company's 2004 consolidated financial statements, the Company's management determined that future minimum lease payments and sublease rental income under non-cancelable operating leases as of December 31, 2004 had been improperly calculated. As a result, future minimum lease payments and sublease rental income have been restated from amounts previously reported. A summary of the effects of this restatement are as follows (in thousands):

|      | <b>As Previously Reported</b> |                        | <b>As Restated</b> |                        |
|------|-------------------------------|------------------------|--------------------|------------------------|
|      | <b>Payments</b>               | <b>Sublease Income</b> | <b>Payments</b>    | <b>Sublease Income</b> |
| 2005 | \$ 24,197                     | \$ 1,294               | \$ 20,025          | \$ 1,518               |
| 2006 | 20,643                        | 737                    | 15,002             | 1,146                  |
| 2007 | 16,558                        |                        | 10,422             |                        |

|            |            |          |            |          |
|------------|------------|----------|------------|----------|
| 2008       | 15,392     |          | 9,051      |          |
| 2009       | 14,889     |          | 8,629      |          |
| Thereafter | 61,810     |          | 37,449     |          |
| Total      | \$ 153,489 | \$ 2,031 | \$ 100,578 | \$ 2,664 |

Included in the above amounts are future minimum payments related to leases that the Company has ceased using and consequently, in connection with recording the related restructuring liabilities, has expensed prior to December 31, 2004 the present value of such future minimum payments, net of related projected sub-lease income.

Rent expense for 2004, 2003, and 2002 was \$21.2 million, \$21.3 million, and \$25.2 million, respectively. Sublease rental income under non-cancelable subleases was \$1.5 million, \$0.4 million, and \$0.1 million for 2004, 2003, and 2002, respectively.

## 12. Warranty Provision and Guarantees

The Company offers warranty on its hardware and software products and records a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and the Company's estimate of the level of future costs. A reconciliation of the change in the Company's warranty obligation for the years ended December 31 follows (in thousands):

**Table of Contents**

|                                       | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|---------------------------------------|-------------|-------------|-------------|
| Warranty provision, beginning of year | \$ 1,103    | \$ 1,153    | \$ 982      |
| Additional accruals                   | 8,037       | 3,881       | 4,624       |
| Disposition of Sniffer                | (807)       |             |             |
| Expenses incurred during the period   | (6,515)     | (3,931)     | (4,453)     |
| Warranty provision, end of year       | \$ 1,818    | \$ 1,103    | \$ 1,153    |

In November 2002, the FASB issued 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 as of December 31, 2004:

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 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.

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 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 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 the 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 fair value of these indemnification agreements is minimal.

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.

Under the terms of the Company's agreement to sell Sniffer in July 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 \$200.0 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.

Under the terms of the Company's agreement to sell McAfee Labs assets in December 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,

**Table of Contents**

the maximum potential loss related to the indemnification is \$1.5 million. The Company has not recorded any accruals related to these agreements.

Under the terms of the Company's agreements to sell the PGP and Gauntlet assets in 2002, 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.

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.

**13. Convertible Debt and Line of Credit**

The convertible debt balance was \$0 and \$347.4 million, net of accumulated fair value adjustment of \$0 and \$2.4 million (see Note 7), at December 31, 2004 and 2003, respectively.

***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 initial price to the public for the debentures was \$391.06 per \$1,000 of face amount at maturity, which equates to a yield to maturity over the term of the Debentures of 4.75% (on a semi-annual Debentures equivalent basis). The Debentures were convertible into common stock at the rate of 8.538 shares per \$1,000 of face amount at maturity, which equated to an initial conversion price of \$45.80 per share. The Debentures were subordinated in right of payment to all existing and future Senior Indebtedness (as defined in the related indenture) and effectively subordinated in right of payment to all indebtedness and other liabilities of the Company's subsidiaries.

In accordance with the indenture, in 2002, the Company redeemed a portion of the Debentures, which had an aggregate face amount at maturity of \$140.0 million, at a net price of \$66.2 million, which was financed from the Company's investment portfolio. In connection with this repurchase, the Company recognized a net gain of approximately \$26,000 in 2002. The gain was calculated as the difference between the accreted value of the debt, net of unamortized issuance costs and the cost of repurchase.

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 repurchased 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 \$2.7 million on the repurchase of Debentures during 2003.

***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 has been calculated using the effective interest method and recorded as additional interest expense in the statements of income. The Notes were unsecured and were subordinated to all existing and future Senior Indebtedness (as defined in the related indenture). The Notes had no restrictive financial covenants.

The Notes had a maturity date of 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 were convertible into the Company's common stock at any time, unless previously redeemed, at a conversion price of \$18.07 per share. The Notes could 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 would be able to 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 would be 100.0% of the principal amount.

In August 2004, the Company redeemed all of the outstanding Notes at a net price of \$265.6 million. Prior to the redemption date, approximately \$83.4 million in aggregate principal amount of the Notes converted into approximately 4.6 million shares of the Company's common stock. The Company recorded a loss on redemption of approximately \$15.1 million, which represented the write-off of unamortized debt issuance costs, fair value adjustment and the 1.3125% premium paid for redemption.

**Table of Contents**

In July 2002, the Company entered into an interest rate swap transaction with two investment banks, which resulted in the convertible notes being carried at fair value (see Note 7).

The estimated fair value of the Company's long-term debt outstanding at December 31, 2003, which consisted of Notes with a carrying amount of \$347.4, was \$373.1 million.

***Line of Credit***

The Company has a \$17.0 million credit facility with a bank. The credit facility 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 the Company and the 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. No balances are outstanding as of December 31, 2004.

**14. Employee Benefit Plans*****Company 401(k) and Profit Sharing Plan***

The Company's 401(k) and Profit Sharing Plan cover substantially all full-time employees. Employees can elect to defer the lesser of 40% of their compensation or \$13,000 per year. The board of directors, at its discretion, can match employee contributions in an amount not to exceed a maximum of \$4,000 per year. The number of plan participants was impacted by headcount reductions resulting from the Magic and Sniffer dispositions, as well as general headcount reductions. Annual amounts contributed by the Company under the plan were \$4.0 million, \$4.7 million, and \$4.3 million in 2004, 2003 and 2002, respectively.

***Company Employee Stock Purchase Plan***

In April 2002, the Company's board of directors adopted McAfee's 2002 Employee Stock Purchase Plan ( 2002 Purchase Plan ) and an initial 2.0 million shares of the Company's common stock were reserved for issuance. In December 2003, the Company's stockholders approved an additional 2.0 million shares for issuance under the 2002 Purchase Plan for a total of 4.0 million shares. All employees are eligible to participate in the 2002 Purchase Plan. The 2002 Purchase Plan is comprised of two year offering periods with four six-month purchase periods. Purchase periods occur twice yearly and each offering effectively contains a six, twelve, eighteen and twenty-four month option. Shares are purchased through employees' contributions at exercise prices equal to 85% of the lesser of the fair market value of the Company's common stock at either the first day of an offering period or the last day of the purchase period. No participant may purchase more than \$25,000 of common stock in any one calendar year and the maximum number of shares a participant may purchase during a single offering period is 10,000 shares. In 2004 and 2003, approximately 0.8 million and 1.6 million shares were issued under the 2002 Purchase Plan at a weighted average purchase price of \$10.41 and \$9.89, respectively.

Under the 1994 Employee Qualified Stock Purchase Plan ( 1994 Purchase Plan ), the Company could grant stock purchase rights to all eligible employees during one year offering periods with exercise dates approximately every six months (beginning each August and February). The Company had reserved 3.8 million shares of common stock for issuance under the plan. Shares were purchased through employees' payroll deductions at exercise prices equal to 85% of the lesser of the fair value of the Company's common stock at either the first day of an offering period or the last day of such offering period. No participant could purchase more than \$25,000 of common stock in any one calendar year. After the purchase on January 31, 2002, the 1994 Purchase Plan was terminated. In 2002, approximately 0.7 million shares were issued under the 1994 Purchase Plan at a weighted average purchase price of \$7.24.

