FORTINET INC
Form 4
February 03, 2015

FORM 4

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

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

OMB Number:	3235-0287
Expires:	January 31, 2005
Estimated average burden hours per response...	0.5

(Print or Type Responses)

1. Name and Address of Reporting Person *
DEL MATTO ANDREW H

(Last) (First) (Middle)

C/O FORTINET, INC., 899 KIFER ROAD

(Street)

SUNNYVALE, CA 94086

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
FORTINET INC [FTNT]

3. Date of Earliest Transaction (Month/Day/Year)
02/01/2015

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Chief Financial Officer

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	02/01/2015		M [(1)]		30,000	A	$ 0	30,898	D	
Common Stock	02/01/2015		F [(2)]		11,398	D	$ 29.895	19,500	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. I De Se (In
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares	
Restricted Stock Units	$ 0 (3)	02/01/2015		M(1)			30,000	(4)	(4)	Common Stock	30,000	

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
DEL MATTO ANDREW H C/O FORTINET, INC. 899 KIFER ROAD SUNNYVALE, CA 94086			Chief Financial Officer	

Signatures

/s/ John Whittle, by power of attorney	02/03/2015
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Vesting of restricted stock units ("RSUs") granted to the Reporting Person on February 12, 2014.

(2) Exempt transaction pursuant to Section 16b-3(e) - payment of exercise price or tax liability by delivering or withholding securities incident to the receipt, exercise or vesting of a security issued in accordance with Rule 16b-3. All of the shares reported as disposed of in this Form 4 were relinquished by the Reporting Person and cancelled by the Issuer in exchange for the Issuer's agreement to pay federal and state tax withholding obligations of the Reporting Person resulting from the vesting of RSUs. The Reporting Person did not sell or otherwise dispose of any of the shares reported on this Form 4 for any reason other than to cover required taxes.

(3) Each RSU represents a contingent right to receive one share of the Issuer's common stock.

(4) 25% of the RSUs vest on February 1, 2015, then the remaining 75% of the RSUs vest in equal installments on each quarterly anniversary thereafter, until such time as the RSUs are 100% vested, subject to the continuing employment of the Reporting Person on each vesting date. Shares of the Issuer's common stock will be delivered to the Reporting Person upon vesting.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. T size="2"> (45,404) (941)
Provision for (recovery from) doubtful accounts, net

149 (64) 674 (387)
Reimbursement related to litigation settlement
(5,890) (24,991)
Amortization of intangibles
3,516 3,721 7,089 8,732
Restructuring charge
682 6,826 2,872 22,607
In-process research and development
6,600 6,600

Total operating costs
174,913 178,969 281,473 362,980

Income from operations
13,201 1,913 88,527 3,555
Interest and other income
4,224 2,660 8,575 7,208
Interest and other expenses
(2,137) (2,034) (2,878) (5,205)
Loss on repurchase of zero coupon convertible debentures
(136) (2,727)
Gain (loss) on sale of marketable securities
(1,319) 500 (831) 1,548

Income before provision for income taxes and cumulative effect of change in accounting principle
13,969 2,903 93,393 4,379
Provision for income taxes
3,769 412 25,223 556

Explanation of Responses:

Income before cumulative effect of change in accounting principle
10,200 2,491 68,170 3,823
Cumulative effect of change in accounting principle, net of tax
11,142

Net income
$10,200 $2,491 $68,170 $14,965

Other comprehensive income:

Unrealized loss on marketable securities, net
$(2,373) $(77) $(2,123) $(766)
Foreign currency translation gain (loss)
(2,307) 8,026 (1,333) 10,485

Comprehensive income
$5,520 $10,440 $64,714 $24,684

Basic income per share:

Income before cumulative effect of change in accounting principle
$0.06 $0.02 $0.42 $0.02
Cumulative effect of change in accounting principle, net of taxes
0.07

Explanation of Responses:

Net income per share basic	$0.06	$0.02	$0.42	$0.09
Shares used in per share calculation basic	160,313	160,341	161,800	159,954
Diluted income per share:				
Income before cumulative effect of change in accounting principle	$0.06	$0.02	$0.40	$0.02
Cumulative effect of change in accounting principle, net of taxes				0.07
Net income per share diluted	$0.06	$0.02	$0.40	$0.09
Shares used in per share calculation diluted	163,925	164,608	184,705	165,053

(1) Includes stock-based compensation charges of $258 and $576 for the three months ended June 30, 2004 and 2003, respectively, and $1,572 and $1,318 for the six months ended June 30, 2004 and 2003, respectively.

(2) Includes stock-based compensation charges of $51 and $158 for the three months ended June 30, 2004 and 2003, respectively, and $687 and $414 for the six months ended June 30, 2004 and 2003, respectively.

(3) Includes stock-based compensation charges of $131 and $225 for the three months ended June 30, 2004 and 2003, respectively, and $407 and $1,194 for the six months ended June 30, 2004 and 2003, respectively.

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

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2004	**2003**
	(In thousands) (Unaudited)	(As Restated, see Note 13)
Cash flows from operating activities:		
Net income	$ 68,170	$ 14,965
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of change in accounting principle		(11,142)
Depreciation and amortization	33,565	31,215
Acquired in-process research and development		6,600
Provision for (recovery from) doubtful accounts, net	674	(387)
Non-cash interest expense on convertible notes	1,050	2,112
Premium amortization on marketable securities	3,064	
(Gain) loss on sale of assets and technology	(45,404)	867
(Gain) loss on sale of marketable securities	831	(1,548)
Loss on redemption of zero coupon convertible debentures		2,727
Deferred taxes	13,430	(35,502)
Stock-based compensation charges	2,666	2,926
Change in fair value of derivative, net	(2,971)	(2,115)
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	54,176	51,341
Prepaid expenses, taxes and other	(5,144)	6,790
Accounts payable and accrued liabilities	(13,667)	4,116
Deferred revenue	83,087	16,899
Net cash provided by operating activities	193,527	89,864
Cash flows from investing activities:		
Purchase of marketable securities	(603,731)	(666,969)
Proceeds from sale and maturity of marketable securities	516,601	625,545
Increase in restricted cash	(202)	(186)
Proceeds from sale of Magic, net	47,565	
Purchase of property and equipment	(15,952)	(41,124)
Purchase of IntruVert, net of cash acquired		(92,393)
Purchase of Entercept, net of cash acquired		(123,605)
Other	(28)	(178)
Net cash used in investing activities	(55,747)	(298,910)
Cash flows from financing activities:		
Proceeds from issuance of stock from option and stock purchase plans	36,955	20,479
Redemption of zero coupon convertible debentures		(177,289)
Repurchase of common stock	(145,265)	

Net cash used in financing activities	(108,310)	(156,810)
Effect of exchange rate fluctuations	(7,603)	22,798
Net increase (decrease) in cash and cash equivalents	21,867	(343,058)
Cash and cash equivalents at beginning of period	333,651	674,226
Cash and cash equivalents at end of period	$ 355,518	$ 331,168
Non cash investing activities:		
Unrealized loss on marketable securities	$ (2,123)	$ (766)
Fair value of assets acquired in business combinations	$	$ 238,545
Liabilities assumed in business combinations	$	$ 29,147
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 12,144	$ 5,157
Cash paid for interest	$ 4,902	$ 5,258

