NETWORKS ASSOCIATES INC/
Form 10-Q
October 31, 2003

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2003

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 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0316593**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification Number)*
3965 Freedom Circle **Santa Clara, California**	**95054**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:

(408) 988-3832

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

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

As of October 27, 2003, 160,329,178 shares of the registrant s common stock, $0.01 par value, were outstanding.

THIS DOCUMENT CONTAINS 72 PAGES.

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

FORM 10-Q

March 31, 2003

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2003	December 31, 2002
	(in thousands, except share and per share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 432,844	$ 674,226
Short-term available-for-sale securities	122,461	133,577
Accounts receivable, net	109,214	160,159
Prepaid expenses, income taxes and other current assets	65,631	51,715
Deferred taxes	169,485	174,469
Total current assets	899,635	1,194,146
Long-term available-for-sale securities	339,660	205,906
Restricted cash	21,410	21,734
Property and equipment, net	99,542	89,277
Deferred taxes	146,194	139,091
Intangible assets, excluding goodwill, net	86,828	93,551
Goodwill, net	274,309	273,934
Other assets	25,892	27,848
Total assets	$1,893,470	$2,045,487
LIABILITIES		
Current liabilities:		
Accounts payable	$ 33,164	$ 29,948
Accrued liabilities	362,649	383,458
Deferred revenue	295,291	292,277
Current portion of convertible debt	232	176,260
Total current liabilities	691,336	881,931
Deferred revenue, less current portion	33,335	36,918
Convertible debt, less current portion	355,803	356,013
Other long term liabilities	11,731	445
Total liabilities	1,092,205	1,275,319
Contingencies (Notes 13 and 14)		
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; issued and outstanding: none at March 31, 2003 and December 31, 2002		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; issued and outstanding: 160,233,358 shares at March 31, 2003 and 157,945,601 shares at December 31, 2002	1,602	1,579
Additional paid-in capital	1,064,533	1,050,288
Deferred stock-based compensation	(2,236)	(5,736)
Accumulated other comprehensive loss	25,866	24,158

Accumulated deficit	(288,500)	(300,121)
Total stockholders equity	801,265	770,168
Total liabilities and stockholders equity	$1,893,470	$2,045,487

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

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND

COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2003	**2002**
	(in thousands, except per share data) (Unaudited)	(As Restated)
Net revenue:		
Product	$126,391	$137,957
Services and support	92,050	117,691
Total net revenue	218,441	255,648
Cost of net revenue:		
Product	18,690	26,605
Services and support	13,230	15,347
Amortization of purchased technology	1,741	802
Total cost of net revenue	33,661	42,754
Operating costs and expenses:		
Research and development(1)	46,430	34,605
Marketing and sales(2)	88,941	102,474
General and administrative(3)	28,208	24,050
Provision for (recovery from) doubtful accounts, net	(323)	730
Amortization of intangibles	5,011	2,050
Restructuring charge	15,781	1,116
Total operating cost and expenses	184,048	165,025
Income from operations	732	47,869
Interest and other income	5,596	6,662
Interest expense	(3,171)	(7,690)
Loss on repurchase of zero coupon convertible debentures	(2,591)	
Gain on sale of product lines	37	6,717
Income before provision for (benefit from) income taxes, minority interest and cumulative effect of change in accounting principle	603	53,558
Provision for (benefit from) income taxes	121	(103)
Income before minority interest and cumulative effect change in accounting principle	482	53,661
Minority interest in net income of consolidated subsidiaries		(2,023)
Income before cumulative effect of change in accounting principle	482	51,638
Cumulative effect of change in accounting principle, net of tax	11,142	

Net income	$ 11,624	$ 51,638
Other comprehensive income:		
Unrealized loss on marketable securities, net	$ (689)	$ (2,527)
Foreign currency translation gain (loss)	2,433	(1,172)
Comprehensive income	$ 13,368	$ 47,939
Basic income per share:		
Income before cumulative effect of change in accounting principle	$	$ 0.36
Cumulative effect of change in accounting principle, net of tax	0.07	
Net income per share basic	$ 0.07	$ 0.36
Shares used in per share calculation basic	159,552	144,436

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	Three Months Ended March 31,	
	2003	**2002**
	(in thousands, except per share data) (Unaudited)	(As Restated)
Diluted income per share:		
Income before cumulative effect of change in accounting principle	$	$ 0.31
Cumulative effect of change in accounting principle, net of tax	0.07	
Net income per share diluted	$ 0.07	$ 0.31
Shares used in per share calculation diluted	165,366	174,074
Pro forma amounts assuming the change in accounting principle is applied retroactively:		
Net income		$ 47,699
Basic income per share		$ 0.33
Diluted income per share		$ 0.29

(1) Includes stock-based compensation charges of $742 and $118 for the three months ended March 31, 2003 and 2002, respectively.

(2) Includes stock-based compensation charges of $256 and $175 for the three months ended March 31, 2003 and 2002, respectively.

(3) Includes stock-based compensation charges (credits) of $969 and $(945) for the three months ended March 31, 2003 and 2002, respectively.

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

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2003	**2002**
	(in thousands) (Unaudited)	(As Restated)
Cash flows from operating activities:		
Net income	$ 11,624	$ 51,638
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of change in accounting principle		
Depreciation and amortization	14,237	11,898
Amortization of purchased technology to cost of revenue	1,741	802
Provision for (recovery from) doubtful accounts, net	(323)	730
Non cash restructuring charge	15,781	
Non cash interest expense on convertible notes	1,584	3,288
Gain on sale of product lines	(37)	(6,717)
Gain on sale of marketable securities	(1,048)	
Loss on repurchase of zero coupon convertible debentures	2,591	
Minority interest		2,023
Deferred taxes	(2,119)	4,250
Stock-based compensation charges (credits)	(260)	714
Tax benefit from exercise of nonqualified stock options	(3,191)	(1,366)
Change in fair value of derivative, net	(1,164)	164
Changes in assets and liabilities:		
Accounts receivable	52,961	48,467
Prepaid expenses, taxes and other	(13,921)	4,453
Accounts payable and accrued liabilities	(21,968)	(22,698)
Deferred revenue	(242)	(43,594)
Net cash provided by operating activities	56,246	54,052
Cash flows from investing activities:		
Purchase of marketable securities	(376,133)	(175,086)
Proceeds from sale of marketable securities	253,855	116,411
Purchase of property and equipment	(23,100)	(7,391)
Increase in restricted cash	(199)	
Purchase price adjustment for prior year acquisitions	(165)	
Net cash used in investing activities	(145,742)	(66,066)
Cash flows from financing activities:		
Proceeds from issuance of stocks from option plan and stock purchase plans	19,830	88,293
Repurchase of zero coupon convertible debentures	(177,055)	
Net cash provided by (used in) financing activities	(157,225)	88,293
Effect of exchange rate fluctuations	5,339	(531)

Net increase (decrease) in cash and cash equivalents	(241,382)	75,748
Cash and cash equivalents at beginning of period	674,226	612,832
Cash and cash equivalents at end of period	$ 432,844	$ 688,580
Non cash investing activities:		
Unrealized loss on marketable securities	$ (689)	$ (2,527)

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

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

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 and educational institutions, small and medium sized businesses and consumer users. The Company operates its business in five geographic regions: North America; Europe, Middle East and Africa (EMEA); Japan; Asia-Pacific and Latin America.

2. Restatement

On March 26, 2003, the Company announced that, as a result of information obtained in connection with ongoing Securities and Exchange Commission (SEC) and Department of Justice investigations into its previously issued consolidated financial statements, it would restate its 2000, 1999 and 1998 financial results to reflect sales to distributors and resellers on a sell-through basis, which is how the Company has recognized revenue from sale to distributors and resellers since the beginning of 2001. In the course of preparing the 2000, 1999 and 1998 consolidated financial statements to properly reflect sales to distributors and resellers on the sell-through basis, the Company identified other items and errors for which accounting adjustments were necessary. As a result of the restatement, the Company delayed the filing of its 2002 Annual Report on Form 10-K and the Quarterly Reports on Form 10-Q for the quarters ended March 31, 2003 and June 30, 2003.

In June 2002, the Company filed Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 in connection with an earlier restatement of its financial results. This previously filed financial information for this quarter is referenced herein as reported. All restated information for the first quarter of 2002 in this Form 10-Q is referenced herein as restated.

