McAfee, Inc.
Form 10-Q
May 10, 2005

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

Form 10-Q

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

For the quarterly period ended March 31, 2005

or

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

For the transition period from to

Commission file number: 001-31216
McAfee, Inc.
(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code:
(408) 988-3832

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

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

As of April 30, 2005, 162,740,357 shares of the registrant s common stock, $0.01 par value, were outstanding.

MCAFEE, INC.
FORM 10-Q
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MCAFEE, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2005	December 31, 2004
	(In thousands, except share and per share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 304,039	$ 291,155
Short-term marketable securities	435,025	232,929
Accounts receivable, net of allowance for doubtful accounts of $1,573 at March 31, 2005 and $2,536 at December 31, 2004	94,225	137,520
Prepaid expenses, income taxes and other current assets	112,798	103,687
Deferred taxes	198,090	200,459
Total current assets	1,144,177	965,750
Long-term marketable securities	241,056	400,597
Restricted cash	618	617
Property and equipment, net	91,080	91,715
Deferred taxes	229,498	220,604
Intangible assets, net	99,781	107,133
Goodwill	439,010	439,180
Other assets	10,187	12,080
Total assets	$ 2,255,407	$ 2,237,676
LIABILITIES		
Current liabilities:		
Accounts payable	$ 30,225	$ 32,891
Accrued liabilities	178,605	197,368
Deferred revenue	492,243	475,621
Total current liabilities	701,073	705,880
Deferred revenue, less current portion	122,457	125,752
Accrued taxes and other long-term liabilities	221,782	204,796
Total liabilities	1,045,312	1,036,428
Commitments and contingencies (Notes 11 and 12)		
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: None		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares		

Issued: 164,660,390 shares at March 31, 2005 and 162,266,174 shares at December 31, 2004				
Outstanding: 162,660,390 shares at March 31, 2005 and 162,266,174 shares at December 31, 2004		1,647		1,623
Treasury stock, at cost: 2,000,000 shares at March 31, 2005 and no shares at December 31, 2004		(47,351)		
Additional paid-in capital		1,199,774		1,178,855
Deferred stock-based compensation		(1,408)		(1,777)
Accumulated other comprehensive income		26,277		27,361
Retained earnings (accumulated deficit)		31,156		(4,814)
Total stockholders equity		1,210,095		1,201,248
Total liabilities and stockholders equity	$	2,255,407	$	2,237,676

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 INCOME AND COMPREHENSIVE INCOME

	Three Months Ended March 31,	
	2005	**2004**
	(In thousands, except per share data) (Unaudited)	
Net revenue:		
Product	$ 44,092	$ 83,731
Services and support	191,635	135,347
Total net revenue	235,727	219,078
Cost of net revenue:		
Product	16,646	19,307
Services and support	18,161	14,492
Amortization of purchased technology	3,850	3,393
Total cost of net revenue	38,657	37,192
Operating costs:		
Research and development(1)	38,230	45,379
Marketing and sales(2)	71,184	92,958
General and administrative(3)	33,621	26,714
Amortization of intangibles	3,528	3,573
Restructuring charge	2,296	2,336
Loss (gain) on sale of assets and technology	259	(45,678)
Provision for doubtful accounts, net	159	525
Reimbursement from transition services agreement	(328)	
Litigation settlement		(19,101)
Total operating costs	148,949	106,706
Income from operations	48,121	75,180
Interest and other income	4,960	4,497
Interest and other expenses		(741)
(Loss) gain on sale of marketable securities	(648)	488
Income before provision for income taxes	52,433	79,424
Provision for income taxes	16,463	21,454
Net income	$ 35,970	$ 57,970
Other comprehensive income:		
Unrealized (loss) gain on available-for-sale securities, net	$ (1,419)	$ 250
Foreign currency translation gain	335	974

Comprehensive income	$	34,886	$	59,194
Net income per share Basic	$	0.22	$	0.35
Net income per share Diluted	$	0.21	$	0.33
Shares used in per share calculation Basic		162,992		163,423
Shares used in per share calculation Diluted		167,339		186,564

(1) Includes stock-based compensation (benefits) charges of ($2,503) and $1,314 in the three months ended March 31, 2005 and 2004, respectively.

(2) Includes stock-based compensation (benefits) charges of ($735) and $636 in the three months ended March 31, 2005 and 2004, respectively.