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

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

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company as of June 30, 2004 and for the three and six months ended June 30, 2004 and June 30, 2003. All significant intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2003 Condensed Consolidated Balance Sheet was derived from audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, the Company believes that all disclosures are adequate to make the information presented not misleading. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in the Company s Annual Report on Form 10-K for fiscal year ended December 31, 2003.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to fairly present the Company s financial position as of June 30, 2004, and results of operations and cash flows for the three and six months ended June 30, 2004 and June 30, 2003 have been included. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

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

Proforma Stock 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 Financial Accounting Standards Board (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.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three and Six Months Ended June 30,	
	2004	2003
Stock option grants:		
Risk free interest rate	3.66%	3.37%
Expected life	4 years	4 years
Volatility	87.98%	93.48%
Dividend yield	None	None
ESPP:		
Risk free interest rate	1.29%	1.43%
Expected life	1.25 years	1.25 years
Volatility	58%	72%
Dividend yield	None	None

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net income, as reported	$10,200	$ 2,491	$ 68,170	$ 14,965
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(7,939)	(16,188)	(17,084)	(34,053)
Add back: Stock-based employee compensation expense, net of tax; included in reported net income	264	575	1,600	1,756
Pro forma net income (loss)	$ 2,525	$(13,122)	$ 52,686	$(17,332)
Net income (loss) per share:				
Basic as reported	$ 0.06	$ 0.02	$ 0.42	$ 0.09
Basic pro forma	$ 0.02	$ (0.08)	$ 0.33	$ (0.11)
Diluted as reported	$ 0.06	$ 0.02	$ 0.40	$ 0.09
Diluted pro forma	$ 0.02	$ (0.08)	$ 0.32	$ (0.11)

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

New Accounting Pronouncements

Accounting for Enhancements to One-Time Termination Benefits

In September 2003, the FASB issued FASB Staff Position No. FAS 146-1, *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an*

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Accounting for Consolidation of Variable Interest Entities

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

The Meaning of Other-Than-Temporary Impairment

In March 2004, the Emerging Issues Task Force (EITF) reached consensus on Issue 03-01 (EITF 03-01), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting guidance of EITF 03-01 is effective for periods beginning after June 15, 2004, while the disclosure requirements are effective for periods ending after June 15, 2004. The Company does not believe that the adoption of EITF 03-01 will have a material impact on its financial position, results of operations or cash flows.

Accounting Change

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

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

3. Stock-Based Compensation

The Company has recorded stock-based compensation charges of $0.4 million and $1.0 million before taxes in the three months ended June 30, 2004 and 2003, respectively, and $2.7 million and $2.9 million before

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

taxes in the six months ended June 30, 2004 and 2003, respectively. These charges are comprised of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Exchange of McAfee.com options	$334	$323	$2,166	$1,063
Existing executives	106	106	213	212
Former employees		5	146	1,126
Extended life of vested options of terminated employees		525	141	525
Total stock-based compensation	$440	$959	$2,666	$2,926

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, 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 FIN 44. 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. This compensation charge will initially be remeasured using the same methodology and recorded as an expense using the accelerated method of amortization under 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. Fully vested options will continue to be remeasured using the same method and compensation charges will be recorded until the earlier of the date of exercise, forfeiture or cancellation without replacement. 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 June 30, 2004 and 2003 and during the six months ended June 30, 2004 and 2003, the Company recorded a charge of approximately $0.3 million, $0.3 million, $2.2 million and $1.1 million, respectively, related to exchanged options subject to variable accounting. This stock based compensation charge was based on the Company s closing share price of $18.13 and $12.68 on June 30, 2004 and 2003, respectively. As of June 30, 2004, the Company had approximately 0.6 million outstanding exchanged options subject to variable accounting.

Existing executive. On January 15, 2002, the Company s board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk, its chairman and chief executive officer. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase such shares will lapse as follows: 3,000 vested as of the grant date and 47,000 are restricted until January 15, 2005. The intrinsic value of the restricted stock was determined to be approximately $1.4 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of the Company s common stock on January 15, 2002. During the three months ended June 30, 2004 and 2003, the Company recorded approximately $0.1 million in both periods, and for the six months ended June 30, 2004 and 2003, the Company recorded approximately $0.2 million in both periods related to stock-based compensation associated with Mr. Samenuk s 2002 restricted stock grant.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Former employees. In November and December 2003, the Company extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. As these employees options continued to vest after termination and their exercise period was extended an additional 90 days, the Company recorded a one time stock-based compensation charge of approximately $0.1 million in the first quarter of 2004.

In July 2002, one of the Company s employees became a non-employee, but continued to provide services to the Company. As he was allowed to continue to hold his vested options beyond the normal exercise period after termination and continue to vest his options, the Company recorded a stock-based compensation charge corresponding to the fair value of his vested options. The unvested options were remeasured using the Black Scholes option valuation model and recognized over the remaining vesting period using the accelerated method of amortization required in FIN 28. Stock-based compensation of approximately $5,000 and $35,000 was expensed during the three and six months ended June 30, 2003, respectively. No future stock compensation charges will be recorded.

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire the Company s common stock. These options are subject to variable accounting as discussed above. Upon the executives termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former 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. On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price of $11.063, the then current fair market value of its common stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted. During the three and six months ended June 30, 2004 and 2003, the Company did not incur a charge related to these repriced options subject to variable plan accounting. For the three and six months ended June 30, 2004 and 2003, the Company s stock-based compensation charge calculation related to options subject to variable plan accounting was based on quarter-end per share price of the Company s stock of $18.13 and $12.68, respectively. The Company will incur stock-based compensation charges if the Company s stock price increases above $20.375 per share. As of June 30, 2004, the Company had options to purchase approximately 0.4 million shares, which were outstanding and subject to variable plan accounting.

Extended life of vested options held by terminated employees. During a significant portion of 2003, the Company suspended exercises of stock options until its required public company reports were filed with the SEC. The period during which stock options were suspended is known as the blackout period. Due to the blackout period, the Company extended the exercisability of any options of terminated employees that would otherwise expire during the blackout period for a period of time equal to a specified period after termination of the blackout period. Accordingly, the Company recorded a stock-based compensation charge on the date the options should have terminated based on the intrinsic value of the option on the modification date and the option price. During the three and six months ended June 30, 2003 and the six months ended June 30, 2004, the Company recorded a stock-based compensation charge of $0.5 million and $0.1 million, respectively.

4. Business Combinations and Divestitures

IntruVert Networks, Inc.

On May 14, 2003, the Company acquired 100% of the outstanding capital shares of IntruVert Networks, Inc., (IntruVert) a provider of network-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for $98.1 million in cash and $5.2 million of

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

direct expenses, totaling $103.3 million. The Company acquired IntruVert to enhance its network protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company s current product offering, and sell IntruVert products to its existing customer base. The results of operations of IntruVert have been included in these condensed consolidated financial statements since the date of acquisition.

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

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

Entercept Security Technologies, Inc.

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

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

The Company accrued $2.8 million in duplicative sites costs for permanently vacated facilities at the acquisition date. The accrual will be fully utilized by 2006, the end of the original lease term. In the fourth quarter of 2003, the Company entered into a sublease for the vacated facility, and therefore, adjusted the

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

accrual by the value of the sublease. The following is a summary of activity in the restructuring accrual related to Entercept (in thousands):

Original accrual, April 30, 2003	$ 2,837
Cash payments	(989)
Adjustments	(1,137)
Balance, June 30, 2004	$ 711

As part of the Entercept acquisition, the Company assumed all outstanding unvested Entercept cash bonus units and agreed to make specified per unit cash payments to former Entercept employees contingent upon their continued employment with the Company for one year based on the vesting terms of such units, generally one year. The payments to former Entercept employees were expensed monthly as salary expense as the employees provided services to the Company. All amounts were fully paid from escrow in May 2004.