Set forth below is selected Company consolidated financial data for the three months ended March 31, 2002 on a restated and previously reported basis and a description of the significant adjustments impacting the financial results for the period. The restatement adjustments relate primarily to the Company s change to the sell-through method to properly reflect the recognition of revenue on these sales for years prior to 2001 and the deferral of revenue in connection with certain multi-element licensing arrangements in 1998 through 2000. These adjustments also include additional revenue amounts recognized as a result of the proper application of the revenue recognition principles under Statement of Position (SOP) 97-2, *Software Revenue Recognition (SOP 97-2),* to correct errors in the application of these principles during 1998 through 2000. In the quarter ended March 31, 2002, the effect of the restatement adjustments increased net revenue by $34.9 million and decrease expenses (primarily cost of revenue) by $1.4 million over amounts previously reported in the quarter ended March 31, 2002. A more detailed description of the adjustments and reconciliation is set forth in note 3 to the consolidated financial statements included in the Company s 2002 Form 10-K filed with the SEC. As a related impact of the restatement, revenue in the quarter March 31, 2003 was increased by $3.2 million, cost of revenue was increased by $0.3 million, and sales and marketing was increased by $0.4 million.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table sets forth the condensed consolidated balance sheet for the Company, showing previously reported, and restated amounts, as of March 31, 2002:

Condensed Consolidated Balance Sheet

(Unaudited)
(In thousands)

	March 31, 2002		
	As Previously Reported	As Restated	Difference
ASSETS			
Current assets:			
Cash and cash equivalents	$ 688,580	$ 688,580	$
Short-term marketable securities	176,584	176,584	
Accounts receivable, net	84,433	84,413	(20)
Prepaid expenses, income taxes and other current assets	49,320	52,811	3,491
Deferred taxes	118,958	143,467	24,509
Total current assets	1,117,875	1,145,855	27,980
Long-term marketable securities	213,038	213,038	
Property and equipment, net	65,872	65,872	
Deferred taxes	85,534	102,156	18,622
Intangible assets, excluding goodwill, net	25,261	25,261	
Goodwill, net	156,892	128,070	(28,822)
Other assets	19,271	19,271	
Total assets	$ 1,681,743	$ 1,699,523	$ 17,780
LIABILITIES			
Current liabilities:			
Accounts payable	$ 22,590	$ 22,590	
Accrued liabilities	274,926	268,486	(6,440)
Deferred revenue	223,418	291,565	68,147
Current portion of convertible debt	236,611	236,611	
Total current liabilities	757,545	819,252	61,707
Deferred revenue, less current portion	36,292	37,541	1,249
Convertible debentures, less current portion	345,000	345,000	
Other long term liabilities	524	524	
Total liabilities	1,139,361	1,202,317	62,956
Minority interest	20,597	21,403	806

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	March 31, 2002		
	As Previously Reported	As Restated	Difference
STOCKHOLDERS EQUITY			
Preferred stock			
Common stock	1,468	1,468	
Additional paid in capital	829,391	838,152	8,761
Cumulative other comprehensive income (loss)	(34,044)	12,978	47,022
Accumulated deficit	(275,030)	(376,795)	(101,765)
Total stockholders equity	521,785	475,803	(45,982)
Total liabilities, minority interest and stockholders equity	$1,681,743	$1,699,523	$ 17,780

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table sets forth the condensed consolidated statement of operations for the Company, showing previously reported and restated amounts, for the three months ended March 31, 2002:

Condensed Consolidated Statement of Operations

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

	Three Months Ended March 31, 2002		
	As Previously Reported	As Restated	Difference
Net revenue:			
Product	$ 139,250	$ 137,957	$ (1,293)
Services and support	81,462	117,691	36,229
Total net revenue	220,712	255,648	34,936
Cost of net revenue:			
Product	25,289	26,605	1,316
Services and support	15,347	15,347	
Amortization of purchased technology	802	802	
Total cost of net revenue	41,438	42,754	1,316
Operating costs and expenses:			
Research and development	34,605	34,605	
Marketing and sales	102,474	102,474	
General and administrative	25,416	24,050	(1,366)
Provision for doubtful accounts, net	730	730	
Amortization of intangibles	2,050	2,050	
Restructuring charge	1,116	1,116	
Total operating costs and expenses	166,391	165,025	(1,366)
Income from operations	12,883	47,869	34,986
Interest and other income	6,662	6,662	
Interest expense	(7,690)	(7,690)	
Loss on repurchase of zero coupon convertible debentures	6,717	6,717	
Income before provision for (benefit from) income taxes and minority interest	18,572	53,558	34,986
Provision for (benefit from) income taxes	1,403	(103)	(1,506)
Income before minority interest	17,169	53,661	36,492
Minority interest in net income of consolidated subsidiaries	(1,417)	(2,023)	(606)
Net income	$ 15,752	$ 51,638	$ 35,886
Other comprehensive income:			
Unrealized (loss) on investments	$ (2,527)	$ (2,527)	
Foreign currency translation loss	(1,172)	(1,172)	

Comprehensive income	$ 12,053	$ 47,939	$35,886

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended March 31, 2002		
	As Previously Reported	As Restated	Difference
Basic net income per share:			
Net income per share basic	$ 0.11	$ 0.36	$ 0.25
Shares used in per share calculation basic	144,436	144,436	
Diluted net income per share:			
Net income per share diluted	$ 0.10	$ 0.31	$ 0.21
Shares used in per share calculation diluted	154,782	174,074	19,292

Restatement to Sell-through Basis of Revenue Recognition

The Company sells certain of its products through distributors and other resellers. Since January 1, 2001, the Company has reported revenue from sales to distributors and resellers on a sell-through basis. Adjustments required under the change to a sell-through revenue recognition policy to correctly report revenue from these sales to distributors and resellers had the effect of deferring revenue from 1998 through 2000 and increasing revenues in later periods, including a $9.1 million related increase in net revenue in the three months ended March 31, 2002.

Allocation of Revenue in Multiple-element Arrangements

The accounting treatment with respect to certain revenue arrangements with multiple obligations during 1998 and 2000 has been adjusted to correct certain errors. The Company s software license arrangements typically include the licensing of software and maintenance and support services or post contract support (PCS). SOP 97-2, as amended by SOP 98-9, provides that for arrangements with multiple obligations, such as the sale of software licenses with undelivered PCS, revenue is allocated to each element of the arrangement based on the vendor s specific objective evidence of fair value of the undelivered elements. Where evidence of fair value of the undelivered elements is determinable and the fair value of the delivered element (e.g. the license) is not determinable, the Company defers revenue from the arrangement equivalent to the fair value of the undelivered elements (e.g. PCS) and recognizes revenue on the delivered element under the residual value method. If the evidence of fair value of undelivered PCS is not determinable, then the entire arrangement fee is recognized ratably over the period that PCS is provided or until evidence of fair value is established. When evidence of fair value is established at a later date, the fair value of the undelivered elements is deferred and the residual portion of the fee is recognized as license revenue.

Arrangements for which adjustments were made include the following:

For one-year and two-year term enterprise software licenses in 1998 through 2000, amounts were allocated based on the list price of the license and the PCS element. In other instances in 1998 through 2000, the Company allocated revenue to the PCS element based on the amount invoiced to the customer. Further in 1998 through 2000, when customers were offered a discount on the list price of bundled licenses and PCS, the discount was allocated proportionately based on list price for the license and PCS. The Company has determined that these discounts should have been allocated entirely to the delivered license elements. In addition, the Company has reevaluated whether its methods for allocating revenues to the PCS element was supported by sufficient evidence of the fair value of the PCS based on prices for which PCS was sold separately in 1998 through 2000. For some products, the Company determined that sufficient evidence of fair value did not exist. For other products, evidence of fair value existed, but the amount of deferred revenue should have been greater.

NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Upon review of maintenance and support agreements included with the sale of retail licenses in 1998 through 2000, the Company determined it had inappropriately established the fair value for the PCS element (updates to virus definition files) of these arrangements. As the Company did not sell the PCS separately until late 2000, all license and PCS revenue under the arrangement should have been deferred and recognized over the three-year estimated life of the retail license or until evidence of fair value of the PCS was established. As a result in 1998 through 2000, the Company recorded adjustments to restate revenue for 1998 through 2000 related to its retail licenses to recognize all related license and PCS revenue ratably over the three-year estimated life of the license until the evidence of fair value of PCS was established in the fourth quarter of 2000. At that time, evidence of fair value for PCS was established based on an annual renewal rate for the PCS element included with its retail licenses.

Overall adjustments to multi-element revenue arrangements resulted in the same amount of revenue recognized in total cumulatively over all periods affected, except for the effect of foreign currency adjustments. However, as there was a significant increase in deferred revenue for 1998 through 2000, service and support revenue will be increased in subsequent periods. Multi-element revenue deferrals from 1998 through 2000 resulted in $21.9 million additional revenue during the three-month period ended March 31, 2002.