***McAfee.com Employee Stock Purchase Plan***

In September 1999, McAfee.com's board of directors adopted McAfee.com's Employee Stock Purchase Plan (the 1999 Purchase Plan). A total of 0.5 million shares of McAfee.com Class A common stock were initially reserved for issuance under the 1999 Purchase Plan. All McAfee.com full-time employees were eligible to participate in the 1999 Purchase Plan. The 1999 Purchase Plan was comprised of two-year offering periods with exercise dates approximately every six months (beginning each August and February), with the exception of the first offering period, which commenced on December 2, 1999, with the first exercise date on January 31, 2000. Shares were purchased through McAfee.com employees' payroll deductions at exercise prices equal to 85% of the lesser of the fair market value of McAfee.com's Class A common stock at either the first day of an offering period or the last day of such offering period. No participant could purchase more than \$25,000 worth of Class A common stock in any one calendar year and the maximum number of shares a participant could purchase during a single purchase period was 2,500 shares. Purchase periods occurred twice yearly and each offering effectively contained a six, twelve, eighteen and twenty-four month option. On September 13, 2002, the Company acquired the minority interest in McAfee.com and therefore the McAfee.com employee stock purchase plan was terminated. In 2002, approximately 0.2 million of McAfee.com shares were issued under the 1999 Purchase Plan at weighted average purchase price of \$6.66. There was no activity under this plan in 2004 and 2003.



**Table of Contents****15. Stockholders Equity*****Common Stock***

In November 2003, the Company's board of directors authorized the repurchase up to \$150.0 million of the Company's common stock in the open market. In August 2004, the board of directors authorized the repurchase of an additional \$200.0 million of common stock through August 2006. The Company repurchased approximately 12.6 million and 0.4 million shares of its common stock in 2004 and 2003 for \$221.8 million and \$4.7 million, respectively. As of December 31, 2004, the Company may repurchase an additional \$123.6 million of its common stock. The timing and size of future repurchases are subject to market conditions, stock prices, the Company's cash position and other cash requirements.

In 2004, the Company retired approximately 13.0 million shares of its common stock which had been purchased on the open market in 2003 and 2004.

In 1998, the Company deposited approximately 1.7 million shares of common stock with a trustee for the benefit of the employees of the Dr. Solomon's acquisition to cover the stock options assumed in the acquisition of this company. These shares, which have been included in the outstanding share balance, were to be issued upon the exercise of stock options by Dr. Solomon's employees. The Company determined in June 2004 that Dr. Solomon's employees had exercised approximately 1.6 million options, and that it had issued new shares in connection with these exercises rather than the trust shares. The trustee returned the 1.6 million shares to the Company in June 2004, at which time they were retired and were no longer included in the outstanding share balance. In December 2004, the trustee sold the remaining 133,288 shares in the trust for proceeds of \$3.8 million, and remitted the funds to the Company. The terms of the trust prohibited the trustee from returning the shares to the Company and stipulated that only employees could benefit from the shares. The Company paid out the \$3.8 million to its employees as a bonus in 2004.

***Preferred Stock***

The Company has authorized 5.0 million shares of preferred stock, par value \$0.01 per share. The Company's board of directors has authority to provide for the issuance of the shares of preferred stock in series, to establish from time to time the number of shares to be included in each such series and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations or restrictions thereof, without any further vote or action by the shareholders.

***Company Stock Option Plans***

Under the amended 1997 Plan, the Company has reserved 32.5 million shares for issuance to employees, officers, directors, third party contractors and consultants. The plan provides for an option price no less than 100% of the fair value of the Company's common stock on the date of grant for incentive stock options granted to employees and officers (including directors who are also employees) or 85% of the fair value on the date of grant for all others. The options may be exercisable immediately, or over time, but generally become exercisable 25% one year after commencing employment or from date of grant and thereafter in monthly increments over three years. All options under the option plan expire ten years after grant.

Under the Stock Option Plan for Outside Directors, the Company has reserved 1.1 million shares of its common stock for issuance to certain members of its board of directors who are not employees of the Company or any affiliated corporation. The plan provides for an option price at fair value of the Company's common stock on the date of grant. The initial grant to each outside director generally vests ratably over a three-year period. Subsequent option grants will become exercisable after three years from the date of grant. All options under the option plan expire ten years after grant.

The Company assumed the Foundstone, Inc. 2000 Stock Plan as part of the acquisition of Foundstone in October 2004 (see Note 4). The Company has reserved 747,144 shares of its common stock for issuance under this plan. The plan provides for an option price no less than 85% of the fair value of the Company's common stock on the date of grant. The options generally become exercisable 25% one year after commencing employment or from the date of grant and thereafter in monthly increments over three years. All options under the plan expire ten years after grant. The Company assumed 428,696 options to purchase its common stock as a result of the acquisition.

In September 2002, the Company acquired the minority interest in McAfee.com. At that time, all outstanding options under McAfee.com's 1999 Stock Plan and 1999 Director Option Plan were converted and transferred into the Company's option plans and the McAfee.com stock option plans were terminated.

**Table of Contents**

Aggregate activity under the Company's stock option plans is as follows (in thousands, except per share data):

|   | Shares<br>Available<br>for<br>Grant | Number<br>of<br>Shares | Outstanding Options |                    | Weighted<br>Average<br>Exercise<br>Price |
|---|-------------------------------------|------------------------|---------------------|--------------------|--|
|   |                                     |                        | Price per<br>Share  | Aggregate<br>Price |  |
| <b>Balances, January 1, 2002</b>                                      | 9,104                               | 31,771                 | \$ 0.23-\$48.72     | \$ 421,493         | \$ 13.27                                 |
| Additional options reserved   | 5,000                               |                        |                     |                    |  |
| Option plan expirations   | (984)                               |                        |                     |                    |  |
| Options granted   | (8,302)                             | 8,302                  | \$ 0.01-\$30.26     | 190,401            | \$ 22.93                                 |
| Options issued in exchange of McAfee.com<br>outstanding stock options |                                     | 2,761                  | \$ 4.63-\$71.26     | 46,748             | \$ 16.93                                 |
| Options exercised   |                                     | (8,197)                | \$ 0.01-\$28.50     | (107,454)          | \$ 13.11                                 |
| Options canceled  | 6,335                               | (6,335)                | \$ 4.19-\$34.69     | (124,025)          | \$ 19.58                                 |
| <b>Balances, December 31, 2002</b>                                    | 11,153                              | 28,302                 | \$ 0.01-\$71.26     | \$ 427,163         | \$ 15.09                                 |
| Option plan expirations   | (1,326)                             |                        |                     |                    |  |
| Options granted   | (7,807)                             | 7,807                  | \$ 10.80-\$20.28    | 118,364            | \$ 15.16                                 |
| Options exercised   |                                     | (2,548)                | \$ 1.78-\$29.82     | (20,532)           | \$ 8.06                                  |
| Options canceled  | 3,821                               | (3,821)                | \$ 4.19-\$65.38     | (69,982)           | \$ 18.32                                 |
| <b>Balances, December 31, 2003</b>                                    | 5,841                               | 29,740                 | \$ 0.01-\$71.26     | \$ 455,013         | \$ 15.30                                 |
| Additional options of acquired company<br>reserved                    | 747                                 |                        |                     |                    |  |
| Option plan expirations   | (1,993)                             |                        |                     |                    |  |
| Options granted   | (5,674)                             | 5,674                  | \$ 14.96-\$33.39    | 102,131            | \$ 18.00                                 |
| Options assumed in conjunction with<br>acquisition                    | (429)                               | 429                    | \$ 1.11-\$3.68      | 1,153              | \$ 2.69                                  |
| Options exercised   |                                     | (9,152)                | \$ 0.65-\$38.23     | (106,235)          | \$ 11.61                                 |
| Options canceled  | 7,262                               | (7,262)                | \$ 2.80-\$58.71     | (139,753)          | \$ 19.24                                 |
| <b>Balances, December 31, 2004</b>                                    | 5,754                               | 19,429                 | \$ 0.01-\$71.26     | \$ 312,309         | \$ 16.08                                 |

Net proceeds from exercise of stock options was \$105.7 million, \$19.6 million and \$99.7 million for 2004, 2003 and 2002, respectively, which is net of a reduction in stock option exercise proceeds of \$0.5 million, \$0.9 million and \$7.8 million, respectively. This reduction is for the payment of the Company's cash obligation, not exceeding the full exercise price, which is triggered upon exercise of the Company stock options that were granted in exchange for the McAfee.com options (see Note 16).