Management determined the purchase price allocation of the above acquisitions based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques and the assistance of valuation consultants. The following is a summary of the assets acquired and liabilities assumed in the acquisitions (in thousands):

	IntruVert Networks, Inc.	Entercept Security Technologies, Inc.	Total Assets Acquired and Liabilities Assumed
Deferred tax assets	$ 436	$ 10,560	$ 10,996
Technology	18,200	21,700	39,900
Other intangible assets	1,900	2,800	4,700
Cash	10,986	1,028	12,014
Goodwill	71,598	99,565	171,163
Other assets	4,984	3,517	8,501
Total assets acquired	108,104	139,170	247,274
Current liabilities	2,649	4,739	7,388
Deferred tax liabilities	7,839	9,555	17,394
Total liabilities assumed	10,488	14,294	24,782
Net assets acquired	$ 97,616	$ 124,876	$ 222,492
In-process research and development (expensed)	5,700	900	6,600
Total acquisition cost	$ 103,316	$ 125,776	$ 229,092

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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, IntruVert and Entercept as if the acquisitions had occurred at the beginning of 2003 (in thousands except per share amounts):

	Three Months Ended June 30, 2003	Six Months Ended June 30, 2003
Net revenue	$217,925	$439,956
Net income	$ 4,965	$ 6,631
Basic net income per share	$ 0.03	$ 0.04
Shares used in per share calculation basic	160,341	159,954
Diluted net income per share	$ 0.03	$ 0.04
Shares used in per share calculation diluted	164,608	165,053

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

Magic Solutions

In December 2003, the Company announced the sale of its Magic Solutions product line (Magic) to BMC Software for approximately $47.0 million in cash plus final purchase price adjustments. At December 31, 2003, the carrying values of assets and liabilities related to Magic were presented as held for sale on the consolidated balance sheet. The following were the components of the Magic at December 31, 2003 (in thousands):

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

The assets and liabilities of Magic were located primarily in the Company s North American and EMEA reporting units. Magic assets and liabilities in the Company s other reporting units were not material. Revenues related to Magic were approximately $16.1 million for the three months ended June 30, 2003, and $2.9 million and $31.4 million for the six months ended June 30, 2004 and 2003, respectively. Revenues related to Magic were $63.2 million for the year ended 2003.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Sniffer Technologies

In April 2004, the Company announced plans to sell its Sniffer product line to a partnership of two investment firms. This sale closed on July 16, 2004 and the Company received cash proceeds of approximately $217 million (See Note 14).

5. Goodwill and Other Intangible Assets

The Company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* The Company performs an impairment review of its goodwill on at least an annual basis. The Company completed its annual goodwill impairment review as of October 1, 2003, during the fourth quarter of 2003 and concluded that goodwill was not impaired. The fair value of the reporting units was estimated using the average of the expected present value of future cash flows and of the market multiple value. On April 22, 2004, the Company announced that it will sell its Sniffer product line (See Note 14). The Company has determined that approximately $50 million of goodwill will be allocated to the Sniffer product line from the North American reporting unit. Furthermore, as a result of the sale of Sniffer and Magic, the Company also tested its reporting units excluding Sniffer and Magic during the three months ended March 31, 2004 and June 30, 2004 as required by SFAS 142 and no impairment was present. The Company will continue to test for impairment annually unless an impairment indicator occurs.

Goodwill information is as follows (in thousands):

	January 1, 2004	Goodwill Acquired	Adjustments	Effects of Foreign Currency Exchange	June 30, 2004
North America	$364,325	$	$ (279)	$(184)	$363,862
EMEA	44,360		(42)	57	44,375
Japan	16,748		(8)		16,740
Asia-Pacific (excluding Japan)	6,087		(9)		6,078
Latin America	12,073		(1,382)	(394)	10,297
Total	$443,593	$	$(1,720)	$(521)	$441,352

Adjustments to goodwill reflect purchase price adjustments made in periods subsequent to the acquisition.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	June 30, 2004			December 31, 2003		
	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount
Other intangible assets:						
Purchased technologies	$110,907	$ (66,140)	$44,767	$116,037	$ (64,439)	$ 51,598
Trademarks, patents, customer base , and other intangibles	88,750	(41,312)	47,438	103,431	(49,077)	54,354
	$199,657	$(107,452)	$92,205	$219,468	$(113,516)	$105,952

The aggregate amortization expenses for the intangible assets listed above totaled $6.8 million and $6.5 million for the three months ended June 30, 2004 and 2003, respectively and $13.8 million and $13.2 million for the six months ended June 30, 2004 and 2003, respectively.

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

Fiscal Years:	
Remainder of 2004	$12,204
2005	23,270
2006	20,401
2007	17,646
2008	12,277
Thereafter	6,407
	$92,205

6. Restructuring

2004 Restructuring

In the first quarter of 2004, the Company recorded a restructuring charge of approximately $2.2 million related to the severance of approximately 160 employees, of which $0.7 million and $1.5 million was related to its North American and EMEA operating segments, respectively. The workforce size was reduced primarily due to the Company s sale of Magic.

In the second quarter of 2004, the Company recorded a restructuring charge of approximately $1.6 million related to the severance of approximately 80 employees in the Company s sales, technical support and general and administrative functions. Approximately $0.6 million of

the restructuring charge was related to the Company s EMEA operating segment and the remaining $1.0 million was related to its North American operating segment. These reductions are part of the previously announced cost-savings measures being implemented by the Company. Approximately 60 employees remained employed at the end of June 30, 2004, but their employment will end within 60 days.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the Company s restructuring accrual established through June 30, 2004 (in thousands):

	Severance and Other Benefits
Balance, January 1, 2004	$
Restructuring accrual	3,838
Cash payments	(2,051)
Adjustment to liability	(340)
Balance, June 30, 2004	$ 1,447

2003 Restructuring

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

As part of the consolidation of activities into the Plano facility, the Company relocated employees from its Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, the Company recorded a restructuring charge of $15.8 million which consisted of a non-cash charge of $2.1 million related to asset disposals and discontinued use of certain leasehold improvements, furniture and equipment; non-cash write off of $1.9 million deferred rent liability; and a $15.6 million accrual for estimated lease related costs associated with the permanently vacated facilities in Santa Clara, California. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The total restructuring charge and related cash outlay are based on management s current estimates. As of June 30, 2004, $1.3 million of the accrued lease termination costs have been classified as current accrued liabilities, while the remaining balance of $11.5 million has been classified as other long term liabilities.

During the second and third quarter of 2003, the Company recorded restructuring charges of $6.8 million and $0.6 million, respectively, which consisted of $6.7 million related to a headcount reduction of 210 employees and $0.7 million related to other expenses such as legal expenses incurred in international locations in conjunction with the headcount reduction. The restructuring charge related to headcount reductions was $0.9 million and $5.8 million in the Company s North American and EMEA operating segments, respectively. The employees were located in the Company s domestic and international locations and were primarily in the sales, product development and customer support areas. In the third and fourth quarters of 2003, the Company reversed a total of $1.0 million of restructuring accrual in Europe that was no longer necessary after paying out substantially all accrued amounts to the former employees.