Cost Of Product Revenue

The Company s cost of net product revenue consists primarily of the following: cost of media, manuals and packaging for products distributed through traditional channels; royalties; and, with respect to hardware-based products, computer platforms and other hardware components. The cost of net product revenue has been adjusted to reflect the Company s conversion to a sell-through revenue recognition, as discussed in *Restatement to Sell-through Revenue Recognition* above. Adjustments have been recorded to adjust cost of net product revenue in the periods that the related revenue is recognized.

Stock-based Compensation

The Company determined that stock-based compensation charges of $1.4 million originally recorded in the first quarter of 2002, when the transactions were discovered, will be recorded in 2000, when the transactions occurred, and stock-based compensation has been decreased by that amount in 2002.

Additional Information

Additional information regarding the Company s restatement adjustments in 1998 through 2001 and subsequent periods is located in the Company s (i) consolidated financial statements for each of the years in the three year period ended December 31, 2000, as filed in Amendment No. 2 to the Company s 2000 Form 10-K, and (ii) consolidated financial statements for each of the years in the three-year period ended December 31, 2002, as filed in the Company s 2002 Form 10-K.

3. Summary of Significant Accounting Policies and Accounting Change

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries as of March 31, 2003 and for the three months ended March 31, 2003 and March 31, 2002. All significant intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2002 Consolidated Balance Sheet was derived from audited

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, the Company believes that all disclosures are adequate to make the information presented not misleading. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in the Company s Annual Report on Form 10-K for fiscal year ended December 31, 2002.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to present a fair statement of financial position as of March 31, 2003, results of operations and cash flows for the three months ended March 31, 2003 and March 31, 2002 have been included. The results of operations for the three month period ended March 31, 2003 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

Proforma Stock-Based Compensation Disclosure

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

The Company utilized the following assumptions in calculating the estimated fair value of each stock option on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants:

	Three Months Ended March 31,	
	2003	**2002**
Risk free interest rate	3.60%	5.02%
Expected life	4 years	4 years
Volatility	98.02%	99.58%
Dividend yield	None	None

NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended March 31,	
	2003	2002
Net income, as reported	$11,624	$51,638
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax	16,684	14,727
Add back: Stock-based compensation expense (credit), net of tax; included in reported net income	1,180	(391)
Pro forma net income (loss)	$ (3,880)	$36,520
Net income (loss) per share:		
Basic as reported	$ 0.07	$ 0.36
Basic pro forma	$ (0.02)	$ 0.25
Diluted as reported	$ 0.07	$ 0.30
Diluted pro forma	$ (0.02)	$ 0.23

Accounting Change

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

As required by accounting principles generally accepted in the United States of America, the cumulative effect of the change in accounting principle effective January 1, 2003 resulted in a one-time credit of $13.9 million ($11.1 million after tax). The following table illustrates the three months ended March 31, 2002 after considering the commission accounting change and presents the 2002 results before the change in accounting principle for comparison to the current period:

	Three Months Ended March 31, 2003		Three Months Ended March 31, 2002	
	Before Commission Change	After Commission Change	Before Commission Change	After Commission Change
Operating expenses	$183,659	$184,048	$165,025	$168,964
	$ 871	$ 482	$ 51,638	$ 47,699

Income before cumulative effect of change in accounting principle				
Per common share diluted	$ 0.00	$ 0.00	$ .31	$ .33
Net income	$ 871	$ 11,624	$ 51,638	$ 71,847
Per common share diluted	$ 0.00	$ 0.07	$ .31	$ .41

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

New Accounting Pronouncements

Accounting for Asset Retirement Obligations

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143 *Accounting for Asset Retirement Obligations* (SFAS 143). SFAS 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal use of the assets, including lease restoration obligations. SFAS 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of the fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset, and this additional carrying amount is expensed over the life of the asset. The Company adopted SFAS 143 effective January 1, 2003. The adoption of SFAS 143 did not have a material impact on the Company s consolidated financial condition, results of operations or cash flows.

Accounting for Extraordinary Items and Discontinued Operations

In May 2002, the FASB issued SFAS No. 145, *Rescission of SFAS Nos. 4, 44, and 64, Amendment of SFAS No. 13, and Technical Corrections* (SFAS 145). Among other things, SFAS 145 rescinds various pronouncements regarding early extinguishment of debt and allows extraordinary accounting treatment for early extinguishment only when the provisions of APB Opinion No. 30, *Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* are met. SFAS 145 provisions regarding early extinguishment of debt are generally effective for fiscal years beginning after May 15, 2002. As a result of adopting this Standard, the Company reclassified the loss on retirement of its convertible debt as other expense and conformed prior periods to be consistent with this presentation.

Accounting for Exit or Disposal Activities

In July 2002, the FASB issued SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146). SFAS 146 addresses the recognition, measurement and reporting of costs associated with exit and disposal activities (i.e., restructuring activities), including costs related to terminating a contract that is not a capital lease and termination benefits due to employees who are involuntarily terminated under the terms of a one-time benefit arrangement.

SFAS 146 supersedes the Emerging Issues Task Force (EITF) Issue No. 94-3 *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)* (EITF 94-3) and EITF Issue No. 88-10 *Costs Associated with Lease Modification or Termination* (EITF 88-10). SFAS 146 prohibits recognition of a liability based solely on an entity s commitment to a plan to exit an activity. SFAS 146 requires that: (i) liabilities associated with exit and disposal activities be measured at fair value and changes in the fair value of the liability at each reporting period be measured using an interest allocation approach; (ii) one-time termination benefits be expensed at the date the entity notifies the employee, unless the employee must provide future service, in which case the benefits are expensed ratably over the future service period; (iii) liabilities to terminate a contract be recorded at fair value when the contract is terminated; (iv) liabilities related to an existing operating lease/ contract, unless terminated, be recorded at fair value, less estimated sublease income, and measured when the contract does not have any future economic benefit to the entity (i.e., the entity ceases to utilize the rights conveyed by the contract); and (v) all other costs related to an exit or disposal activity be expensed as incurred.

NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SFAS 146 is effective for exit or disposal activities initiated after December 31, 2002. The Company adopted SFAS 146 during the fourth quarter of 2002 and for the restructuring charge recorded thereafter in the quarter ended March 31, 2003. The adoption of SFAS 146 did not impact the Company s restructuring obligations recognized in 2002 as these obligations must continue to be accounted for in accordance with EITF 94-3 and other applicable pre-existing guidance.

Accounting for Stock-Based Compensation Charges

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure* (SFAS 148). SFAS 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS 148 are effective for fiscal years ended after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. The Company has adopted the interim disclosure provisions of SFAS 148 in its financial reports for the quarter ended March 31, 2003. As the adoption of this standard involves disclosures only, there was no material impact on the consolidated financial statements.

Accounting for Derivative Instruments and Hedging Activities

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (SFAS 149). SFAS 149 (i) clarifies under what circumstances a contract with an initial net investment meets the characteristics of a derivative discussed in SFAS 133; (ii) clarifies when a derivative contains a financing component; and (iii) amends the definition of an underlying to conform it to language in FIN 45. SFAS 149 is generally effective for contracts entered into or modified after June 30, 2003. The Company has adopted the provisions of SFAS 149 which did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (SFAS 150). SFAS 150 establishes standards for how companies classify and measure certain financial instruments with characteristics of both liabilities and equity. It requires companies classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) as defined in SFAS 150. The Company has adopted the provisions of SFAS 150 which did not have a material impact on the Company s consolidated financial position, results of operations or cash flows based on the types of financial instruments the Company currently has issued.

Accounting for Multiple Deliverable Revenue Arrangements

In November 2002, the EITF reached a consensus on Issue No. 00-21, *Multiple Deliverable Revenue Arrangements* (EITF 00-21). EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. It also addresses when and how an arrangement involving multiple deliverables should be divided into separate units of accounting. The guidance in EITF 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early application permitted. Companies may elect to report the change in accounting as a cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements (an amendment of APB Opinion No. 28).* The Company has adopted the provisions of EITF 00-21 for transactions to which

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SOP 97-2 does not apply, such as sales of hardware without software and hosted applications. The adoption of EITF 00-21 did not have a significant impact on its consolidated financial position, results of operations or cash flows.