During 2004 the Company granted 1.1 million stock options to employees for which the exercise price was below the fair value of its common stock on the date of grant. The Company is recognizing approximately \$0.1 million in compensation expense over the vesting period of the options. During 2002, the Company exchanged approximately 2.3 million options in the McAfee.com acquisition at exercise prices below fair value as of the acquisition date (see Note 16). No options were granted to employees below or above fair value during 2003.

For various price ranges, weighted average characteristics of outstanding stock options of the Company at December 31, 2004 were as follows (in thousands, except per share data):

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---------------------------------|
|                          | Number Outstanding  | Weighted Average Remaining Contractual Life (Yrs) | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$0.01-\$1.98            | 98                  | 4.3   | \$ 0.63                         | 51                  | \$ 1.21                         |
| \$1.99-\$4.12            | 359                 | 5.1   | \$ 2.88                         | 237                 | \$ 2.80                         |
| \$4.13-\$6.19            | 2,370               | 5.1   | \$ 4.66                         | 2,269               | \$ 4.67                         |
| \$6.20-\$9.30            | 534                 | 5.5   | \$ 7.63                         | 421                 | \$ 7.58                         |
| \$9.31-\$13.97           | 2,926               | 7.2   | \$ 12.22                        | 1,399               | \$ 11.98                        |
| \$13.98-\$20.97          | 9,169               | 8.1   | \$ 17.27                        | 2,339               | \$ 17.09                        |
| \$20.98-\$31.47          | 3,817               | 6.3   | \$ 25.17                        | 2,432               | \$ 24.98                        |
| \$31.48-\$47.22          | 133                 | 6.0   | \$ 35.47                        | 99                  | \$ 36.13                        |
| \$47.23-\$74.00          | 23                  | 3.7   | \$ 57.39                        | 23                  | \$ 57.53                        |
|                          | 19,429              | 7.1   | \$ 16.08                        | 9,270               | \$ 14.76                        |

At December 31, 2003 and 2002, the Company had 14.1 million and 10.0 million options that were exercisable with weighted average exercise prices of \$15.33 and \$14.27, respectively.

**Table of Contents****Proforma Stock Compensation Disclosure**

The fair value of options granted by the Company and McAfee.com has been calculated using the Black-Scholes option-pricing model using the single option approach. A typical option grant vests over a four-year period.

Parameters for the option analysis are listed below.

|                         | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|-------------------------|-------------|-------------|-------------|
| <b>The Company:</b>     |             |             |             |
| Risk free interest rate | 3.07%       | 2.44%       | 3.46%       |
| Expected life (years)   | 4           | 4           | 4           |
| Volatility              | 63%         | 96%         | 84%         |
| Dividend yield          |             |             |             |

The weighted average grant date fair value of options granted by the Company in 2004, 2003 and 2002 was \$9.08, \$10.38 and \$10.07, respectively.

The weighted average fair value of restricted stock granted by the Company in 2002 was \$27.19.

|                         | <b>Options<br/>Granted<br/>to<br/>Employees<br/>2002</b> | <b>Options<br/>Granted<br/>to<br/>Non-<br/>Employees<br/>2002</b> |
|-------------------------|--|---|
| <b>McAfee.com:</b>      |  |   |
| Risk free interest rate | 3.82%  | 3.82%   |
| Expected life (years)   | 5  | 10  |
| Volatility              | 110%   | 110%  |
| Dividend yield          |  |   |

The weighted average expected life of the option grants was estimated based on historical exercise patterns.

The weighted average grant date fair value of options granted by McAfee.com to employees in 2002 was \$7.76.

The Company and McAfee.com have also estimated the fair value of purchase rights issued under their employee stock purchase plans. Rights under these plans were also valued using the Black-Scholes option pricing model.

Parameters for the purchase rights analysis are listed below:

**The Company:**

|                         | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|-------------------------|-------------|-------------|-------------|
| Risk free interest rate | 2.03%       | 1.43%       | 2.05%       |
| Expected life (years)   | 1.25 years  | 1.25 years  | 6 months    |
| Volatility              | 48%         | 72%         | 84%         |
| Dividend yield          |             |             |             |

The weighted average fair value of rights issued pursuant to the Company's employee stock purchase plans in 2004, 2003 and 2002, was \$6.58, \$13.75, and \$14.62, respectively.

**McAfee.com:**

|                         | <b>2002</b> |
|-------------------------|-------------|
| Risk free interest rate | 1.72%       |
| Expected life (years)   | 6 months    |
| Volatility              | 110%        |
| Dividend yield          |             |

The weighted average fair value of rights issued by McAfee.com pursuant to its employee stock purchase plan until September 13, 2002 was \$39.60.

***Preferred Shares Rights Agreement***

On October 19, 1998, pursuant to a Preferred Shares Rights Agreement between the Company and BankBoston, N.A. as Rights Agent, the board of directors of the Company announced that it had declared a dividend distribution of one preferred share purchase

**Table of Contents**

right (a Right ) on each outstanding share of the Company s common stock. Each Right will entitle stockholders to buy one one-thousandth of a share of the Company s Series B Participating Preferred Stock at an exercise price of \$200.00. The Rights will become exercisable following the tenth day after a person or group announces the acquisition of 15% or more of the Company s common stock or announces commencement of a tender or exchange offer, the consummation of which would result in ownership by the person or group of 15% or more of the common stock of the Company. The Company will be entitled to redeem the Rights at \$0.01 per Right at any time on or before the tenth day following acquisition by a person or group of 15% or more of the Company s common stock. The dividend distribution was made on November 3, 1998, payable to the stockholders of record on November 3, 1998. The Rights expire on October 20, 2008.

**16. Stock-Based Compensation**

The Company recorded \$14.3 million, \$12.5 million, and \$22.4 million in 2004, 2003 and 2002, respectively, of stock-based compensation. Stock-based compensation charges relate primarily to the exchange of McAfee.com options in connection with the Company s acquisition of the publicly traded minority interest in McAfee.com, non-recurring stock compensation charges related to executive compensation and the repricing of employee stock options. The Company expects significant future stock-based compensation charges related to the exchange of McAfee.com options, repriced employee stock options and the adoption of SFAS 123R (see Note 2).

The following is a summary of the Company s compensation charges for the years presented (in thousands):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b> |
| Exchange of McAfee.com options                                  | \$ 6,669                        | \$ 3,369    | \$ 16,101   |
| Former employees  | 1,216                           | 1,125       | 10,118      |
| New and existing executives and employees                       | 1,928                           | 424         | 1,478       |
| Extended life of vested options of terminated employees         | 1,164                           | 3,720       |             |
| Extended vesting term of options                                |                                 |             | 193         |
| Extended period of Employee Stock Purchase Plan                 |                                 | 3,869       |             |
| Shares purchased outside Employee Stock Purchase Plan and other |                                 |             | 62          |
| Repriced options  | 3,343                           |             | (5,548)     |
| Total stock-based compensation                                  | \$ 14,320                       | \$ 12,507   | \$ 22,404   |

*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 the Company s common stock plus \$8.00 in cash, \$11.85 after applying the option exchange ratio, which is paid to the option holder upon exercise of the option and without interest. 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 Accounting for Stock Compensation under APB Opinion No. 25*, and FASB Interpretation No. 44 ( FIN 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 acquisition 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 common stock over the exercise price of the options plus the \$11.85 per share payable in cash. This compensation 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*. For those options that were fully vested at the date of the closing of the acquisition, the Company immediately recorded compensation expense of \$10.5 million. Charges related to unvested options are recorded as deferred stock-based compensation in stockholders equity in the consolidated balance sheet, and recognized as expense as the options vest.