(3) Includes stock-based compensation (benefits) charges of ($54) and $276 in the three months ended March 31, 2005 and 2004, 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

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income	$ 35,970	$ 57,970
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,421	16,634
Provision for doubtful accounts, net	159	525
Non cash restructuring charge	1,554	788
Non cash interest expense on convertible notes		525
Premium amortization on marketable securities	654	1,537
Loss (gain) on sale of assets and technology	259	(45,814)
Loss (gain) on sale of marketable securities	648	(488)
Deferred taxes	(6,073)	14,869
Stock-based compensation (benefits) charges	(3,292)	2,226
Change in fair value of derivative, net		(2,151)
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	40,128	61,842
Prepaid expenses, income taxes and other	(9,582)	4,142
Accounts payable, accrued taxes and other liabilities	(2,495)	(23,087)
Deferred revenue	26,099	29,479
Net cash provided by operating activities	100,450	118,997
Cash flows from investing activities:		
Purchase of marketable securities	(253,419)	(313,133)
Proceeds from sale and maturity of marketable securities	207,196	234,060
Proceeds from sale of Magic, net		47,565
Purchase of property and equipment	(9,146)	(8,653)
Increase in restricted cash	(1)	(100)
Other		(28)
Net cash used in investing activities	(55,370)	(40,289)
Cash flows from financing activities:		
Proceeds from issuance of stock from option and stock purchase plans	24,816	22,408
Repurchase of common stock	(47,351)	
Net cash provided by (used in) financing activities	(22,535)	22,408

Effect of exchange rate fluctuations		(9,661)		(4,438)
Net increase in cash and cash equivalents		12,884		96,678
Cash and cash equivalents at beginning of period		291,155		333,651
Cash and cash equivalents at end of period	$	304,039	$	430,329
Non cash investing activities:				
Unrealized gain (loss) on marketable securities	$	(1,419)	$	250
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	19,960	$	5,645
Cash paid for interest	$		$	2,504

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

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

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

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

In December 2004, the Company entered into an agreement to sell its McAfee Labs assets. The sale closed on April 8, 2005 (see Note 13).

2. Summary of Significant Accounting Policies and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company as of March 31, 2005 and December 31, 2004 and for the three months ended March 31, 2005 and March 31, 2004. 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, 2004 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 the fiscal year ended December 31, 2004.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to fairly present the Company s financial position as of March 31, 2005, and results of operations and cash flows for the three months ended March 31, 2005 and March 31, 2004 have been included. The results of operations for the three months ended March 31, 2005 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

Approximately $3.6 million was reclassified from cost of product net revenue to cost of services and support net revenue in the three months ended March 31, 2004 to be consistent with current-period presentation. This reclassification did not have an impact to total cost of net revenue. Certain other immaterial prior-period amounts have been reclassified to conform to current-period presentation.

Pro forma Stock-Based Compensation Disclosure

As permitted by Statement of Financial Accounting Standard (SFAS) No. 123, *Accounting for Stock-Based Compensation,* (SFAS 123) and as amended by SFAS No. 148, *Accounting for Stock- Based Compensation Transition and Disclosure,* (SFAS 148), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25,

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Accounting for Stock Issued to Employee, (APB 25), and related interpretations. Under APB 25, if the exercise price of an employee s stock options equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is recognized. Stock-based compensation is based on the excess of the market price on the grant date over the exercise price and is recognized ratably over the vesting period. Stock-based compensation related to non-employees is based on the excess of the market price on the grant date over the exercise price and is recognized ratably over the vesting period in accordance with SFAS 123.

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:

	Three Months Ended March 31,	
	2005	2004
Stock grants:		
Risk free interest rate	3.8%	3.1%
Weighted average expected lives	4.0	4.0
Volatility	60.4%	63.0%
Dividend yield		
ESPP:		
Risk free interest rate	2.9%	1.3%
Weighted average expected lives	1.3	1.3
Volatility	40.0%	58.0%
Dividend yield		

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

	Three Months Ended March 31,	
	2005	2004
Net income, as reported	$ 35,970	$ 57,970
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax	(7,403)	(4,367)
Add back: Stock-based compensation expense (benefit), net of tax, included in reported net income	(2,136)	1,427
Pro forma net income	$ 26,431	$ 55,030
Basic net income per share, as reported	$ 0.22	$ 0.35
Diluted net income per share, as reported	$ 0.21	$ 0.33

Basic net income per share, pro forma	$	0.16	$	0.34
Diluted net income per share, pro forma	$	0.16	$	0.31

The impact on pro forma income per share and net income 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.

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Recent Accounting Pronouncements

Stock-based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123R, *Share Based Payment* (SFAS 123R) which requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the consolidated statements of income. In April 2005, the United States Securities and Exchange Commission extended the compliance date for SFAS 123R to fiscal years beginning after June 15, 2005. Therefore, the Company is required to adopt SFAS 123R in the first quarter of fiscal year 2006. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition. See Pro forma Stock-based Compensation Disclosure above for the pro forma net income and net income per share amounts, in the three months ended March 31, 2005 and March 31, 2004, respectively, as if the Company had used a fair-value-based method similar to the methods required under SFAS 123R to measure compensation expense for employee stock incentive awards. Although the Company has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, the Company is evaluating the requirements under SFAS 123R and expects the adoption to have a significant adverse impact on the consolidated results of operations.