Accounting for Retroactive Insurance Contracts

In May 2003, the EITF reached a consensus on Issue No. 03-03, *Accounting for Retroactive Insurance Contracts Purchased by Entities Other Than Insurance Enterprises to Claims-Made Insurance Policies* (EITF 03-03). The consensus requires the insured company to determine if their claims-made policy is retroactive, prospective, or both and account for the policy accordingly. A policy has a retroactive provision if it covers a specific known claim(s) that was reportable before the policy s effective date. The continued applicability of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39), to the recording of liabilities and the related insurance recoverables is also addressed. Since FIN 39 does not allow for offsetting the insurance liability with the recoverable, regardless of whether the company is recording the insurance policy as prospective or retroactive, there will likely be a balance sheet gross-up for all covered losses. EITF 03-03 is applicable to all claims-made insurance arrangements entered into beginning in a company s next reporting period following ratification, which is June 30, 2003 for the Company. The Company is assessing the potential impact of EITF 03-03 on its consolidated financial position, results of operations and cash flows.

Accounting for and Disclosure of Guarantees

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). FIN 45 requires that a liability (at fair value) be recorded in the guarantor s balance sheet upon issuance of a guarantee or indemnification. In addition, FIN 45 requires disclosures about the guarantees and indemnifications that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees and indemnifications issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The Company has adopted FIN 45, which did not have a material impact on its consolidated financial position, results of operations, or cash flows.

Accounting for Consolidation of Variable Interest Entities

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51* (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The original effective date of FIN 46 was delayed to the first reporting period after December 15, 2003 (December 31, 2003 for the Company) for any variable interest entities or potential variable interest entities created before February 1, 2003. The Company is studying the impact of FIN 46 on its consolidated financial position, results of operations and cash flows.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Stock-Based Compensation

The Company recorded stock-based compensation charges (credits) of $2.0 million and $0.7 million in the three months ended March 31, 2003 and 2002, respectively. These charges (credits) are comprised of the following (in thousands):

	Three Months Ended March 31,	
	2003	2002
Exchange of McAfee.com options	$ 741	$
New and existing executives	106	430
Former employees	1,120	
Repriced options		(1,144)
Shares purchased outside Employee Stock Purchase Plan		62
Total stock-based compensation	$ 1,967	$ (652)

Exchange of McAfee.com options. On September 13, 2002, the Company acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of Networks Associates, Inc. common stock plus $8.00 in cash, which will be paid to the option holder only upon exercise of the option and without interest, in exchange for each McAfee.com option. McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of the Company s common stock. The assumed options have been accounted for under the guidance in EITF Issue No. 00-23 *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25* and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB Opinion No. 25*. Accordingly, these options are subject to variable accounting treatment, which means that a compensation charge has been measured initially at the date of the closing of the merger and then remeasured at the end of each reporting period. The initial charge was based on the excess of the closing price of the Company s stock over the exercise price of the options plus the $8.00 per share payable in cash, which will be paid upon exercise of the option. The charge has been and will be remeasured, using the same methodology, until the earlier of the date of exercise, forfeiture or cancellation without replacement. This compensation charge will be recorded as an expense over the remaining vesting period of the options, using the accelerated method of amortization under FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* (FIN 28). To the extent that the options issued were fully vested at the date of the closing of the McAfee.com acquisition, the Company immediately recorded a compensation expense of approximately $10.5 million. Charges related to unvested options will be recorded in deferred stock-based compensation in stockholders equity. Depending upon movements in the market value of the Company s common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

During the three months ended March 31, 2003, the Company recorded a charge of approximately $0.7 million related to exchanged options subject to variable accounting. This stock-based compensation charge, related to exchanged options subject to variable accounting, was based on the Company s closing share price of $13.81 on March 31, 2003. As of March 31, 2003, the Company had approximately 1.0 million outstanding exchanged options subject to variable accounting.

New and existing executives. On January 3, 2001, the Company entered into an employment agreement with George Samenuk to become its president and chief executive officer. In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. Stock-based compensation associated with Mr. Samenuk s 2001 restricted stock grant was valued at $2.0 million and was amortized over 24 months beginning January 2001

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

through December 2002. Approximately $0.2 million was expensed during the three months ended March 31, 2002 related to stock-based compensation associated with Mr. Samenuk s 2001 restricted stock grant.

On January 15, 2002, the Company s board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk, its chairman and chief executive officer. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase such shares will lapse as follows: 3,000 vested as of the grant date and 47,000 are restricted until January 15, 2005. The fair value of the restricted stock was determined to be approximately $1.4 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of our common stock on January 15, 2002. During the three months ended March 31, 2003 and 2002, the Company recorded approximately $0.1 million and $0.2 million related to stock-based compensation associated with Mr. Samenuk s 2002 restricted stock grant.

Former employees. In July 2002, one of the Company s employees became a non-employee, but continued to provide services to the Company. As he was allowed to continue to hold his vested employee options beyond the normal exercise period after termination and continue to vest his options, the Company recorded a stock-based compensation charge corresponding to the fair value of his vested options. The unvested options have been and will be remeasured periodically using the Black Scholes option valuation model and recognized over the remaining vesting period using the accelerated method of amortization discussed in FIN 28. Stock-based compensation of approximately $30,000 was expensed during the three months ended March 31, 2003.

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

Repriced Options. During the three months ended March 31, 2003 and 2002, the Company did not incur a charge and incurred a credit of approximately $1.9 million, respectively, related to options subject to variable plan accounting. For the three months ended March 31, 2003, the Company s stock-based compensation charge calculation related to options subject to variable plan accounting were based on quarter-end per share price of the Company s stock of $13.81. For the three months ended March 31, 2002, the Company s stock-based compensation charge calculation related to options subject to variable plan accounting were based on quarter-end per share price of the Company s stock of $24.20 and per share price of McAfee.com stock of $16.47. As of March 31, 2003, the Company had options to purchase approximately 0.8 million shares, which were outstanding and subject to variable plan accounting.

The Company also incurred a 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. No charges were incurred for the three months ended March 31, 2003 and approximately $(1.1) million was credited to expense during the three months ended March 31, 2002.

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 available for purchase by plan participants by a pro rata amount, additional shares were required to be purchased outside of the plan. As a result, the Company recorded a one-time stock-based compensation

NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

charge of approximately $0.1 million in the three months ending March 31, 2002. The charge was based on the difference between the fair value of the shares purchased outside of the plan and the exercise price.

5. Business Combinations

On September 13, 2002, the Company repurchased the 25% minority interest in its McAfee.com subsidiary for approximately $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 established. 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 a 100% interest 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 (loss) before minority interest of the Company. Prior to the acquisition, the minority interest in the McAfee.com income (loss) was excluded from the Company s consolidated net income (loss). Since the date of acquisition on September 13, 2002, no minority interest has existed in McAfee.com and accordingly the consolidated net income (loss) 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 preliminary 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 will be deductible for tax purposes.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition.

	September 13, 2002
	(In thousands)
Deferred tax assets	$ 25,767
Technology	1,401
Other intangible assets	49,335
Goodwill	145,756
Minority interest	21,044
Total assets acquired	$243,303
Current liabilities	2,065
Deferred tax liabilities	21,345
Total liabilities assumed	$ 23,410
Net assets acquired	$219,893

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following unaudited pro forma financial information presents the combined results of the Company and McAfee.com as if the acquisition had occurred on January 1, 2002, after giving effect to certain adjustments, including amortization of identifiable intangible assets (in thousands except per share amounts):

	Three Months Ended March 31, 2002
Pro forma:	
Net revenue	$255,648
Net income	$ 51,638
Basic net income per share:	
Net income	$ 0.34
Shares used in per share calculation basic	152,743
Diluted net income per share:	
Net income	$ 0.30
Shares used in per share calculation diluted	182,380

The above 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. The expenses incurred by McAfee.com amounted to $1.9 million in the three months ended March 31, 2002. The pro forma information is based on various assumptions and estimates. The pro forma information is not necessarily indicative of the operating results that would have occurred if the McAfee.com acquisition had been consummated as of January 1, 2002, nor is it necessarily indicative of future operating results.

The pro forma information does not give effect to any potential revenue enhancements or cost synergies or other operating efficiencies that could result from the acquisition.

6. Sale of Product Line

On October 9, 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 products. On February 13, 2002, the Company announced the sale of Gauntlet firewall/VPN product to Secure Computing. As a result of the transaction, the Company received common shares of Secure Computing in exchange for the Gauntlet assets. The Company recorded a gain on sale of net assets of $6.7 million. On August 19, 2002, the Company announced the sale of the PGP desktop encryption products line to PGP Corporation, a new venture funded company, for $2.0 million in cash and assumption of $1.1 million of net liabilities. As a result of the transaction, the Company recorded a gain on sale of product line of $2.6 million in the third quarter of 2002.