During the second quarter of 2004, the Company adjusted the restructuring accrual related to lease termination costs. The adjustment decreased the liability by approximately $0.5 million, and was related to changes in estimates related to the sublease income to be received over the remaining lease term. The Company also recorded a $55,000 adjustment to severance and other benefits from its EMEA operating segment as the benefits were not utilized.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the Company s restructuring accrual established in 2003 and activity through June 30, 2004 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2003	$	$	$	$
Restructuring accrual	15,734	6,692	739	23,165
Cash payments	(1,707)	(6,259)	(167)	(8,133)
Adjustment to liability	(273)	(116)	(572)	(961)
Accretion	463			463
Balance, December 31, 2003	14,217	317		14,534
Cash payments	(1,119)	(194)		(1,313)
Adjustment to liability	(576)	(49)		(625)
Accretion	288			288
Balance, June 30, 2004	$ 12,810	$ 74	$	$ 12,884

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 actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charge was allocated to North America.

7. Convertible Debt and Line of Credit

Convertible debt is comprised of the following amounts (in thousands):

	June 30, 2004	December 31, 2003
5.25% Convertible Subordinated Notes due 2006		
Face Value (including accumulated fair value adjustment of $(5,921) and $2,397 at June 30, 2004 and December 31, 2003, respectively)	$ 339,079	$ 347,397

5.25% Convertible Subordinated Note Due 2006

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

The Notes mature on August 15, 2006, unless earlier redeemed by the Company at its option or converted at the holder s option. At the option of the holder, the Notes may be converted into the Company s common stock at any time, unless previously redeemed, at a conversion price of $18.07 per share. The Notes may also be redeemed at the option of the holder in the event of a Change of Control (as defined in the related indenture). At any time between August 20, 2004 and August 14, 2005, the Company may redeem all or a

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

portion of the Notes for cash at a repurchase price of 101.3125% of the principal amount. After August 14, 2005, the repurchase price is 100.0% of the principal amount. The Company has announced that it intends to redeem the Notes for approximately $350 million in cash on their first call date of August 20, 2004, and accordingly, they have been classified as current liabilities in the accompanying condensed consolidated balance sheet at June 30, 2004 (See Note 14).

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

Zero Coupon Convertible Debentures Due 2018

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

In February 2003, outstanding Debentures, with an aggregate face amount at maturity of $358.5 million, became redeemable for cash at the option of the holders thereof, at which time the Company repurchased Debentures which had an aggregate face amount at maturity of $358.0 million for a net price of $177.1 million. In June 2003, the Company redeemed the remaining Debentures with an aggregate face amount at maturity of $0.5 million for a net price of $0.2 million. The Company recognized a loss of $2.7 million on the redemption of Debentures during 2003. The loss was calculated as the difference between the accreted value of the debt, net of unamortized issuance costs and the cost of redemption.

Line of Credit

In April 2004, the Company renewed and expanded its $16.5 million credit facility with a bank. The credit facility was increased $2.0 million and is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including, but not limited to, interest rate, maturity, representations, covenants and events of default, as mutually agreed between the Company and bank at the time of each specific transaction. The credit facility is intended to be used for short term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time. No balances are outstanding at June 30, 2004.

8. Interest Rate Swap Transaction

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

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

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

August 20, 2004 (See Note 14), however, the Company plans to leave the swap intact after the Notes are called. The swap will become a speculative investment and be marked to market each period with gains and losses being reported in the statement of income.

The Transactions qualified and were designated as a fair value hedge against movements in the fair value of the Notes due to changes in the benchmark interest rate. Under the fair value hedge model, the derivative is recognized at fair value on the balance sheet with an offsetting entry to the income statement. In addition, changes in fair value of the Notes due to changes in the benchmark interest rate are recognized as a basis adjustment to the carrying amount of the Notes with an offsetting entry to the income statement. The gain or loss from the change in fair value of the Transaction and the offsetting change in the fair value of the Notes are recognized as interest and other expense. The net unrealized gain recorded for the three months ended June 30, 2004 and 2003 was approximately $0.8 million and $1.0 million, respectively and for the six months ended June 30, 2004 and 2003 was approximately $3.0 million and $2.1 million, respectively. The estimated fair value of the Transactions was $4.1 million and $16.1 million at June 30, 2004 and 2003, respectively.

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

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

9. Net Income Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Numerator Basic				
Income before cumulative effect of change in accounting principle	$10,200	$2,491	$68,170	$ 3,823
Cumulative effect of change in accounting principle, net of tax				11,142
Net income	$10,200	$2,491	$68,170	$14,965
Numerator Diluted				
Income before cumulative effect of change in accounting principle	$10,200	$2,491	$68,170	$ 3,823
Cumulative effect of change in accounting principle, net of tax				11,142
Interest on convertible debentures(1)			6,015	
Net income	$10,200	$2,491	$74,185	$14,965

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Denominator Basic				
Basic weighted average common shares outstanding	160,313	160,341	161,800	159,954
Denominator Diluted				
Basic weighted average common shares outstanding	160,313	160,341	161,800	159,954
Effect of dilutive securities:				
Convertible debentures(1)			19,092	
Common stock options and shares subject to repurchase(2)	3,612	4,110	3,789	4,933
Warrants		157	24	166
Diluted weighted average shares	163,925	164,608	184,705	165,053
Basic net income per share:				
Income before cumulative effect of change in accounting principle	$ 0.06	$ 0.02	$ 0.42	$ 0.02
Cumulative effect of change in accounting principle, net of tax				0.07
Net income per share Basic	$ 0.06	$ 0.02	$ 0.42	$ 0.09
Diluted net income per share:				
Income before cumulative effect of change in accounting principle change	$ 0.06	$ 0.02	$ 0.40	$ 0.02
Cumulative effect of change in accounting principle, net of tax				0.07
Net income per share Diluted	$ 0.06	$ 0.02	$ 0.40	$ 0.09

(1) For the three months ended June 30, 2004 and the three and six months ended June 30, 2003, convertible debt interest and related as-if converted shares were excluded from the calculation since the effect was anti-dilutive. The total number of shares excluded from the calculation related to as-if converted shares was 19.1 million.

(2) For the three and six months ended June 30, 2004, 7.8 million and 7.7 million options, respectively, and for the three and six months ended June 30, 2003, 17.7 million and 16.1 million options, respectively, to purchase common stock, were excluded from the calculation since the effect was anti-dilutive.

10. Business Segment Information

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

The Company markets and sells, through its geographic regions, anti-virus and security software, hardware and services and network management software, hardware and services. These products and services are marketed and sold worldwide primarily through resellers, distributors, systems integrators, retailers, original equipment manufacturers, Internet service providers and directly by the Company. In addition, the

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net revenue by region:				
North America	$143,737	$139,098	$277,858	$274,773
EMEA (Europe, Middle East and Africa)	56,556	57,779	113,404	119,858
Japan	12,065	8,600	25,882	19,275
Asia-Pacific (excluding Japan)	9,044	7,384	16,534	14,044
Latin America	4,276	4,164	11,078	8,389
Net revenue	$225,678	$217,025	$444,756	$436,339
Income before provision for income taxes and cumulative effect of change in accounting principle:				
North America	$ 25,575	$ 2,557	$ 93,831	$ (8,488)
EMEA	(18,606)	(4,540)	(14,800)	684
Japan	(1,777)	(1,833)	(4,039)	(221)
Asia-Pacific (excluding Japan)	9,990	6,905	18,542	13,611
Latin America	(1,213)	(186)	(141)	(1,207)
Income before provision for income taxes and cumulative effect of change in accounting principle	$ 13,969	$ 2,903	$ 93,393	$ 4,379

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Software licenses	$ 41,172	$ 82,592	$ 98,212	$187,216
Maintenance	106,224	71,427	209,239	139,849
Hardware	23,656	18,467	48,885	35,947
Consulting	4,619	7,727	8,603	14,844
Training	2,090	2,357	3,972	4,426
Hosting arrangements	32,738	16,310	59,204	30,710
Retail and other	15,179	18,145	16,641	23,347

Total	$225,678	$217,025	$444,756	$436,339

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
McAfee	$175,226	$146,675	$341,232	$296,731
Sniffer	38,438	49,590	80,691	98,498
Magic		16,110	2,850	31,394
IntruShield	10,184	910	16,793	910
McAfee Research	1,830	3,433	3,190	7,155
PGP		307		1,651
Total	$225,678	$217,025	$444,756	$436,339

11. Litigation

General

From time to time, the Company has been subject to litigation as part of the ordinary course of business 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. In such cases, the Company has recorded the minimum estimated liability related to those claims, where there is a range of loss. In other instances, because of the uncertainties related to both the amount and range of loss on the remaining pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, the Company will assess its potential liability and revise its estimates. Pending or future litigation could have a material adverse effect on the business, results of operations, financial condition and cash flow.