During 2004, 2003 and 2002, the Company recorded charges of approximately \$6.7 million, \$3.4 million and \$16.1 million, including the \$10.5 million described above, respectively, related to exchanged options subject to variable accounting. These stock-based compensation charges were based on the Company's closing stock prices of \$28.93, \$15.04 and \$16.09 on December 31, 2004, 2003 and 2002, respectively. As of December 31, 2004, the Company had outstanding exchanged options to acquire approximately 0.4 million shares subject to this variable accounting. Further fluctuations in the stock price may result in significant additional stock based compensation charges in future periods.

*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. 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 2004.



**Table of Contents**

As a result of the sale of the Company's Sniffer product line in July 2004, the Company modified the stock option agreements of several Sniffer executives by accelerating the vesting of their unvested outstanding options. The Company recorded a stock-based compensation charge of approximately \$1.0 million in 2004.

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com exchanged options, which are subject to variable accounting as discussed above. Upon termination, the options were modified in accordance with a change in control provision. As a result, the Company recorded a stock compensation charge of approximately \$1.1 million and \$9.9 million in 2003 and 2002, respectively.

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 vest his options, the Company recorded a stock-based compensation charge corresponding to the fair market value of his vested options. The Company recorded stock-based compensation of \$0.2 million in 2002.

*New and Existing Executives and Employees.* In January 2002, the Company's board of directors approved a grant of 50,000 shares of restricted stock to its 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 fair value of the restricted stock was determined to be approximately \$1.4 million and was determined based on the difference between the exercise price of the restricted stock and the fair value of the common stock on January 15, 2002. During 2004, 2003 and 2002, the Company recorded approximately \$0.4 million, \$0.4 million and \$0.5 million related to stock-based compensation associated with the chief executive officer's 2002 restricted stock grant.

In September 2004, the Company's chief financial officer and chief operating officer announced that he was retiring from the Company effective December 31, 2004. Under the terms of his transition agreement, his options were modified such that all remaining unvested outstanding stock options would immediately vest on December 31, 2004 under specified conditions. The total stock based compensation charge related to this modification was approximately \$1.3 million, which was recorded as expense in 2004.

In connection with the acquisition of Foundstone in October 2004, the Company exchanged options to purchase shares of its common stock for Foundstone stock options. The fair value of the Company's stock options was included in the Foundstone purchase price. In accordance with FIN 44, the Company recorded \$2.3 million of deferred stock-based compensation related to the exchange of unvested stock options which are subject to vesting provisions as employment services are provided by the former Foundstone employees. The unvested stock options granted to Foundstone employees vest over periods ranging through 2008. The Company recorded stock-based compensation of \$0.2 million in 2004 related to the unvested stock options exchanged in the Foundstone acquisition.

On January 3, 2001, the Company entered into an employment agreement with its current chief executive officer. In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to its chief executive officer. The price of the underlying shares was \$0.01 per share. The shares vested and the Company's right to repurchase such shares lapsed as follows: 12.5% on the first four quarterly anniversaries of employment and the remaining 50% on the second year anniversary of employment. The fair value of the restricted stock was determined to be approximately \$2.0 million and was estimated based on the difference between the exercise price of the restricted stock and the fair value of the Company's common stock on the employment commencement date. During 2002, the Company recorded approximately \$1.0 million in stock-based compensation.

*Extended life of vested options held by terminated employees.* In connection with the Foundstone acquisition, the Company exchanged vested options to purchase shares of its common stock for vested Foundstone options. Certain Foundstone employees terminated their employment in October 2004 subsequent to the acquisition. Under the terms

of their options, the terminated employees had 90 days to exercise their options before they would expire. The Company determined prior to the end of 2004 that it would not be able to file the required public company reports with the SEC that would allow the terminated Foundstone employees to exercise their options within the 90 day period. On December 7, 2004, the Company extended the expiration date of the options through the end of January 2005. In accordance with FIN 44, this modification was considered to result in a new measurement of compensation cost as if the options were newly granted. The compensation charge was calculated based on the difference between the Company's closing stock price on December 7, 2004, the date of modification, and the closing stock price on the date of the Foundstone acquisition. The Company recorded a stock-based compensation charge of \$1.0 million in 2004.

In March 2003, the Company announced that the filing of its Form 10-K for 2002 would be postponed in order to restate prior financial results for 2000, 1999 and 1998. As a result, effective April 9, 2003, the Company suspended all exercises of stock options until the 2002 Form 10-K and all required quarterly reports on Form 10-Q were filed with the SEC, as these reports are incorporated by reference into the securities registration statements for each of the stock option plans. The period during which all stock option exercises were suspended was 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

**Table of Contents**

terminated based on the intrinsic value of the option on the modification date and the option price. The Company recorded stock-based compensation charges of approximately \$0.1 million and \$3.7 million for 2004 and 2003.

*Extended Vesting Term of Options.* In the second quarter of 2002, the Company recorded a one-time stock-based compensation charge of approximately \$0.2 million as a result of the modification of the terms of the options previously granted to certain employees.

*Extended period of Employee Stock Purchase Plan.* In March 2003, the Company announced that the filing of its Form 10-K for 2002 would be postponed in order to restate prior financial results for 2000, 1999 and 1998. As a result, effective April 9, 2003, the Company suspended all stock purchases until the 2002 Form 10-K and all required quarterly reports on Form 10-Q were filed with the SEC, as these reports are incorporated by reference into the securities registration statements for the 2002 Employee Stock Purchase Plan ( 2002 Purchase Plan ). The period during which all stock purchases were suspended was known as the blackout period. Due to the blackout period, the Company extended the purchase period of the 2002 Purchase Plan that would otherwise had been purchased on July 31, 2003. Accordingly, during 2003, the Company recorded a stock-based compensation charge of approximately \$3.9 million for the extended period of the 2002 Purchase Plan. The blackout period ended in November 2003, and therefore no additional stock-based compensation will be recorded.

*Shares Purchased Outside Employee Stock Purchase Plan.* On January 31, 2002, the Company experienced a shortfall in the number of shares available under the 1994 Employee Qualified Stock Purchase Plan to meet the requirements of the open purchase period. Although the Company reduced the number of shares plan participants could purchase by a pro rata amount, additional shares were required to be purchased outside of the plan in order to meet this shortfall. As a result, the Company recorded a one-time stock-based compensation charge of approximately \$0.1 million in 2002. The charge was based on the difference between the fair value of the shares purchased outside of the plan and the price the shares were sold to plan participants.

*Repriced Options.* On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price of \$11.063, the then current fair value of the stock. Options to purchase a total of 9.5 million shares were cancelled and the same number of new options were granted. These new options vest at the same rate that they would have vested under previous option plans and are subject to variable accounting. Accordingly, the Company has and will continue to remeasure compensation cost for these repriced options until these options are exercised, cancelled, or forfeited without replacement. The first valuation period began July 1, 2000.

The amount of stock-based compensation recorded was and will be based on any excess of the closing stock price at the end of the reporting period or date of exercise, forfeiture or cancellation without replacement, if earlier, over the fair value of the Company's common stock on July 1, 2000, which was \$20.375. The resulting compensation charge to earnings is recorded over the remaining vesting period, using the accelerated method of amortization required by FASB Interpretation 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an Interpretation of APB Opinions No. 15 and 25*. At December 31, 2004, these options were fully vested. Depending upon movements in the market value of the Company's common stock, this variable accounting treatment can result in additional stock-based compensation charges in future periods until the options are exercised, forfeited or cancelled.