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 are the Secure Computing shares. The Company designated the purchased collar as a fair value hedge of the Secure Computing available-for-sale securities in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities.* At the inception of the hedge, the Company assessed that the collar is highly effective based upon expected changes in the collar s intrinsic value. On an ongoing basis, changes in the fair value of Secure Computing shares within the collar s range of $17.31 and $22.04 are recorded as part of accumulated other comprehensive income within stockholders

equity. Changes in the fair value of Secure Computing s shares outside of the collar range of

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$17.31 and $22.04 are recorded immediately in earnings. Changes in the fair value of the collar are measured using an option pricing model and are also recorded immediately in earnings. During the three months ended March 31, 2002, the Company recognized a loss of approximately $15,000 related to the change in fair value of the collar, net of changes of fair value of the Secure Computing shares outside of the collar range. In July 2002, the Company sold its shares in Secure Computing, closed its collar and recorded a net gain of approximately $0.3 million.

7. Goodwill and Other Intangible Assets

The Company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* In lieu of amortization, the Company performs an impairment review of its goodwill balance on at least an annual basis. This impairment review involves a two-step process. The Company performed Step 1 of the initial goodwill impairment analysis as of January 1, 2002, and concluded that goodwill was not impaired, as the fair value of each reporting unit exceeded its carrying value, including goodwill. Accordingly, Step 2 was not performed. As required, the Company completed its annual goodwill impairment review as of October 1, 2002 and concluded that goodwill was not impaired. The fair value of the reporting units was estimated using the average of the expected present value of future cash flows and of the market multiple value. 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.

Goodwill (net) information is as follows (in thousands):

	January 1, 2003	Goodwill Acquired	Adjustments	Effects of Foreign Currency Exchange	March 31, 2003
United States	$227,395	$	$	$	$227,395
EMEA	$ 25,424	$	$	$375	$ 25,799
Japan	$ 12,071	$	$	$	$ 12,071
Canada	$ 4,727	$	$	$	$ 4,727
Asia-Pacific (excluding Japan)	$ 2,301	$	$	$	$ 2,301
Latin America	$ 2,016	$	$	$	$ 2,016
Total	$273,934	$	$	$375	$274,309

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

	March 31, 2003			December 31, 2002		
	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount
Other intangible assets:						
Purchased technologies	$ 69,147	$(47,917)	$21,230	$ 69,286	$(45,995)	$23,291
Trademarks, patents customer base, and other intangibles	104,358	(38,760)	65,598	104,540	(34,280)	70,260
	$173,505	$(86,677)	$86,828	$173,826	$(80,275)	$93,551

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The aggregate amortization expenses for the intangible assets listed above totaled $6.8 million and $2.9 million for the three months ended March 31, 2003 and 2002, respectively.

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

Fiscal Years:	
Remainder of 2003	$ 14,981
2004	18,429
2005	15,549
2006	12,744
2007	10,508
Thereafter	14,617
	$ 86,828

8. Restructuring

In January 2003, as part of a restructuring effort to gain operational efficiencies, the Company consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into its newly constructed 170,000 square-foot regional headquarters facility in Plano, Texas. The new facility houses approximately 1,000 employees working in finance, legal, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses. As part of the consolidation of activities into the Plano facility, the Company relocated approximately 170 employees from its Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, the Company recorded a restructuring charge of $15.8 million which consisted of a non-cash expense of $2.1 million related to asset disposals and discontinued use of certain leasehold improvements, furniture and equipment; non-cash income of $(1.9) million attributable to the reduction of deferred rent liability; and a $15.6 million accrual for estimated lease related costs associated with vacated facilities in Santa Clara, California. The remaining costs associated with permanently vacating the Santa Clara facilities are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facilities. The remaining costs associated with permanently vacating the facilities will generally be paid over the remaining lease term ending in 2013. The total restructuring charge and related cash outlay are based on management s current estimates. Amounts to be paid, relative to the restructuring accrual, within 12 months ($2.4 million) have been included in accrued liabilities, while amounts to be paid beyond 12 months ($13.2 million) have been included in other long term debt and liabilities in these condensed consolidated financial statements.

The following table sets forth the Company s restructuring accrual established in 2003 (in thousands):

	Lease Termination Costs
Balance, January, 1, 2003	$
Additional accrual	15,635
Balance, March 31, 2003	$ 15,635

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

actual lease exit costs or sublease income differ from amounts currently expected. The restructuring charge was not allocated to reporting segments.

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 cash restructuring charge of approximately $1.1 million was recorded during the first quarter of 2002. The restructuring charge consists of costs of severance packages for 44 employees as well as related legal and outplacement services.

The following table sets forth the Company s restructuring accrual established in February 2002 and the activity against the accrual during the three months ended March 31, 2002 (in thousands):

	Other Costs	Severance and Benefits	Total
Balance, February 2002	$190	$ 926	$1,116
Cash payments	(90)	(470)	(560)
Balance, March 31, 2002	$100	$ 456	$ 556

The remaining balances were paid during the second quarter of 2002.

9. Convertible Debt

Convertible debt comprises the following amounts (in thousands):

	March 31, 2003	December 31, 2002
Zero Coupon Convertible Subordinated Debentures due 2018		
Face Value	$ 465	$ 358,500
Unamortized Discount	(233)	(182,240)
	232	176,260
5.25% Convertible Subordinated Notes due 2006		
Face Value (net of accumulated fair value adjustment of $10,803 and $11,012 at March 31, 2003 and December 31, 2002, respectively)	355,803	356,013
Total convertible debt	$356,035	$ 532,273

Zero Coupon Convertible Debentures due 2018

On February 13, 1998, the Company completed a private placement of zero coupon convertible subordinated debentures due in 2018 (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 bond equivalent basis).

Periodically, through a limited number of privately negotiated purchases, the Company repurchased previously outstanding Debentures. In 2002, the Company repurchased Debentures, which had an aggregate face amount at maturity of $140.0 million, at a net price of $66.2 million. In connection with these repurchases, the Company recognized a gain of approximately $26,000, calculated as the difference between the accreted value of the debt, net of unamortized issuance costs, and the cost of repurchase.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The remainder of the outstanding Debentures, with an aggregate face amount at maturity of $358.5 million, became redeemable for cash at the option of the holders beginning on February 13, 2003, 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 connection with this repurchase, the Company recognized a loss of approximately $2.6 million calculated as the difference between the accreted value of the debt, net of unamortized issuance costs, and the cost of repurchase. At March 31, 2003, Debentures with an aggregate face amount at maturity of $0.5 million remained outstanding. The remaining Debentures were repurchased in full in June 2003.

5.25% Convertible Subordinated Note due 2006

On August 17, 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 approximately $335.1 million. The amortization of the issuance costs related to the Notes is calculated using the effective interest method. The Notes mature on August 15, 2006, unless earlier redeemed by the Company at its option or converted at the holder s option. Interest is payable in cash semi-annually in arrears on February 15 and August 15 of each year, commencing February 15, 2002.

At the option of the holder, Notes may be converted into the Company s common stock at any time, unless previously redeemed, at a conversion price of $18.07 per share. The Notes may also be redeemed at the option of the holder in the event of a Change of Control (as defined in the related indenture). At any time between August 20, 2004 and August 14, 2005, the Company may redeem all or a portion of the Notes for cash at a redemption price of 101.3125% of the principal amount. After August 14, 2005, the redemption price is 100.0% of the principal amount. The Notes are unsecured and are subordinated to all existing and future Senior Indebtedness (as defined in the related indenture). In July 2002, the Company entered into an interest rate swap transaction with two investment banks, which required that the convertible notes be carried at fair value.

10. Interest Rate Swap Transaction

In July 2002, the Company entered into interest rate swap transactions (Transactions) with two investment banks (Banks) to hedge the interest rate risk of its outstanding 5.25% Convertible Subordinated Notes due 2006 (Notes). The notional amount of the Transactions was $345.0 million to match the entire principal amount of the Notes. The Company will receive from the Banks fixed payments equal to 5.25% of the notional amount, payable on February 15 and August 15 starting on August 15, 2002. In exchange, the Company will pay to the Banks floating rate payments based upon the London InterBank Offered Rate (LIBOR) plus 1.66% multiplied by the notional amount of the Transactions with the LIBOR resetting every three months beginning August 15, 2002. The LIBOR was 1.34% at March 31, 2003.