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

During the first and second quarters of 2004, the Company received net insurance reimbursements from its insurance carriers totaling approximately $25.0 million. The insurance reimbursements are a result of the settling of the class action securities litigation case against the Company in October 2003. In October 2003, the Company paid approximately $70.0 million to settle the litigation.

Securities Case

Certain investment bank underwriters, the Company, and certain of our directors and officers have been named in a putative class action lawsuit for violation of the federal securities laws in the United States District Court for the Southern District of New York, captioned *In re McAfee.com Corp. Initial Public Offering Securities Litigation,* 01 Civ. 7034 (SAS). This is one of a number of cases challenging underwriting practices in the initial public offerings (IPOs) of more than 300 companies. These cases have been coordinated for pretrial proceedings as *In re Initial Public Offering Securities Litigation,* 21 MC 92 (SAS). Plaintiffs generally allege that certain underwriters engaged in undisclosed and improper underwriting activities, namely the receipt of excessive brokerage commissions and customer agreements regarding post-offering purchases of stock in exchange for allocations of IPO shares. Plaintiffs also allege that various investment bank securities analysts issued false and misleading analyst reports. The complaint against the Company claims that the purported improper underwriting activities were not disclosed in the registration statements for McAfee.com s

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

IPO and seeks unspecified damages on behalf of a purported class of persons who purchased the Company s securities or sold put options during the time period from December 1, 1999 to December 6, 2000. On February 19, 2003, the Court issued an Opinion and Order dismissing certain of the claims against the Company with leave to amend. A settlement proposal was accepted by the Company on July 15, 2003 and is awaiting Court approval. The proposed settlement would not have material impact on the Company s financial position, results of operations or cash flows, if approved by the court.

Other Matters

On June 6, 2002, Paul Cozza filed a Complaint in the United States District Court, District of Massachusetts alleging breach of contract, fraud and bad faith arising out of a dispute concerning the licensing of certain technology used in the Company s Virex 6.1 product. The Complaint seeks royalties on the Company s sale of Virex 6.1 products from January 1, 2002 to the present. The Company filed papers in opposition to the Complaint and asserted various defenses. The Company is engaging in discovery efforts.

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

12. Contingencies and Guarantees

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

Under the terms of the Company s software license agreements with its customers, the Company agrees that in the event the software sold infringes upon any patent, copyright, trademark, or any other proprietary right of a third party, it will indemnify its customer licensees, against any loss, expense, or liability from any damages that may be awarded against its customer. The Company includes this infringement indemnification in all of its software license agreements and selected managed service arrangements. In the event the customer cannot use the software or service due to infringement and the Company can not obtain the right to use, replace or modify the license or service in a commercially feasible manner so that it no longer infringes then the Company may terminate the license and provide the customer a pro-rata refund of the fees paid by the customer for the infringing license or service. The Company has recorded no liability associated with this indemnification, as it is not aware of any pending or threatened infringement actions that are probable losses. The Company believes the estimated fair value of these intellectual property indemnification clauses is minimal. The Company has not paid any significant amounts under these agreements.

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

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Under the terms of the Company s agreement to sell Sniffer in July 2004, the Company agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is $200 million. To date, the Company has paid no amounts under the representations and warranties indemnification. The Company has not recorded any accruals related to these agreements.

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

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

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

13. Restatement

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended June 30, 2003		Six Months Ended June 30, 2003	
	As Previously Reported	As Restated	As Previously Reported	As Restated
Product revenue	$119,205	$119,204	$245,596	$246,510
Services and support revenue	99,081	97,821	191,131	189,829
Net revenue	$218,286	$217,025	$436,727	$436,339
Income from operations	$ 2,270	$ 1,913	$ 3,002	$ 3,555
Provision for income taxes	$ 445	$ 412	$ 566	$ 556
Net income	$ 3,719	$ 2,491	$ 15,343	$ 14,965
Basic income per share:				
Income before cumulative effect of change in accounting principle	$ 0.02	$ 0.02	$ 0.02	$ 0.02
Cumulative effect of change in accounting principle net of taxes			0.07	0.07
Earnings per share Basic	$ 0.02	$ 0.02	$ 0.09	$ 0.09
Diluted income per share:				
Income before cumulative effect of change in accounting principle	$ 0.02	$ 0.02	$ 0.02	$ 0.02
Cumulative effect of change in accounting principle net of taxes			0.07	0.07
Earnings per share Diluted	$ 0.02	$ 0.02	$ 0.09	$ 0.09

14. Subsequent Events

On July 16, 2004, the Company completed its previously announced sale of its Sniffer product line to a partnership of two investment firms. The total consideration received by the Company was approximately $217 million in cash. The Company has preliminarily calculated the gain on the sale of Sniffer to be approximately $201 million before income taxes. The following is a preliminary listing of assets and liabilities that were sold or assumed through the transaction as of June 30, 2004 (in thousands):

Assets:	
Prepaid expenses	$ 2,391

Inventory	7,866
Equipment, net	4,214
Goodwill	50,876
Total assets	$65,347

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Liabilities	
Accounts payable	$ 327
Accrued liabilities	3,741
Deferred revenue	45,643
Total liabilities	$49,711

In conjunction with the sale of the Sniffer product line, the Company has entered into a transaction services agreement with the buyer, Network General Corporation. Under the agreement, the Company will provide certain transitional services for Network General Corporation for a period up to nine months. The Company will be reimbursed for its costs plus a profit margin.

On July 27, 2004, the Company called for redemption on August 20, 2004, all of its outstanding 5.25% Convertible Subordinated Notes due 2006. Subject to conversion prior to the redemption date, holders of the $345,000,000 aggregate principal amount of notes will have their notes redeemed at a redemption price of $1,013.7083 per $1,000 principal amount of notes, consisting of $1,013.125 principal amount plus accrued and unpaid interest of approximately $0.5833.

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

Forward-Looking Statements; Trademarks

Some of the statements contained in this Report on Form 10-Q are forward-looking statements that involve risks and uncertainties. The statements contained in the Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, pr targets, goals, projects, continue, or variations of such words, similar expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors beginning on page 42 in 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 McAfee and other corporations. Trademarks or trade names owned by McAfee and/or our affiliates include the marks: McAfee, and Network Associates.