During 2004, the Company recorded a stock-based compensation charge of \$3.3 million, and during 2002, the Company recorded a credit to earnings of approximately \$6.5 million. For 2004 and 2002, the Company's stock-based compensation charge (credit) was based on year-end per share prices of its stock of \$28.93 and \$16.09, respectively. There was no charge or credit recorded by the Company in 2003 as the stock price was below \$20.375 as of December 31, 2002 and throughout 2003. As of December 31, 2004, the Company had 0.3 million options outstanding subject to variable accounting.

The Company also incurred an initial stock-based compensation charge in connection with the initial issuance of the repriced options. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately \$1.0 million was expensed during 2002.

**17. Provision for Income Taxes**

The domestic and foreign components of income before provision for income taxes were as follows (in thousands):

|          | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|----------|-------------|-------------|-------------|
| Domestic | \$ 180,462  | \$ 17,303   | \$ 278      |
| Foreign  | 136,009     | 69,752      | 129,655     |
|          | \$ 316,471  | \$ 87,055   | \$ 129,933  |

**Table of Contents**

Significant components of the provision (benefit) for income taxes attributable to continuing operations are as follows (in thousands):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b> |
| Federal:                                  |                                 |             |             |
| Current                                   | \$ 2,630                        | \$ 18,148   | \$ 39,916   |
| Deferred                                  | 68,370                          | (23,332)    | (61,674)    |
| Total Federal                             | 71,000                          | (5,184)     | (21,758)    |
| State:                                    |                                 |             |             |
| Current                                   | (1,834)                         | 5,863       | 5,189       |
| Deferred                                  | 8,439                           | (4,802)     | (2,362)     |
| Total State                               | 6,605                           | 1,061       | 2,827       |
| Foreign:                                  |                                 |             |             |
| Current                                   | 21,648                          | 18,167      | 19,829      |
| Deferred                                  | (7,847)                         | 2,766       | (1,172)     |
| Total Foreign                             | 13,801                          | 20,933      | 18,657      |
| Provision for (benefit from) income taxes | \$ 91,406                       | \$ 16,810   | \$ (274)    |

Approximately \$3.6 million of the provision for income taxes in 2003 was reflected as part of the cumulative effect of a change in accounting principal in the consolidated statement of income.

Significant components of net deferred tax assets are as follows (in thousands):

|  | <b>Years Ended December</b> |             |
|--|-----------------------------|-------------|
|  | <b>31,</b>                  |             |
|  | <b>2004</b>                 | <b>2003</b> |
| <b>ASSETS</b>                                |                             |             |
| Deferred revenue                             | \$ 154,910                  | \$ 124,932  |
| Accrued liabilities and allowances           | 74,627                      | 61,802      |
| Depreciation and amortization                | 165,279                     | 137,554     |
| Tax credits                                  | 107,871                     | 117,998     |
| Deferred stock compensation                  | 7,870                       | 4,116       |
| Net operating loss carryover                 | 27,948                      | 51,332      |
|  | 538,505                     | 497,734     |
| Valuation allowance                          | (65,820)                    | (88,283)    |
| Total deferred tax assets                    | 472,685                     | 409,451     |
| <b>LIABILITIES</b>                           |                             |             |
| Intangibles not amortizable for tax purposes | 39,677                      | 40,178      |

|                                    |            |            |
|------------------------------------|------------|------------|
| Accrued liabilities and allowances | 11,947     | 9,527      |
| Total deferred tax liability       | 51,624     | 49,705     |
| Net deferred tax asset             | \$ 421,061 | \$ 359,746 |
| Current portion                    | \$ 200,459 | \$ 160,550 |
| Noncurrent portion                 | 220,602    | 199,196    |
|                                    | \$ 421,061 | \$ 359,746 |

At December 31, 2004, the Company has net operating loss carryovers for federal income tax purposes of approximately \$74.2 million. These net operating loss carryovers relate to acquisitions and are limited in the amount that can be recognized in any one year, and have expiration dates ranging from 2008 to 2024. The net decrease in the valuation allowance primarily relates to the utilization of foreign tax credits and net operating loss carryforwards from acquisitions for which there was uncertainty of future utilization prior to 2004. This decrease was partially offset by approximately a \$2.2 million valuation allowance recorded related to deferred tax assets of Foundstone. Management believes that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the net deferred tax assets, other than certain acquired net operating loss and credit carryforwards and certain other foreign tax credits for which a valuation allowance has been provided.

United States income taxes have not been provided for on a cumulative total of approximately \$341.3 million of earnings of certain non-U.S. subsidiaries, as the Company's historical intent has been to reinvest these earnings indefinitely in operations outside the U.S. See *Recent Accounting Pronouncements and Guidance* in Note 2 of the Consolidated Financial Statements for discussion of recent legislation regarding the repatriation of foreign earnings.

**Table of Contents**

The Company's effective tax rate on income before income taxes differs from the U.S. Federal statutory tax rate as follows (in thousands):

|  | <b>Years Ended December 31,</b> |                  |                 |
|--|---------------------------------|------------------|-----------------|
|  | <b>2004</b>                     | <b>2003</b>      | <b>2002</b>     |
| U.S. Federal income tax provision at statutory rate          | \$ 110,765                      | \$ 30,470        | \$ 45,469       |
| State provision  | 8,979                           | 1,258            | 2,725           |
| Non deductible acquisition and other costs                   |                                 | 2,310            | 5,343           |
| Foreign earnings taxed at rates different than the U.S. Rate | (10,266)                        | (3,480)          | (26,724)        |
| Other permanent differences                                  | (2,335)                         | 867              | (957)           |
| Tax credits  | (12,183)                        | (2,532)          | (26,096)        |
| Difference between book and tax basis of businesses sold     | 22,840                          |                  |                 |
| Benefit from accruals for tax exposures no longer required   | (25,036)                        | (12,083)         |                 |
| Other  | (1,358)                         |                  | (34)            |
|  | <b>\$ 91,406</b>                | <b>\$ 16,810</b> | <b>\$ (274)</b> |

In 2004, the Company realized the benefit of certain tax deductions related to a prior period acquisition. The \$27.0 million benefit has been recorded as a credit to additional paid in capital in the consolidated statement of stockholders' equity in 2004 as the acquisition was accounted for under the pooling of interests method.

**18. 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):

|   | <b>Years Ended December 31,</b> |             |             |
|---|---------------------------------|-------------|-------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b> |
| <b>Numerator - Basic</b>  |                                 |             |             |
| Income before cumulative effect of change in accounting principle   | \$ 225,065                      | \$ 59,905   | \$ 128,312  |
| Cumulative effect of change in accounting principle, net of tax     |                                 | 10,337      |             |
| Net income  | \$ 225,065                      | \$ 70,242   | \$ 128,312  |
| <b>Numerator - Diluted</b>  |                                 |             |             |
| Income before cumulative effect of change in accounting principle   | \$ 225,065                      | \$ 59,905   | \$ 128,312  |
| Cumulative effect of change in accounting principle, net of tax     |                                 | 10,337      |             |
| Interest on convertible debentures(1)                               | 7,556                           |             | 12,042      |
| Net income, adjusted  | \$ 232,621                      | \$ 70,242   | \$ 140,354  |
| <b>Denominator - Basic</b>  |                                 |             |             |
| Weighted average shares of common stock outstanding                 | 160,714                         | 160,338     | 149,641     |
| Less: weighted average shares of common stock subject to repurchase |                                 |             | (200)       |
| Basic weighted average common shares outstanding                    | 160,714                         | 160,338     | 149,441     |

|   |         |         |         |
|---|---------|---------|---------|
| Denominator Diluted   |         |         |         |
| Basic weighted average common shares outstanding                  | 160,714 | 160,338 | 149,641 |
| Effective of dilutive securities:                                 |         |         |         |
| Convertible debentures(1)   | 12,154  |         | 19,092  |
| Common stock options(2)   | 4,207   | 3,992   | 7,333   |
| Warrants  | 24      | 159     | 183     |
| Diluted weighted average shares                                   | 177,099 | 164,489 | 176,249 |
| Basic net income per share:                                       |         |         |         |
| Income before cumulative effect of change in accounting principle | \$ 1.40 | \$ 0.37 | \$ 0.86 |
| Cumulative effect of change in accounting principle, net of tax   |         | 0.07    |         |
| Net income per share Basic  | \$ 1.40 | \$ 0.44 | \$ 0.86 |
| Diluted net income per share:                                     |         |         |         |
| Income before cumulative effect of change in accounting principle | \$ 1.31 | \$ 0.36 | \$ 0.80 |
| Cumulative effect of change in accounting principle, net of tax   |         | 0.07    |         |
| Net income per share Diluted                                      | \$ 1.31 | \$ 0.43 | \$ 0.80 |

---

(1) Convertible debt interest and related 19.1 million as-if converted shares were excluded from the calculation since the effect was anti-dilutive in 2003. The total number of shares excluded from the calculation related to as-if converted shares was 3.1 million for 2002.