The Transactions will terminate on August 15, 2006 (Termination Date), subject to certain early termination provisions if on or after August 20, 2004 and prior to August 15, 2006, the twenty-day average closing price of the Company s common stock equals or exceeds $22.59. Depending on the timing of the early termination event, the Banks would be obligated to pay the Company an amount equal to the redemption 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. To test the effectiveness of the hedge, regression analysis is performed at least quarterly comparing the change in fair value of the Transactions and the Notes. The fair values of the Transactions and the Notes are calculated as the present value of the contractual cash flows to the expected maturity date, where the expected maturity date is based on probability-weighted analysis of interest rates relating to the five-year LIBOR curve and the Company s stock prices. For the three

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

months ended March 31, 2003, the hedge was highly effective and therefore, the ineffective portion did not have a material impact on earnings.

Under the fair value model, the derivative is recognized at fair value on the consolidated balance sheet with an offsetting entry to the statement of operations. In addition, changes in the 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 statement of operations.

The gain or loss from the change in fair value of the Transaction and the offsetting change in the fair value of the Notes are recognized as interest expense. The net gain recorded for the three months ended March 31, 2003 was $1.2 million and is recorded in interest expense in these consolidated financial statements.

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

11. Net Income Per Share

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

	Three Months Ended March 31,	
	2003	**2002**
		(As Restated)
Numerator Basic		
Income before cumulative effect of change in accounting principle	$ 482	$ 51,638
Cumulative effect of change in accounting principle, net of tax	11,142	
Net income, adjusted	$ 11,624	$ 51,638
Numerator Diluted		
Net income	$ 482	$ 51,638
Interest on convertible debentures(1)		2,999
Income before cumulative effect of change in accounting principle	482	54,637
Cumulative effect of change in accounting principle, net of tax	11,142	
Net income, adjusted	$ 11,624	$ 54,637
Denominator Basic		
Weighted average shares of common stock outstanding	159,552	144,675
Less: weighted average shares of common stock subject to repurchase		(239)
Basic weighted average common shares outstanding	159,552	144,436

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended March 31,	
	2003	**2002**
		(As Restated)
Denominator Diluted		
Basic weighted average common shares outstanding	159,552	144,675
Effective of dilutive securities:		
Convertible debentures(1)		19,092
Common stock options and shares subject to repurchase (2)	5,641	10,109
Warrants (3)	173	198
Diluted weighted average shares	165,366	174,074
Basic net income per share:		
Income before cumulative effect of change in accounting principle	$	$ 0.36
Cumulative effect of change in accounting principle, net of tax	0.07	
Net income per share Basic	$ 0.07	$ 0.36
Diluted net income per share:		
Income before cumulative effect of change in accounting principle	$	$ 0.31
Cumulative effect of change in accounting principle, net of tax	0.07	
Net income per share Diluted	$ 0.07	$ 0.31

(1) Convertible debt interest and related as-if converted shares were excluded from the calculation since the effect was anti-dilutive. The total number of shares excluded from the calculation related to as-if converted shares was 19.1 million and 4.2 million for the three months ended March 31, 2003 and 2002, respectively.

(2) At March 31, 2003 and 2002, 14.8 million and 2.3 million options to purchase common stock, respectively, were excluded from the calculation since the effect was anti-dilutive.

(3) Warrants to purchase 0.2 million shares of the Company s common stock were excluded from the determination of diluted net loss per share for the three months ended 2002, as the effect of such warrants was anti-dilutive.

12. Business Segment Information

The Company has concluded that it has one business and operates in one industry, developing, marketing, distributing and supporting computer security solutions for large enterprises, governments, educational institutions, small and medium sized businesses and consumer users, as well as resellers and distributors. Management measures profitability based on the Company s five geographic regions. 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 directly to consumers, corporate and government users, as well as through resellers, distributors, systems integrators and retailers. 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.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Following is the summary of the Company s revenue and income (loss) from operations by geographic region. The accounting policies of the businesses and geographic regions are the same as disclosed in Note 3 to these Notes to Condensed Consolidated Financial Statements. 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; corporate marketing expenses, amortization of intangibles, stock-based compensation charges, and restructuring costs. These corporate expenses are not considered attributable to any specific geographic region. Summarized financial information concerning the Company s net revenue and operating income (losses) by business and geographic region is as follows (in thousands):

	Three Months Ended March 31,	
	2003	2002
		(As Restated)
Net revenue by region:		
North America	$135,675	$153,964
Europe, Middle East and Africa (EMEA)	61,206	78,454
Japan	10,675	11,712
Asia-Pacific (excluding Japan)	6,660	8,150
Latin America	4,225	3,368
Net revenue	$218,441	$255,648
Income (loss) from operations by region:		
North America	$ 40,583	$ 41,595
EMEA	23,097	40,715
Japan	3,738	3,273
Asia-Pacific (excluding Japan)	1,438	(162)
Latin America	(431)	(140)
Corporate	(67,693)	(37,412)
Income from operations	$ 732	$ 47,869

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

	Three Months Ended March 31,	
	2003	2002
		(As Restated)
Software licenses	$104,624	$112,360
Support and maintenance	67,549	93,146
Hardware	17,480	18,924
Retail	4,645	4,326
Consulting	7,117	9,073
Training	2,069	3,708
Hosting arrangements	14,400	11,764
Other	557	2,347

Total	$218,441	$255,648

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Litigation

General

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

Securities Cases

Between December 29, 2000 and February 7, 2001, the Company and certain of its current and former officers and directors were named in securities class action lawsuits filed in the United States District Court for the Northern District of California. On September 24, 2001, a consolidated class action complaint, styled *In re Network Associates, Inc. II Securities Litigation,* was filed which asserts claims against the Company, William Larson, Prabhat Goyal and Peter Watkins on behalf of a putative class of persons who purchased the Company s stock between July 19 and December 26, 2000. The complaint asserts causes of action (and seeks unspecified damages) for alleged violations of Exchange Act Section 10(b)/SEC Rule 10b-5 and Exchange Act Section 20(a). In particular, the complaint alleges that defendants engaged in improper practices designed to increase the Company s revenues and earnings and that, as a result of those practices, the Company s class period financial statements were false and misleading and failed to comply with Generally Accepted Accounting Principles (GAAP). After a hearing on defendants motion to dismiss was held on April 16, 2002, the Court entered an order approving a jointly stipulated withdrawal of defendants motion to dismiss. On September 30, 2002, plaintiffs filed a first amended and consolidated complaint. The amended and consolidated complaint asserts claims on behalf of an expanded class of plaintiffs, *i.e.*, persons who purchased the Company s stock between April 15, 1999 and December 26, 2000, and, in addition to reasserting the allegations contained in the consolidated complaints, adds allegations regarding the Company s restatement of its 1998, 1999, and 2000 consolidated financial statements, which restatement resulted from the Company s discovery of certain accounting inaccuracies impacting those consolidated financial statements. The first amended and consolidated complaint also adds Terry Davis, the Company s former Controller as a party defendant. On November 11, 2002, the Company and the individual defendants each moved to dismiss certain claims asserted on the first amended and consolidated complaint. Prior to the hearing on Defendant s motions, which took place on February 11, 2003, plaintiff voluntarily dismissed Peter Watkins as a party defendant in the lawsuit. A decision on the remaining motions to dismiss was issued on March 25, 2003, where the Court granted, in part, defendants motion to dismiss. On September 23, 2003, the Company and the plaintiffs entered into a memorandum of agreement of settlement. The settlement was preliminarily approved by the Court on October 22, 2003 and is subject to notice to and opportunity to object and opt-out by members of the class and final approval by the court following a hearing on any objections to the settlement. The Company funded the settlement amount into escrow in October 2003.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On February 5, 2001, the Company was nominally sued in a derivative lawsuit filed in the Superior Court in Santa Clara County. The lawsuit, captioned *Mead Ann Krim v. William L. Larson, et al.*, Case No. CV795734, asserts claims against William Larson, Peter Watkins, Prabhat Goyal, Leslie Denend, Virginia Gemmell, Edwin Harper, Enzo Torresi (collectively the individual defendants), and PricewaterhouseCoopers LLP for breach of fiduciary duty, unjust enrichment and professional negligence against the accountants. In particular, the complaint alleges that the defendants engaged in a course of conduct by which they improperly accounted for revenue from software license sales, and that, as a result of their actions, certain of the Company s consolidated financial statements were false and misleading and not in compliance with GAAP. The complaint seeks an unspecified amount of damages. Nominal defendant Network Associates, Inc. filed a demurrer to the complaint on May 21, 2001. A hearing on the demurrer was held on June 29, 2001. On July 24, 2001, the Court sustained the demurrer with leave to amend. By Order dated August 21, 2001, the Court granted plaintiff limited discovery for purposes of amending the complaint to meet the demand futility test imposed by Delaware law. Plaintiff filed an amended complaint on December 26, 2001. Nominal defendant Network Associates, Inc. filed a demurrer, which was joined by the individual defendants, to the amended complaint on January 30, 2002. A hearing on the demurrer was held on March 8, 2002. The Court entered an order on March 28, 2002 sustaining the demurrer without leave to amend and dismissing the amended complaint with prejudice. Plaintiff filed a Notice of Appeal in the California Court of Appeals, Sixth Appellate District on June 24, 2002. On December 19, 2002, plaintiff filed a motion seeking the Court s approval of the parties settlement stipulation and dismissal of the case with prejudice. By order dated January 7, 2003, the Court entered the parties stipulation and dismissed the case with prejudice as to all parties and all claims.