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

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

Overview and Executive Summary

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

We derive our revenue and generate cash from customers from primarily two sources (i) product revenue, which includes software license, hardware and royalty revenue, and (ii) services and support revenue, which includes software license maintenance, training, consulting and on-line subscription arrangements revenue. For the three and six months ended June 30, 2004, our net revenue was $225.7 million and $444.8 million, respectively, and our net income was $10.2 million and $68.2 million, respectively. For the three and six months ended June 30, 2003, our net revenue was $217.0 million and $436.3 million, respectively, and our net income was $2.5 million and $15.0 million, respectively. Net income for the six months ended June 30, 2004 was favorably impacted by a $46.5 million gain from the sale of our Magic product line in January 2004 and insurance reimbursements of approximately $25.0 million ($19.1 million

received in first quarter of 2004 and $5.9 million received in the second quarter of 2004) relating to our previously settled class action lawsuit. Net income for the first six months of 2003 was favorably impacted by a cumulative effect of a change in accounting principle of $11.1 million related to our accounting for sales commissions. Our net revenue is impacted by corporate, government and consumer spending levels. In addition to total net revenue and net income, in evaluating our business, management considers, among many other factors, the following:

Sales by geography. We operate our business in five geographic regions: North America (U.S. and Canada); Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific (excluding Japan) and Latin America. During the three and six months ended June 30, 2004, 36% and 38% of our net revenue, respectively, was generated outside of North America, with North America and EMEA collectively accounting for approximately 89% of our total net revenue in the three months ended June 30, 2004 and 88% in the six months ended June 30, 2004. During the three and six months ended June 30, 2003, 36% and 37% of our net revenue, respectively, was generated outside of North America, with North America and EMEA collectively accounting for approximately 91% and 90% of our total net revenue in the three months and six months ended June 30, 2003, respectively. During all of fiscal 2003 and the first quarter of 2004, sales in EMEA were favorably impacted by the strengthening of the Euro and the British Pound.

Sales by product and customer category:

McAfee. Our McAfee products include enterprise, small and medium sized businesses and consumer products, with enterprise including our Entercept host-based intrusion protection products which were acquired in connection with the Entercept acquisition in April 2003. While sales to small and medium sized businesses (SMB) have been down, sales to enterprises have recently begun to show improvement, and we have experienced significant growth in the consumer market. Weakness in SMB sales reflects changes made to our SMB sales organization in Europe during the quarter. Our consumer market is comprised of our McAfee consumer on-line subscription service and retail boxed product sales. In the quarter ended June 30, 2004, we added 822,100 net new subscribers. Revenue from our consumer security market increased 47% from $47.0 million during the first quarter of 2004 to $68.9 million during the second quarter of 2004. Our consumer security revenue was $40.0 million during the second quarter of 2003. At June 30, 2004, we had a total subscriber base of approximately 5.4 million customers and our average subscriptions per subscriber was 1.4. Drivers of this subscriber growth include (i) numerous virus outbreaks during the second half of 2003 and in early 2004, including variations of Sasser, MyDoom, Bagle and NetSky, and (ii) continued strategic relationships with channel partners, such as AOL, Dell and MSN.

IntruShield. Our IntruShield network protection products, acquired by us in the second quarter of 2003, are sold primarily to enterprises and small and medium sized businesses. During the three and six months ended June 30, 2004, we recorded $10.2 million and $16.8 million, respectively, of sales of IntruShield products. During the six months ended June 30, 2003, we recorded sales of IntruShield products of $0.9 million.

Sniffer Technologies. The sale of our Sniffer product line to Network General was announced in April 2004 and completed on July 16, 2004. In addition to retaining the pre-closing Sniffer accounts receivable, at closing we received approximately $217 million in cash. Sniffer revenues decreased 23% from $49.6 million in the second quarter of 2003 to $38.4 million in the second quarter of 2004, in significant part due to the announcement of the pending sale. We have agreed to provide certain post-closing transitional services to Network General for up to nine months. We will be reimbursed for our cost plus a profit margin and will present these reimbursements as a reduction of operating expenses on a separate line in our statement of operations. In the near term, the loss of future Sniffer revenues may increase our operating expenses as a percentage of net revenue as we will not be able to reduce expenses as quickly as revenue will be reduced since Sniffer has been sold.

Magic. We sold the assets of our Magic Solutions service desk product line to BMC Software, Inc. The sale closed on January 30, 2004 and we received cash proceeds of approximately $47.6 million, net

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of direct expenses. During the three months ended June 30, 2003, net revenue from the sale of Magic Solutions products totaled approximately $16.1 million. During the six months ended June 30, 2004 and 2003, net revenue from the sale of Magic Solutions products totaled approximately $2.9 million and $31.4 million, respectively.

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

Deferred revenue balances. Our deferred revenue balance at June 30, 2004 and December 31, 2003 was $536.6 million, including $45.6 million of Sniffer deferred revenue, and $459.6 million, excluding approximately $22.0 million which relates to our Magic product line at December 31, 2003 classified as liabilities related to assets held for sale, respectively. We believe that the deferred revenue balance improves predictability of future revenues. In the middle of 2003, we introduced our perpetual plus licensing program in EMEA and completed the planned implementation of perpetual plus worldwide with its introduction in North America in the first quarter of 2004. Under the perpetual plus licensing program more revenue is allocated to service and support, therefore increasing the deferred revenue balance. Primarily, as a result of the perpetual plus licensing program, the balance of deferred revenue has increased 50% from $356.9 million at June 30, 2003 to $536.6 million at June 30, 2004.

Bookings. Bookings represent contractual and other arrangements entered into in a particular period for which revenue may be recognized by us in the current or future periods. Although deferred revenue is a better predictor of future revenues, we believe bookings are also an indicator of future revenues. There is no certainty that bookings will result in future revenues because, among other things, customers may modify or cancel these orders or we may be unable to fulfill our obligations under the arrangements. For the three months ended June 30, 2004, bookings totaled $307.4 million, which increased 19% from $259.4 million for the first quarter of 2004. Excluding Sniffer bookings, for the three months ended June 30, 2004, bookings totaled $265.9 million.

Cash, cash equivalents and investment balances. Cash, cash equivalents and investment balances at June 30, 2004 and December 31, 2003 totaled $869.2 million and $766.3 million, respectively. During the six month ended June 30, 2004, we generated $193.5 million of cash from operations; used $55.7 million of cash in investing activities; and used $108.3 million of cash from financing activities. Our cash, cash equivalents and investment balances increased due to payments from our customers from sales recorded in the fourth quarter, which is historically our highest quarter of sales. We also received approximately $47.6 million of cash, net of direct expenses, related to our sale of Magic and approximately $25.0 million from reimbursements from our insurance carriers related to the class action lawsuit that was settled in October 2003. These increases in cash and investments were offset by our purchase of approximately 8.7 million shares of our common stock during the second quarter of 2004 for approximately $145.3 million. Offsetting these balances and the $217 million in cash received in July 2004 from the closing of the Sniffer sale is our planned use of approximately $350 million to redeem in full our outstanding convertible subordinated notes on August 20, 2004. The notes are convertible prior to redemption into approximately 19 million shares of our common stock at an effective conversion price of approximately $18.31 per share.

Cost reduction and profitability plan. We are engaged in an ongoing cost reduction and profitability plan. The plan, announced in April 2004, is designed to significantly enhance our operating margins by mid-2005. Some of these measures, including programs designed to improve our sales process efficiencies or to rationalize the facilities and infrastructure required to deliver product and customer support, will require initial investments with the related benefits expected in later periods.

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

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

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

McAfee Network Protection Solutions, which offers products designed to maximize the security of networks including network intrusion prevention with McAfee IntruShield and InfiniStream Security Forensics, and had included Sniffer Technologies network analysis and availability technologies before its sale in July 2004.