(2) At December 31, 2004, 2003 and 2002, 5.1 million, 15.6 million, and 9.9 million options to purchase common stock, respectively, were excluded from the calculation since the effect was anti-dilutive.



**Table of Contents****19. Business Segment and Major Customer 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; 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; network management software, hardware and services; and help desk software and services. These products and services are marketed and sold worldwide primarily through resellers, distributors, systems integrators retailers, 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 users' PC configuration, attached peripherals and resident software. The Company also offers managed security and availability applications to corporations and governments on the Internet.

The accounting policies of the businesses and geographic segments are the same as disclosed in Note 2. To reconcile to the consolidated financial statements, where applicable, Corporate represents costs and expenses associated with corporate activities. Corporate activities include general and administrative expenses and corporate marketing expenses of \$65.0 million, \$61.9 million, and \$37.3 million in 2004, 2003 and 2002, respectively; stock-based compensation charges; and acquisition, restructuring and other related costs. These corporate expenses are not considered attributable to any specific geographic region. The \$25.0 million litigation reimbursement received in 2004 and the \$70.0 million litigation charge incurred in 2002 were recorded in North America. Summarized financial information concerning the Company's net revenue and operating income by geographic region is as follows (in thousands):

|   | <b>Years Ended December 31,</b> |             |              |
|---|---------------------------------|-------------|--------------|
|   | <b>2004</b>                     | <b>2003</b> | <b>2002</b>  |
| <b>Net revenue by region:</b>             |                                 |             |              |
| North America                             | \$ 554,641                      | \$ 606,685  | \$ 653,532   |
| EMEA                                      | 241,724                         | 240,616     | 298,659      |
| Japan                                     | 54,609                          | 40,519      | 39,369       |
| Asia-Pacific (excluding Japan)            | 38,494                          | 29,014      | 33,595       |
| Latin America                             | 21,074                          | 19,502      | 17,889       |
| Net revenue                               | \$ 910,542                      | \$ 936,336  | \$ 1,043,044 |
| <b>Operating income (loss) by region:</b> |                                 |             |              |
| North America                             | \$ 195,195                      | \$ 215,027  | \$ 156,080   |
| EMEA                                      | 90,612                          | 88,884      | 135,629      |
| Japan                                     | 18,650                          | 11,061      | 8,710        |
| Asia-Pacific (excluding Japan)            | 11,903                          | 5,962       | 6,682        |
| Latin America                             | 4,188                           | 1,338       | 2,436        |
| Corporate                                 | 2,123                           | (257,870)   | (185,509)    |
| Operating income                          | \$ 322,671                      | \$ 64,402   | \$ 124,028   |

Following is a summary of the Company's total assets by geographic region. Assets purchased to support infrastructure and general and administrative activities, including land purchases, are included in Corporate in the table below. These corporate assets are not assigned to any specific geographic region. Summarized financial information concerning the Company's total assets by business and geographic region is as follows (in thousands):

|                                | <b>December 31,</b> |              |
|--------------------------------|---------------------|--------------|
|                                | <b>2004</b>         | <b>2003</b>  |
| North America                  | \$ 1,579,401        | \$ 1,452,407 |
| EMEA                           | 533,987             | 485,613      |
| Japan                          | 64,736              | 51,331       |
| Asia-Pacific (excluding Japan) | 25,794              | 25,479       |
| Latin America                  | 19,729              | 17,839       |
| Corporate                      | 14,029              | 87,829       |
| Total assets                   | \$ 2,237,676        | \$ 2,120,498 |

**Table of Contents**

Property and equipment based on the physical location of the assets is as follows (in thousands):

|                 | <b>2004</b>      | <b>2003</b>       | <b>2002</b>      |
|-----------------|------------------|-------------------|------------------|
| United States   | \$ 72,769        | \$ 89,857         | \$ 73,990        |
| Japan           | 4,038            | 5,484             | 4,560            |
| India           | 3,667            | 4,261             | 1,506            |
| The Netherlands | 2,354            | 3,991             | 1,835            |
| Other countries | 8,887            | 8,079             | 7,386            |
| <b>Total</b>    | <b>\$ 91,715</b> | <b>\$ 111,672</b> | <b>\$ 89,277</b> |

Net revenues attributed to countries based on the location of the customer for the years ended December 31 is as follows (in thousands):

|                 | <b>2004</b>       | <b>2003</b>       | <b>2002</b>         |
|-----------------|-------------------|-------------------|---------------------|
| United States   | \$ 520,211        | \$ 573,263        | \$ 618,936          |
| United Kingdom  | 67,443            | 67,229            | 87,010              |
| Germany         | 41,910            | 43,717            | 50,533              |
| Japan           | 54,609            | 40,519            | 39,369              |
| Other countries | 226,369           | 211,608           | 247,196             |
| <b>Total</b>    | <b>\$ 910,542</b> | <b>\$ 936,336</b> | <b>\$ 1,043,044</b> |

Net revenue information on a business unit basis is as follows for the years ended December 31 (in thousands):

|                          | <b>2004</b>       | <b>2003</b>       |
|--------------------------|-------------------|-------------------|
| McAfee                   | \$ 766,696        | \$ 634,812        |
| Sniffer                  | 90,878            | 210,176           |
| Magic                    | 2,850             | 63,164            |
| IntruShield              | 43,707            | 15,510            |
| McAfee Labs              | 6,411             | 11,023            |
| PGP                      |                   | 1,651             |
| <b>Total net revenue</b> | <b>\$ 910,542</b> | <b>\$ 936,336</b> |

Net revenue information on a business unit basis is not available for 2002.

Net revenue information on a product and service basis is as follows for the years ended December 31 (in thousands):

|                   | <b>2004</b> | <b>2003</b> | <b>2002</b> |
|-------------------|-------------|-------------|-------------|
| Software licenses | \$ 157,983  | \$ 341,188  | \$ 459,707  |

|                                   |            |            |              |
|-----------------------------------|------------|------------|--------------|
| Support and maintenance           | 436,299    | 313,731    | 310,473      |
| Hardware                          | 79,828     | 99,502     | 93,359       |
| Retail                            | 27,787     | 45,993     | 63,236       |
| Consulting                        | 19,157     | 27,421     | 36,740       |
| Training                          | 8,394      | 9,486      | 12,527       |
| On-line subscription arrangements | 152,529    | 72,088     | 51,754       |
| Other                             | 28,565     | 26,927     | 15,248       |
| Total                             | \$ 910,542 | \$ 936,336 | \$ 1,043,044 |

At December 31, 2004 and 2003, one customer had an accounts receivable balance which comprised 23% and 22%, respectively, of the Company's total accounts receivable balance. During 2004, 2003 and 2002, one customer accounted for 22%, 24% and 25%, respectively, of the total net revenue for each year. During 2004 and 2002, another customer accounted for 11% and 10%, respectively, of the net revenue. The net revenue derived from these customers is reported primarily in the Company's North American and EMEA geographic segments.

## 20. 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 the 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 be costly,

## **Table of Contents**

could cause the diversion of management's attention and could upon resolution, have a material adverse effect on the business, results of operations, financial condition and cash flow.

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 the Company's financial position, results of operations or cash flows.