In March 2002, several putative securities class action lawsuits were filed in the Court of Chancery in the State of Delaware, County of New Castle, and the Superior Court of the State of California, County of Santa Clara, arising out of the Company s proposed acquisition of McAfee.com Corporation (McAfee.com). The lawsuits named as defendants Network Associates and certain of McAfee.com s officers and directors, and with respect to the Delaware Court of Chancery actions, McAfee.com. The lawsuit filed in Santa Clara County is encaptioned *Peyton v. Richards, et al.*, No. CV 806199. The lawsuits filed in the Delaware Court of Chancery, which were encaptioned *Bank v. McAfee.com Corp., et al.*, Civil Action No. 19481; *Birnbaum v. Sampath, et al.*, Civil Action No. 19482 NC; *Brown v. Sampath, et al.*, Civil Action No. 19483 NC; *Chin v. McAfee.com Corp., et al.,* Civil Action No. 19484 NC; *Monastero v. Sampath, et al.*, Civil Action No. 19485; and *Ebner v. Sampath, et al.*, Civil Action No. 19487, were consolidated into a single case (the Consolidated Action) by Court order dated April 9, 2002. Plaintiffs amended the complaint in the Consolidated Action on July 8, 2002. The second amended complaint asserts claims against defendants for breach of fiduciary duty on the grounds that (i) the price at which Network Associates proposed to consummate the current exchange offer purportedly was unfair and inadequate, and (ii) defendants purportedly failed to disclose information material to assessing the propriety of the exchange offer. The plaintiffs seek, among other things, to recover unspecified damages and costs and to enjoin or rescind the transaction contemplated by the offer. On September 19, 2002 the parties entered into a memorandum of understanding. On July 18, 2003, the Delaware Court of Chancery approved the settlement and the case was dismissed. Another class action lawsuit was filed on April 9, 2002 in the United States District Court for the Northern District of California, encaptioned *Getty v. Sampath, et. al.*, Case No. C 02 1692. On September 30, 2002, the parties in the *Getty* action filed a joint request with United States District Court for the entry of an order staying the *Getty* proceedings until after the Delaware Chancery Court has an opportunity to approve the proposed settlement in the Delaware Consolidated Action. On April 2, 2002, defendants removed the California state action encaptioned *Peyton v. Richards, et al.*, No. CV 806199 to the United States District Court for the Northern District of California. Subsequently, by stipulation filed June 20, 2002, the parties in *Peyton* agreed for the action to be remanded to California Superior Court for the County of Santa Clara solely for the purpose of allowing plaintiff Justin Peyton to dismiss the action. On July 1, 2002, a putative class action lawsuit encaptioned *Peyton v. Richards, et al*., Case No. CV 809111, was filed in the California Superior Court for the County of Santa Clara against

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Network Associates and various officers and directors of McAfee.com. The complaint generally alleges that (i) the defendant directors of McAfee.com are liable for breach of fiduciary duty because they failed to maximize the price of Network Associates exchange offer, and (ii) defendant Network Associates aided and abetted these breaches of fiduciary duty by structuring the exchange offer in terms preferential to Network Associates. The plaintiff seeks, among other things, to enjoin or rescind the transaction contemplated by the offer, to recover costs, and to impose a constructive trust upon any benefits improperly received by defendants. On September 20, 2002, the Superior Court entered an order approving the parties joint stipulation to stay the *Peyton* proceedings pending the Delaware Chancery Court s approval of the proposed settlement in the Delaware Consolidated Action. On August 14, 2003, the parties entered into a stipulation for an order that would dismiss the *Peyton* action with prejudice.

Certain investment bank underwriters, the Company, and certain of the Company s 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.

Other Matters

On February 6, 2002, the Attorney General of the State of New York filed a Petition in the Supreme Court, New York County, alleging that certain restrictions posted by the Company on and with its software are deceptive, unenforceable and illegal. The challenged restrictions relate to publication of benchmark tests and reviews concerning the Company s software products. The Petition seeks damages, costs and an injunction requiring the Company to give notice to the Attorney General before making any representations to consumers concerning the right to review, test or criticize its products. This is a special proceeding under New York law. The Company filed papers in opposition to the Petition in which it denied the substantive allegations of the Petition and asserted various affirmative defenses. By a Final Order of the Supreme Court, New York County dated May 6, 2003, the Company and the Attorney General of the State of New York resolved the action.

On March 22, 2002, the Securities and Exchange Commission (SEC) notified the Company that it had 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.

14. Contingencies

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

NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

Under the terms of certain vendor agreements, in particular, vendors used as part of the Company s managed services, the Company 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.

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

The Company has agreed to indemnify members of the board of directors as well as officers of the Company, if they are made a party or are threatened to be made a party to any proceeding (other than an action by or in the right of the Company) by reason of the fact that they are an agent of the Company, or by reason of anything done or not done by them in any such capacity. The indemnity is for any and all expenses and liabilities of any type whatsoever (including but not limited to, judgements, 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 it or any members of board of directors or officers that will result in probable losses in excess of amounts covered by its D&O insurance.

If the Company believes a liability associated with any of the aforementioned indemnifications obligations 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.

15. Subsequent Events

On April 30, 2003, the Company acquired all of the capital stock of Entercept Securities Technologies, Inc. (Entercept) for approximately $124.6 million in cash plus direct transaction costs. Entercept provides a host-based intrusion prevention solution designed to proactively detect and stop security attacks before they cause damage.

On May 14, 2003, the Company acquired all of the capital stock of IntruVert Networks, Inc. (IntruVert) for approximately $103.4 million in cash plus direct transaction costs. IntruVert develops and provides a network-based intrusion prevention solution designed to proactively detect and stop security attacks before they cause damage.

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NETWORK ASSOCIATES, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company filed with the SEC its Form 10-Q for the quarterly period ended June 30, 2003 concurrent with filing this Form 10-Q for the quarterly period ended March 31, 2003. This concurrent filing and the subsequent events described therein should be read in conjunction with these consolidated financial statements.

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Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Forward-Looking Statements; Trademarks

Some of the statements contained in this Report on Form 10-Q are forward-looking statements that involve risks and uncertainties. The statements contained in the Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, pr targets, goals, projects, continue, or variations of such words, similar expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors beginning on page 51 in this document. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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

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

Overview

We are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. We offer two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. Our computer security solutions are offered primarily to large enterprises, governments, small and medium-sized business and consumer users. We operate our business in five geographic regions: North America; Europe, Middle East and Africa (EMEA); Japan; Asia-Pacific and Latin America. See note 12 to the condensed consolidated financial statements.

The majority of our net revenue has historically been derived from our McAfee Security anti-virus products and our Sniffer network fault identification and application performance management products. In addition to these two flagship products, we have focused our efforts on building a full line of complementary network and system protection solutions. On the system protection side, we strengthened our anti-virus lineup by adding complementary products in the anti-spam and host intrusion prevention categories. On the network protection side, we built upon our Sniffer line by adding products in the network monitoring, network reporting, network application performance monitoring, network intrusion prevention, and forensics categories. We continuously seek to expand our product lines.

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

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

Solutions also includes our Magic Service Desk family of products designed to offer management and visibility of desktop and server systems; and

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

In the three months ended March 31, 2003 and 2002, our net revenue was approximately $218.4 million and $255.6 million, respectively, and our net income was approximately $11.6 million and $51.6 million, respectively.

McAfee System Protection Solutions

McAfee System Protection Solutions help enterprises, small businesses, consumers and government agencies assure the availability and security of their desktops, application servers and web service engines. The McAfee System Protection Solutions portfolio features a range of best-of-breed products including anti-virus, managed services, McAfee SpamKiller anti-spam solutions, McAfee ThreatScan vulnerability assessment and McAfee Entercept for host-based intrusion prevention. Each is backed by the McAfee Anti-Virus Emergency Response Team, a leading threat research organization.