McAfee System Protection Solutions

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

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

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

McAfee Network Protection Solutions

McAfee Network Protection Solutions helps enterprises, small businesses, government agencies, educational organizations and service providers maximize the availability, performance and security of their network infrastructure. The McAfee Network Protection Solutions portfolio features a range of products including InfiniStream Security Forensics for security forensics and McAfee IntruShield for network intrusion detection and prevention. Customers for these products include enterprises, government agencies and educational organizations, as well as service providers. We sold our Sniffer product line in July 2004. Previously, this Sniffer product line included products that capture data, monitor network traffic and collect and report on key network statistics.

Expert Services and Technical Support

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

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

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

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

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

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

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

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

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

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

McAfee Research

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

Strategic Alliances

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

Product Licensing Model

We typically license our products to corporate and government customers on a perpetual basis. Most of our licenses are sold with maintenance contracts, and typically these are sold on an annual basis. As the maintenance contracts near expiration, we contact customers to renew their contracts, as applicable. We

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typically sell perpetual licenses in connection with sales of our hardware-based products in which software is bundled with the hardware platform.

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

On-Line Subscription Services and Managed Applications

For our on-line subscription services, customers essentially rent the use of our software. Because our on-line subscription services are version-less, or self-updating, customers subscribing to these services are assured of using the most recent version of the software application, eliminating the need to purchase product updates or upgrades. Our on-line subscription consumer products and services are found at our McAfee.com web site where consumers download our anti-virus application using their Internet browser which allows the application to detect and eliminate viruses on their PCs, repair their PCs from damage caused by viruses, optimize their hard drives and update their PCs virus protection system with current software patches and upgrades. Our McAfee.com web site also offers customers access to McAfee Personal Firewall Plus, McAfee SpamKiller and McAfee Internet Privacy Service, as well as combinations of these services through suites. At June 30, 2004, we had 5.4 million McAfee consumer on-line subscribers.

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

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

Critical Accounting Policies

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

Results of Operations

Three and Six Months Ended June 30, 2004 and 2003

Net Revenue

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

	Net Revenue				Percentage of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							

Product	$ 80,007	$119,204	$163,738	$246,510	35%	55%	37%	56%
Services and support	145,671	97,821	281,018	189,829	65	45	63	44
Net revenue	$225,678	$217,025	$444,756	$436,339	100%	100%	100%	100%

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Net revenue increased 4% or $8.7 million for the three months ended June 30, 2004 from the three months ended June 30, 2003. The increase reflects (i) a $26.7 million increase in our McAfee business and $9.3 million increase in IntruShield product sales following our May 2003 IntruVert acquisition, offset by (ii) a $16.1 million decrease related to the January 2004 sale of Magic, (iii) a Sniffer revenue decline of $11.2 million, and (iv) the introduction of our perpetual plus licensing arrangements. Net revenue increased 2%, or $8.4 million, for the six months ended June 30, 2004 from the six months ended June 30, 2003. The increase reflects (i) a $38.8 million increase in our McAfee business and $15.9 million increase in IntruShield product sales following our May 2003 IntruVert acquisition, offset by (ii) a $28.5 million decrease related to the January 2004 sale of Magic, (iii) a Sniffer revenue decline of $17.8 million, and (iv) the introduction of our perpetual plus licensing arrangements. In 2003, many of our customers and potential customers had: (i) delayed initiating the purchase process; (ii) increased the evaluation time to complete a purchase or postponed, sometimes indefinitely, full IT deployments; and/or (iii) reduced their capital expenditure budgets, thereby restricting their software/services purchases to those believed by them to be necessary to satisfy an immediate need.

In the first quarter of 2004, we expanded our perpetual plus licensing arrangements to North America and have completed the planned worldwide introduction of this model. Under these arrangements, we provide a perpetual license coupled with additional support, with a higher percentage of the contract value allocated to support revenues. As a result of these arrangements, there has been (i) an increase in services and support revenue relative to product revenue, due to higher renewal rates for support bundled in these arrangements and (ii) an increase of revenue being deferred to future periods as support revenues are deferred and recognized over the life of the arrangement. The perpetual plus licensing model is designed to make our products more competitive in the channel and increase channel volumes, while having the added effect of improving the visibility and predictability of our business through increased deferred revenue balances. As a result of the perpetual plus licensing program, the balance of deferred revenue has increased 50% from $356.9 million at June 30, 2003 to $536.6 million, which includes $45.6 million of deferred revenue related to Sniffer at June 30, 2004.

The sale of our Sniffer product line was completed in July 2004. Net revenue from our Sniffer product line for the three months ended June 30, 2004 and 2003 was $38.4 million and $49.6 million, respectively. Net revenue from our Sniffer product line for the six months ended June 30, 2004 and 2003 was $80.7 million and $98.5 million, respectively. Net revenue from Sniffer for the year 2003 was $210.2 million. Our deferred revenue balance at June 30, 2004 includes $45.6 million of Sniffer related deferred revenue that was transferred as part of the sale in July 2004.

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Net Revenue by Geography

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

	Net Revenue				Percentage of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Net Revenue:								
North America	$143,737	$139,098	$277,858	$274,773	64%	64%	62%	63%
EMEA	56,556	57,779	113,404	119,858	25	27	25	28
Japan	12,065	8,600	25,882	19,275	5	4	6	4
Asia-Pacific (excluding Japan)	9,044	7,384	16,534	14,044	4	3	4	3
Latin America	4,276	4,164	11,078	8,389	2	2	3	2
Total net revenue	$225,678	$217,025	$444,756	$436,339	100%	100%	100%	100%

Net revenue outside of North America (United States and Canada) accounted for approximately 36% of net revenue for the three months ended June 30, 2004 and 2003. Net revenue outside of North America (United States and Canada) accounted for approximately 38% and 37% of net revenue for the six months ended June 30, 2004 and 2003, respectively. Historically and continuing during the first and second quarters of 2004 and 2003, net revenue from North America and EMEA has comprised 88% to 91% of our business. In comparing the second quarter of 2003 and 2004, we saw a weakening of the U.S. dollar against many currencies, but most dramatically against the Euro and Great Britain Pound. As a result, we have experienced positive impacts on our net revenue in EMEA region.

For the three months ended June 30, 2004, total net revenue in North America increased 3% or $4.6 million to $143.7 million as compared to the three months ended June 30, 2003. For the six months ended June 30, 2004, total net revenue in North America increased 1%, or $3.1 million, as compared to the six months ended June 30, 2003. The increase in revenue for both periods is due increased sales of our IntruShield product and on-line subscription revenues, offset by the introduction of our perpetual plus licensing model in North America in the first quarter of 2004.

In EMEA, total net revenue decreased 2% or $1.2 million for the three months ended June 30, 2004 compared to the three months ended June 30, 2003. In EMEA, total net revenue decreased 5% or $6.5 million for the six months ended June 30, 2004 compared to the six months ended June 30, 2003. The decrease in EMEA net revenues in both periods is primarily the result of the perpetual plus licensing model. The perpetual plus licensing model allocates more value to services and support revenue, which is deferred and recognized over the service period, and not recorded into revenue immediately.