### ***Securities Cases***

In September 2003, the Company entered into a settlement agreement with the plaintiffs in the *In re Network Associates, Inc. II Securities Litigation*, which was originally filed in September 2001. Under the settlement agreement the Company paid \$70.0 million, which was recorded as litigation settlement in the consolidated statement of income for 2002. The settlement was approved by the court in February 2004, and the case was dismissed with prejudice to all parties and claims. In 2004, the Company received approximately \$25.0 million from its insurance carriers related to this litigation, which was recorded as litigation reimbursement in the consolidated statement of income for 2004.

Certain investment bank underwriters, the Company, and certain of its directors and officers have been named in a putative class action 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. Under this settlement proposal, the Company may assign its claims against certain underwriters to the plaintiffs, and the Company would be dismissed from the lawsuit without paying any monetary damages.

### ***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 and the First Circuit Court of Appeals. In September 2004 the parties filed cross-motions for partial summary judgment on liability, but not damages, issues relating to whether the contract claims extend beyond the Virex 6.1 product. The District Court has heard argument on the pending cross-motions for partial summary judgment but has not yet issued any decision.

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.

## **21. Related Party Transactions**

Under the terms of the amended and restated employment agreement for Mr. George Samenuk, Chairman of the Board and Chief Executive Officer, the Company agreed to loan Mr. Samenuk the funds necessary to pay the taxes due on each vesting date for the 400,000 shares of restricted stock granted to Mr. Samenuk on January 3, 2001. In addition, the Company agreed to loan Mr. Samenuk the funds necessary to pay the taxes due on the 3,000 shares of stock granted to Mr. Samenuk on January 15, 2002. In accordance with the provisions of the Sarbanes-Oxley Act of 2002, no additional loans were made to Mr. Samenuk after July 30, 2002 and no material modifications were made to any loan outstanding on that date.

In total, the Company extended five separate loans to Mr. Samenuk. As of December 31, 2002, four loans in an aggregate amount of approximately \$955,000 were outstanding. The loans each had a two-year maturity and bore interest at the applicable federal rate. The loans were full recourse and secured by Mr. Samenuk's restricted stock and 3,000 shares of stock. The last remaining loan was fully repaid in October 2003.

**Table of Contents**

**22. Subsequent Events**

In March 2005, the Company repurchased approximately 2.0 million shares of its common stock in the open market for approximately \$47.4 million.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Santa Clara, State of California, on the 23rd day of May, 2005.

MCAFEE, INC.

By: /s/ GEORGE SAMENUK  
George Samenuk  
*Chairman of the Board and Chief  
Executive Officer*

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints George Samenuk and Eric F. Brown, and each of them acting individually, as his or her attorney-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K/A, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or any substitute, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this Report has been signed on May 23, 2005 by the following persons on behalf of the Registrant in the capacities indicated:

| <b>Signature</b>                                    | <b>Title</b>   | <b>Date</b>  |
|---|--|--------------|
| <u>/s/ GEORGE SAMENUK</u><br>(George Samenuk)       | Chairman of the Board and Chief<br>Executive Officer | May 23, 2005 |
| <u>/s/ ERIC F. BROWN</u><br>(Eric F. Brown)         | Chief Financial Officer                              | May 23, 2005 |
| <u>/s/ ROBERT B. BUCKNAM</u><br>(Robert B. Bucknam) | Director   | May 23, 2005 |
| <u>/s/ LESLIE G. DENEND</u><br>(Leslie G. Denend)   | Director   | May 23, 2005 |
| <u>/s/ ROBERT DUTKOWSKY</u><br>(Robert Dutkowsky)   | Director   | May 23, 2005 |
| <u>/s/ DENIS J. O LEARY</u><br>(Denis J. O Leary)   | Director   | May 23, 2005 |
| <u>/s/ ROBERT PANGIA</u>                            | Director   | May 23, 2005 |



(Robert Pangia)  
/s/ LIANE WILSON

---

Director

May 23, 2005

(Liane Wilson)

75

---

**Table of Contents**

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 2.1                       | Asset Purchase Agreement made and entered into as of April 22, 2004, by and among, Network General Corporation (formerly named Starburst Technology Holdings, Inc.), on the one hand; and (ii) McAfee, Inc. (formerly named Networks Associates, Inc.), Network Associates Technology, Inc., Network Associates International BV, Network Associates (India) Private Limited, McAfee Japan Co., Ltd. (formerly named Network Associates Japan Co., Ltd.), on the other hand, as amended by Amendment No. 1 thereto dated as of July 15, 2004.(1) |
| 3.1                       | Second Restated Certificate of Incorporation of the Registrant, as amended on December 1, 1997.(3)   |
| 3.2                       | Certificate of Ownership and Merger between Registrant and McAfee, Inc.(2)   |
| 3.3                       | Amended and Restated Bylaws of the Registrant.(2)  |
| 3.4                       | Certificate of Designation of Series A Preferred Stock of the Registrant.(5)   |
| 3.5                       | Certificate of Designation of Series B Participating Preferred Stock of the Registrant.(6)   |
| 4.3                       | Indenture dated as of August 17, 2001 between the Registrant and State Street Bank and Trust Company of California.(7)   |
| 10.1                      | Lease Assignment dated November 17, 1997 for facility at 3965 Freedom Circle, Santa Clara, California by and between Informix Corporation and McAfee Associates, Inc.(8)   |
| 10.2                      | Consent to Assignment Agreement dated December 19, 1997 by and among Birk S. McCandless, LLC, Guaranty Federal Bank, F.S.B., Informix Corporation and the Registrant.(8)   |
| 10.3                      | Subordination, Nondisturbance and Attornment Agreement dated December 18, 1997, between Guaranty Federal Bank, F.S.B., the Registrant and Birk S. McCandless, LLC.(8)  |
| 10.4                      | Lease dated November 22, 1996 by and between Birk S. McCandless, LLC and Informix Corporation for facility at 3965 Freedom Circle, Santa Clara, California.(8)   |
| 10.5*                     | 2002 Employee Stock Purchase Plan.(9)  |
| 10.6*                     | 1997 Stock Incentive Plan, as Amended.(9)  |
| 10.7*                     | Amended and Restated 1993 Stock Option Plan for Outside Directors.(4)  |
| 10.8*                     | 2000 Nonstatutory Stock Option Plan.(10)   |
| 10.9<br>*                 | Amended and Restated Employment Agreement between George Samenuk and the Registrant, dated October 9, 2001.(11)  |
| 10.10*                    | Employment agreement between Stephen C. Richards and the Registrant, dated April 3, 2001.(12)  |

Edgar Filing: McAfee, Inc. - Form 10-K/A

- 10.11 1st Amendment to Lease dated March 20, 1998 between Birk S. McCandless, LLC and the Registrant.(13)
- 10.12 Confirmation, Amendment and Notice of Security Agreement dated March 20, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
- 10.13 Second Amendment to Lease dated September 1, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
- 10.14 Subordination, Nondisturbance and Attornment Agreement dated June 21, 2000, among Column Financial, Inc., Informix Corporation, Birk S. McCandless, LLC, and the Registrant.(13)
- 10.15 Lease Agreement dated November 14, 1996 between Blue Lake Partners and McAfee Associates, Inc.(13)
- 10.16 Lease Amendment dated November 24, 1997 between Blue Lake Partners and McAfee Software, Inc.(13)
- 10.17 Lease Amendment dated March 17, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)