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

McAfee System Protection Solutions also include our Magic Service Desk family of products, offering management and visibility of desktop and server systems. Magic Service Desk is a modularized workflow engine for collecting, tracking, managing and reporting. This product is primarily used to manage service items, manage people resources, manage assets and assist in tracking successful change within an organization. Magic Service Desk is complemented by solutions allowing for remote diagnostics and asset discovery. Customers for these products are corporate, governmental and educational organizations.

McAfee Network Protection Solutions

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

Expert Services and Technical Support

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

Consulting Services supports product integrations and deployment with an array of standardized and custom offerings. Consulting Services also offers other services in both the security and networking areas,

including early assessment and design work, as well as emergency outbreak and network troubleshooting assistance. Our consulting services organization is organized around our product groups.

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

The PrimeSupport program provides our customers on-line and telephone-based technical support in an effort to ensure that our products are installed and working properly. To meet customers varying needs, PrimeSupport offers a choice of the on-line KnowledgeCenter or the telephone-based Connect, Priority and Enterprise. All PrimeSupport programs include software updates and upgrades. PrimeSupport is available to all customers worldwide from various regional support centers.

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

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

PrimeSupport Priority Provides support with priority, unlimited, toll-free telephone access to technical support 24 hours a day, 7 days a week and access to the on-line KnowledgeCenter.

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

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

Network Associates Labs

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

Strategic Alliances

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

Product Licensing Model

We typically license our products to corporate and government customers on a subscription basis for a period of two years or on a perpetual basis. As the software licenses or maintenance contracts near expiration, we contact customers to renew their licenses or maintenance contracts, as applicable. Typically, our maintenance contracts are sold on an annual basis.

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

We also provide single user and corporate user licenses for our products under traditional perpetual licenses with product updates, upgrades and support available to customers under separate maintenance contracts. As compared to subscription licenses, sales of perpetual licenses may result in significantly higher up-front revenue and lower recurring and future revenues. We typically sell perpetual licenses in connection with sales of our hardware-based products in which software is bundled with the hardware platform. Magic Service DeskSolutions sales are primarily on a perpetual license basis while allowing customers to purchase annual maintenance renewals.

On-Line Subscription Services and Managed Applications

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

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

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

Critical Accounting Policies

Except as described below, there have been no material changes to our critical accounting policies and estimates as disclosed in our report on Form 10-K for the year ended December 31, 2002.

Effective January 1, 2003, we changed our method for recognizing commission expenses to sales personnel. Prior to January 1, 2003, our policy was to expense the commissions as incurred. However, we believe that expensing commissions as incurred does not provide a fair representation of the income (loss) from operations when 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. As required by generally accepted accounting principles, the cumulative effect of the change in accounting principle effective January 1, 2003 is a one-time credit of $13.9 million ($11.1 million after tax) in the first quarter of 2003. As a result of the change in accounting, operating expense for the first quarter was reduced by $0.4 million.

Impact of Restatement on Consolidated Financial Statements

This Management s Discussion and Analysis of Financial Condition and Results of Operations gives effect to the restatement of our financial statements for 1998 through 2001 and the quarter ended March 31,

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2002. Due to the impact of the restatement, the results discussed herein for the quarters ended March 31, 2003 and 2002 differ from those previously announced by us in April 2003 or reported in our Form 10-Q for the quarter ended March 31, 2002. We do not intend to restate the Q1 2002 Form 10-Q and that document should not be relied upon. The results set forth below should be read in conjunction with (i) the unaudited consolidated financial statements included in this Form 10-Q and (ii) the consolidated financial statements for 1998 through 2002 and related notes contained in Amendment No. 2 to our 2000 Form 10-K (1998 through 2000) and 2002 Form 10-K (2000 through 2002).

Among others, the more significant categories of restatement adjustments were recorded:

- to properly reflect sales to our distributors and resellers on the sell-through basis for 1998 through 2000, which is how we have accounted for these sales since 2001; and

- to correct an error in our recognition of revenue under SOP 97-2 with respect to multi-element licensing arrangements in 1998 through 2000.

We have determined that, excluding the effect of currency-related adjustments, the aggregate amount of net revenue was not reduced as a result of our change to the sell-through revenue recognition method for years prior to 2001 or adjustments related to multi-element licensing arrangements in 1998 through 2000. These adjustments had the effect of deferring revenue from 1998 through 2000 to be recognized in later periods, with amounts deferred in connection with our multi-element licensing arrangements generally being recognized in later periods as service and support revenue. In the aggregate, for the three months ended March 31, 2003 and 2002, the restatement adjustments had the effect of increasing net revenues by $3.2 million and $34.9 million, respectively, and increasing expenses (primarily cost of revenue) by $0.3 million and $0.1 million, respectively, over amounts previously announced or reported.

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Results of Operations

The following table sets forth, for the periods indicated, the percentage of net revenue represented by certain items in our Condensed Consolidated Statements of Operations.

	Three Months Ended March 31,	
	2003	**2002**
		(As Restated)
Net revenue:		
Product	58%	54%
Services and support	42	46
Total net revenue	100	100
Cost of net revenue:		
Product	9	10
Services and support	6	6
Amortization of purchased technology	1	
Total cost of net revenue	16	16
Operating costs and expenses:		
Research and development	21	14
Marketing and sales	41	40
General and administrative	13	10
Provision for (recovery from) doubtful accounts, net		
Amortization of intangibles	2	1
Restructuring charge	7	1
Total operating costs and expenses	84	66
Income from operations		18
Interest and other income	3	3
Interest expense	(2)	(3)
Loss on repurchase of zero coupon convertible debentures	(1)	
Gain on sale of assets and technology		3
Income before provision (benefit from) for income taxes, minority interest and cumulative effect of change in accounting principle		21
Provision for (benefit from) income taxes		
Income before minority interest and cumulative effect of change in accounting principle Income before minority interest		21
Minority interest in net income of consolidated subsidiary		(1)
Income before cumulative effect of change in accounting principle		20
Cumulative effect of change in accounting principle, net of taxes	5	
Net income	5%	20%

Net Revenue. Net revenue decreased 15% to $218.4 million from $255.7 million in the three months ended March 31, 2003 and 2002, respectively. The decrease in overall net revenue reflects continued weakness in the worldwide economy and continued reductions in corporate capital spending. Accordingly, many of our customers and potential customers have: (i) delayed initiating the purchasing 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

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believed by them to be necessary to satisfy an immediate need. In addition, during the latter part of March 2003, we believe that events in Iraq further exacerbated the lack of corporate confidence in and uncertainty regarding the economy.

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

	Three Months Ended March 31,	
	2003	**2002**
		(As Restated)
Product	58%	54%
Services and support	42	46
Net revenue	100%	100%

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

	Three Months Ended March 31,	
	2003	**2002**
		(As Restated)
Subscription licenses	33%	34%
Perpetual licenses	50	46
Hardware	14	12
Retail	3	6
Royalties and other	0	2
Product revenue	100%	100%

Product revenue includes revenue from software licenses, hardware, retail products and royalties. The software component of most of our Sniffer and Magic products and a significant portion of our enterprise McAfee anti-virus software products are licensed on a perpetual basis. We continuously monitor our sales activities to ensure we have an appropriate mix of subscription and perpetual license revenues. Product revenue decreased 8% to $126.4 million from $138.0 million in the three months ended March 31, 2003 and 2002, respectively. The decrease in product revenue is attributable to decreases in the size of transactions as customers continued to limit expenditures or postpone full deployments. The decrease is also due to a deferral of an increasing share of perpetual and subscription license sales to ongoing product and customer support, which is recognized as maintenance revenue ratably over the service period. The drop in retail revenue from 6% to 3% of net revenue reflects a consumer shift from retail purchases to our on-line subscription offerings.

We may experience higher overall revenue in the near-term but lower future software license revenue due to increased levels of perpetual licenses. Sales of perpetual licenses may result in significantly higher up-front revenue and lower recurring and future revenues as the sales price for related upgrades and updates tends to be significantly lower than that of the initial perpetual license.

We recently introduced in Europe and Asia our perpetual plus licensing arrangements. Under these arrangements, we provide a perpetual license coupled with additional support, with a higher percentage of the contract value allocated to support revenues, which are deferred and recognized over the service period rather than being recorded immediately into earnings.

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

	Three Months Ended March 31,	
	2003	2002
		(As Restated)
Support and maintenance	74%	79%