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

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

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

	Product Revenue				Percentage of Product Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Term subscription licenses	$10,331	$ 28,042	$ 27,861	$ 70,202	13%	24%	17%	28%
Perpetual licenses	30,841	54,550	70,351	117,014	38	46	43	47
Hardware	23,656	18,467	48,885	35,947	30	15	30	15
Retail and other	15,179	18,145	16,641	23,347	19	15	10	10
Total product revenue	$80,007	$119,204	$163,738	$246,510	100%	100%	100%	100%

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. Each of the $39.2 million, or 33%, decrease in product revenue for the three months ended June 30, 2003 to the three months ended June 30, 2004 and the $82.8 million, or 34%, decrease in product revenue for the six months ended June 30, 2003 to the six months ended June 30, 2004 is due to (i) the introduction of our perpetual plus licensing arrangements in North America, which has now been implemented worldwide, resulting in reduced product revenues and increased services and support revenue and (ii) our continued shift in focus from retail boxed products to our on-line subscription model for consumers and small and medium sized businesses. Our hardware revenue increased $5.2 million from the three months ended June 30, 2003 to the three months ended June 30, 2004 and $12.9 million from the six months ended June 30, 2003 to the six months ended June 30, 2004, primarily as the result of sales of our IntruShield product. We purchased IntruVert in the second quarter of 2003. We expect that in the near-term hardware sales will decrease given the Sniffer sale. Retail and other revenue decreased due to an increase in retailers in the United States converting to the consignment model as well as additional return reserves recorded for the retail channel.

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

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

	Service and Support Revenue				Percentage of Service and Support Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Support and maintenance	$106,224	$71,427	$209,239	$139,849	73%	73%	74%	74%
Consulting	4,619	7,727	8,603	14,844	3	8	3	8
Training	2,090	2,357	3,972	4,426	1	2	2	2

On-line subscriptions	32,738	16,310	59,204	30,710	23	17	21	16
Total service and support revenue	$145,671	$97,821	$281,018	$189,829	100%	100%	100%	100%

Services and support revenues include revenues from software support and maintenance contracts, consulting, training and on-line subscription arrangements. From the three months ended June 30, 2003 to the three months ended June 30, 2004 service and support revenue increased $47.8 million, or 49%, due to (i) a $34.8 million increase in support and maintenance due to our perpetual plus licensing model and (ii) a $16.4 million increase in our on-line subscription (McAfee consumer on-line and McAfee ASaP) arrange-

ments offset by a $3.4 million combined decrease in consulting and training revenues. From the six months ended June 30, 2003 to the six months ended June 30, 2004 service and support revenue increased $91.2 million, or 48%, due to (i) a $69.4 million increase in support and maintenance due to our perpetual plus licensing model and (ii) a $28.5 million increase in our on-line subscription arrangements offset by a $6.7 million combined decrease in consulting and training revenues. The increase in our on-line subscription arrangements is due to an increase in our customer base to approximately 5.4 million subscribers at June 30, 2004, from 3.7 million subscribers at December 31, 2003 and from 2.4 million subscribers at June 30, 2003. The increase in customers was due to our continued OEM relationships with Dell, AOL and others, as well as an outbreak of computer viruses in the second half of 2003 through the first half of 2004. We believe that the decrease in our consulting and training revenues of $3.4 million for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003 and $6.7 million for the six months ended June 30, 2004 as compared to the six months ended June 30, 2003, was due to our customers reducing consulting and training budgets when reducing overall IT costs and projects.

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

Cost of Net Revenue; Gross Margin

	Cost of Net Revenue				Percentage of Cost of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Cost of net revenue:								
Product	$ 24,496	$ 20,365	$ 47,448	$ 39,055	65%	56%	63%	56%
Services and support	9,792	13,002	20,639	26,232	26	36	28	38
Amortization of purchased technology	3,276	2,776	6,669	4,517	9	8	9	6
Total cost of net revenue	$ 37,564	$ 36,143	$ 74,756	$ 69,804	100%	100%	100%	100%
Gross margin	$188,114	$180,882	$370,000	$366,535				
Gross margin percentage	83%	83%	83%	84%				

Our total cost of net revenue increased for the three and six months ended June 30, 2004, as compared to the three and six months ended June 30, 2003, by $1.4 million, or 4%, and by $5.0 million, or 7%, respectively. These increases are primarily due to increased hardware sales of IntruShield during the six months ended June 30, 2004 as IntruVert was not acquired until May 2003, and an increase in revenue-sharing costs related to our McAfee consumer on-line subscription model due to higher subscriptions originated through strategic partners, offset by the sale of Magic in January 2004.

Cost of Product Revenue. Our cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels; royalties; and, with respect to hardware-based anti-virus products and network fault and performance products, computer platforms and other hardware components. Our cost of product revenue increased $4.1 million, or 20% for the three months ended June 30, 2004 compared to the three months ended June 30, 2003. This increase is due to the sales of IntruShield hardware (IntruVert was acquired in May 2003), and an increase in costs related to revenue-sharing arrangements with our McAfee consumer on-line strategic partners.

As a percentage of total cost of

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net revenue, these costs increased from 56% to 65% from the three months ended June 30, 2003 to the three months ended June 30, 2004.

Our cost of product revenue increased $8.4 million, or 21% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003. This increase is due to the sales of IntruShield hardware (IntruVert was acquired in May 2003), and an increase in costs related to revenue-sharing arrangements with our McAfee consumer on-line strategic partners. As a percentage of total cost of net revenue, these costs increased from 56% to 63% from the six months ended June 30, 2003 to the six months ended June 30, 2004. We anticipate that cost of product revenue will continue to fluctuate as a percent of cost of net revenue, but decrease in the near term due to the sale of our Sniffer product line.

Cost of Services and Support. Cost of services and support revenue consists principally of salaries and benefits related to employees providing customer support and consulting services. Our cost of services and support revenue decreased $3.2 million, or 25% for the three months ended June 30, 2004 compared to the three months ended June 30, 2003. This decrease is primarily due to our sale of Magic in January 2004. As a percentage of total cost of net revenue, these costs decreased from 36% to 26% from the three months ended June 30, 2003 to the three months ended June 30, 2004.

Our cost of services and support revenue decreased $5.6 million, or 21% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003. This decrease is primarily due to our sale of Magic in January 2004. As a percentage of total cost of net revenue, these costs decreased from 38% to 28% from the six months ended June 30, 2003 to the six months ended June 30, 2004. We anticipate that cost of service revenue will continue to fluctuate as a percent of cost of net revenue.

Amortization of Purchased Technology. Amortization of purchased technology increased $0.5 million or 18%, from the three months ended June 30, 2003 to the three months ended June 30, 2004. Amortization of purchased technology increased $2.2 million or 48%, from the six months ended June 30, 2003 to the six months ended June 30, 2004. The increase in both periods is due to our acquisitions of Entercept and IntruVert in the three months ended June 30, 2003, in which we recorded purchased technology of $21.7 million and $18.2 million, respectively. The purchased technology is being amortized over its estimated useful life of seven years. Amortization of purchased technology is expected to be $12.2 million in 2004.

Gross Margins. Our gross margins remained consistent at 83% from the three months ended June 30, 2003 to the three months ended June 30, 2004. Our gross margins were 83% during the six months ended June 30, 2004 and 84% during the six months ended June 30, 2003.

Operating Costs Three and Six Months Ended June 30, 2004 and 2003

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

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

	Operating Expenses				Percentage of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Research and development	$44,346	$45,965	$ 89,725	$ 92,395	20%	21%	20%	21%
Marketing and sales	96,114	87,045	189,072	175,986	43	40	43	40
General and administrative	35,722	29,780	62,436	57,988	16	14	14	13
Gain (loss) on sale of assets and technology	274	(904)	(45,404)	(941)			(10)	
Provision for (recovery from) doubtful accounts, net	149	(64)	674	(387)				
Reimbursement related to litigation settlement	(5,890)		(24,991)					