**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.18                     | Lease Amendment dated March 27, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)    |
| 10.19                     | Lease Amendment dated June 4, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)      |
| 10.20                     | Lease Amendment dated July 21, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)     |
| 10.21                     | Lease Amendment dated November 20, 1998 between Blue Lake Partners and McAfee Software, Inc.(13) |
| 10.22                     | Lease Amendment dated March 18, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)    |
| 10.23                     | Lease Amendment dated June 3, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)      |
| 10.24                     | Lease Amendment dated October 7, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)   |
| 10.25                     | Lease Amendment dated March 25, 2000 between Daltex Centre LP and the Registrant.(13)            |
| 10.26                     | Lease Amendment dated July 31, 2000 between Daltex Centre LP and the Registrant.(13)             |
| 10.27                     | Lease Amendment dated January 24, 2001 between Daltex Centre LP and the Registrant.(13)          |
| 10.28                     | Lease Amendment dated May 31, 2001 between Daltex Centre LP and the Registrant.(13)              |
| 10.29*                    | Employment Agreement between Kent H. Roberts and the Registrant, dated October 9, 2001.(14)      |
| 10.30<br>*                | Employment Agreement between Vernon Gene Hodges and the Registrant, dated December 3, 2001.(14)  |
| 10.31*                    | Employment Agreement between Raymond J. Smets and the Registrant, dated October 7, 2002(14)      |
| 10.32*                    | Employment Agreement between Kevin M. Weiss and the Registrant Dated October 15, 2002.(17)       |
| 10.33                     | Form of Indemnification Agreement between the Registrant and its Executive Officers(17)          |
| 10.34*                    | Summary of Pay for Performance Plan.(4)  |
| 10.35*                    | Network Associates, Inc. Tax Deferred Savings Plan.(16)  |
| 10.36                     | Umbrella Credit Facility of Registrant dated April 15, 2004.(18)                                 |
| 10.37                     | Fifth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(18)                       |
| 10.38                     | Amendment to Employment Agreement of George Samenuk effective as of January 20, 2004.(18)        |
| 10.39                     | Amendment to Employment Agreement of Stephen C. Richards effective as of January 20, 2004.(18)   |

Edgar Filing: McAfee, Inc. - Form 10-K/A

|        |  |
|--------|--|
| 10.40  | Sniffer Bonus Plan.(18)  |
| 10.41  | Form of Sniffer Bonus Plan Participation Agreement (Ray Smets).(18)                    |
| 10.42  | Addendum to Raymond J. Smets Employment Agreement.(20)                                 |
| 10.43  | Sixth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(20)             |
| 10.44  | Transition Agreement by and between Registrant and Stephen C. Richards.(19)            |
| 10.45  | Employment Agreement between Registrant and Eric F. Brown dated December 10, 2004 (22) |
| 10.46* | 2005 Independent Director Cash Compensation Plan                                       |
| 21.1   | Subsidiaries of the Registrant   |
| 23.1   | Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm        |
| 23.2   | Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm   |

**Table of Contents**

| <b>Exhibit<br/>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                                  |
| <hr/>                     |   |
| (1)                       | Incorporated by reference from the Registrant's Report on Form 8-K filed with the Commission on July 16, 2004.  |
| (2)                       | Incorporated by reference from the Registrant's Report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.    |
| (3)                       | Incorporated by reference from the Registrant's Registration Statement on Form S-4 filed with the Commission on March 25, 1998.                                 |
| (4)                       | Incorporated by reference from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002, filed with the Commission on October 31, 2003. |
| (5)                       | Incorporated by reference from the Registrant's Report on Form 10-Q for the quarter ended September 30, 1996, filed with the Commission on November 14, 1996.   |
| (6)                       | Incorporated by reference from the Registrant's Report on Form 8-A filed with the Commission on October 22, 1998.   |
| (7)                       | Incorporated by reference from the Registrant's Registration Statement on Form S-3 filed with the Commission on November 9, 2001.                               |
| (8)                       | Incorporated by reference from the Registrant's Registration Statement on Form S-3, filed with the Commission on February 11, 1998.                             |
| (9)                       | Incorporated by reference from the Registrant's Registration Statement on Form S-8 filed with the Commission on June 28, 2002.                                  |
| (10)                      | Incorporated by reference from the Registrant's report on Form 10-K for the year ended December 31, 2000, filed with the Commission on April 2, 2001.           |
| (11)                      | Incorporated by reference from the Registrant's report on Form 10-K for the year ended December 31, 2001, filed with the Commission on February 8, 2002.        |
| (12)                      | Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended March 31, 2001, filed with the Commission on May 15, 2001.            |
| (13)                      | Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended September 30, 2001, filed with the Commission on November 13, 2001.   |
| (14)                      |   |

Edgar Filing: McAfee, Inc. - Form 10-K/A

Incorporated by reference from the Registrant's report on Form 10-K for the year ended December 31, 2001, filed with the Commission on February 8, 2002.

- (15) Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended September 30, 2002, filed with the Commission on November 12, 2002.
- (16) Incorporated by reference from the Registrant's Registration Statement on Form S-8 filed with the Commission on November 5, 2003.
- (17) Incorporated by reference from the Registrant's report on Form 10-K for the year ended December 31, 2003, filed with the Commission on March 9, 2004.
- (18) Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended March 31, 2004, filed with the Commission on May 10, 2004.
- (19) Incorporated by reference from the Registrant's report on Form 8-K filed with the Commission on September 7, 2004.

**Table of Contents**

- (20) Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended June 30, 2004, filed with the Commission on August 9, 2004.
- (21) Incorporated by reference from the Registrant's report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.
- (22) Incorporated by reference from the Registrant's report on Form 8-K filed with the Commission on December 14, 2004.
- \* Management contracts or compensatory plans or arrangements covering executive officers or directors of McAfee, Inc.



Table of Contents

## SCHEDULE II

## NETWORKS ASSOCIATES, INC.

## VALUATION AND QUALIFYING ACCOUNTS

|  | Balance<br>at<br>Beginning<br>of<br>Period | Provision for<br>Doubtful<br>Accounts,<br>Additions<br>Charged<br>to Expense or<br>Revenue Net(1)<br>(In thousands) | Write-Offs<br>of<br>Previously<br>Provided<br>Accounts | Balance<br>at<br>End of<br>Period |
|--|--|---|--|-----------------------------------|
| Year Ended December 31, 2004<br>Allowance for Doubtful Accounts    | \$ 3,070                                   | \$ 1,716  | \$ (2,250)   | \$ 2,536                          |
| Year Ended December 31, 2003<br>Allowance for Doubtful Accounts(2) | \$ 6,638                                   | \$ (1,216)  | \$ (2,352)   | \$ 3,070                          |
| Year Ended December 31, 2002<br>Allowance for Doubtful Accounts    | \$ 8,394                                   | \$ (219)  | \$ (1,537)   | \$ 6,638                          |

- (1) *Provision for Doubtful Accounts, Net.* The provision for doubtful accounts, net consists of our estimates with respect to the uncollectibility of our receivables, net of recoveries of amounts previously written off. Our management must make estimates of the uncollectibility of our accounts receivables. Management specifically analyzes accounts receivable and analyzes historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts.
- (2) The allowance for doubtful accounts in the consolidated balance sheet as of December 31, 2003 is net of the \$0.2 million allowance for Magic, which is included in assets held for sale.

|  | Balance<br>at<br>Beginning<br>of<br>Period | Provision<br>for<br>Sales<br>Returns<br>and Other<br>Allowances(3) | Actual<br>Returns<br>and<br>Allowances | Balance<br>at<br>End of<br>Period |
|--|--|--|--|-----------------------------------|
| Year Ended December 31, 2004<br>Sales Returns and Allowances | \$ 39,599                                  | \$ 65,350  | \$ (75,725)                            | \$ 29,224                         |
| Year Ended December 31, 2003<br>Sales Returns and Allowances | \$ 32,337                                  | \$ 85,612  | \$ (78,350)                            | \$ 39,599                         |
| Year Ended December 31, 2002<br>Sales Returns and Allowances | \$ 32,586                                  | \$ 130,163   | \$ (130,412)                           | \$ 32,337                         |

- (3) *Provision for Sales Returns and Allowances.* The provision for sales returns and allowances consists of our estimates of potential future product returns related to current period product revenue, and specific provisions for distributor, reseller, and retailer sales incentives ( allowances ) that are reductions in the revenue to be realized. Management analyzes historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns and allowances. Significant management judgments and estimates must be made and used in connection with establishing the sales returns and allowances in any accounting period. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates.

80