Income Taxes

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

Inventory

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

MCAFEE, INC. AND SUBSIDIARIES
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consolidated financial position or results of operations as the Company does not directly manufacture any of its products.

The Meaning of Other-Than-Temporary Impairment

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

3. Stock-Based Compensation

The Company recorded stock-based compensation (benefits) charges of ($3.3) million and $2.2 million, before taxes, in the three months ended March 31, 2005 and 2004, respectively. These (benefits) charges are comprised of the following (in thousands):

	Three Months Ended March 31,	
	2005	**2004**
Exchange of McAfee.com options	$ (1,976)	$ 1,833
Repriced options	(1,699)	
New and existing executives and employees	383	106
Former employees		146
Extended life of vested options held by terminated employees		141
Total stock-based compensation (benefit)	$ (3,292)	$ 2,226

Exchange of McAfee.com options. On September 13, 2002, the Company acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of the Company s common stock plus $8.00 in cash, $11.85 after applying the option exchange ratio, which is paid to the option holder upon exercise of the option and without interest. McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of the Company s common stock. The assumed options are subject to variable accounting treatment, which means that a compensation charge was measured initially at the date of the closing of the acquisition and is remeasured each reporting period based on the Company s common stock fair market value at the end of each report period.

The initial charge was based on the excess of the closing price of the Company s common stock over the exercise price of the options plus the $11.85 per share payable in cash. This compensation charge has been and will be remeasured using the same methodology until the earlier of the date of exercise, forfeiture or cancellation without replacement. This compensation charge is recorded as an expense over the remaining vesting period of the options using the accelerated method of amortization under FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.* For those options that were fully vested at the date of the closing of the acquisition, the Company immediately recorded compensation expense of $10.5 million. Charges related to unvested options are recorded as deferred stock-based compensation in stockholders equity in the consolidated balance sheet and recognized as expense as the options vest.

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During the three months ended March 31, 2005 and 2004, the Company recorded a benefit of approximately $2.0 million and a charge of approximately $1.8 million, respectively, related to exchanged options subject to variable accounting. This stock-based compensation was based on the Company s closing stock price of $22.56 on March 31, 2005 and $18.00 on March 31, 2004. The benefit in the three months ended March 31, 2005 was due to a decline in the Company s stock price from $28.93 at December 31, 2004 to $22.56 as of March 31, 2005. As of March 31, 2005, the Company had approximately 0.4 million outstanding options subject to variable accounting. Further fluctuations in the stock price may result in significant additional stock-based compensation charges or benefits in future periods.

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

The amount of stock-based compensation recorded was and will be based on any excess of the closing stock price at the end of the reporting period or date of exercise, forfeiture or cancellation without replacement, if earlier, over the fair value of the Company s common stock on July 1, 2000, which was $20.375. As the options are fully vested, the charge is recorded to earnings immediately. Depending upon movements in the market value of the Company s common stock, this variable accounting treatment can result in additional stock-based compensation charges or benefits in future periods until the options are exercised, forfeited or cancelled.

During the three months ended March 31, 2005, the Company recorded a benefit of approximately $1.7 million, and did not record any charges or benefits in the three months ended March 31, 2004. The stock-based compensation for these options were based on closing stock prices as of March 31, 2005 and 2004 of $22.56 and $18.00, respectively. The benefit in the three months ended March 31, 2005 was due to a decline in the Company s stock price from $28.93 at December 31, 2004 to $22.56 as of March 31, 2005. There was no charge or benefit in the three months ended March 31, 2004 as the Company s closing stock price at March 31, 2004 and December 31, 2003 was below $20.375. As of March 31, 2005, there were approximately 0.2 million options which were outstanding and subject to variable plan accounting.

New and existing executives and employees. In January 2005, the Company s board of directors granted 75,000 shares of restricted stock to its chief financial officer. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase the shares will lapse over three years from the date of grant. The fair value of the restricted stock was determined to be approximately $2.1 million and was based on the difference between the exercise price of the restricted stock and the fair value of the common stock on the date of grant. The Company recorded expense of approximately $0.2 million during the quarter ended March 31, 2005 related to the stock-based compensation associated with the chief financial officer s restricted stock grant.

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

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lion in the three months ended March 31, 2005, related to the unvested stock options exchanged in the Foundstone acquisition.

In January 2002, the Company s board of directors approved a grant of 50,000 shares of restricted stock to its chief executive officer. The price of the underlying shares is $0.01 per share. The shares vested and the Company s right to repurchase such shares lapsed as follows: 3,000 vested as of the grant date and 47,000 were restricted until January 15, 2005. The fair value of the restricted stock was determined to be approximately $1.4 million and was determined based on the difference between the exercise price of the restricted stock and the fair value of the common stock on the date of grant. During the three months ended March 31, 2005 and 2004, the Company recorded less than $0.1 million and $0.1 million, respectively, related to stock-based compensation associated with the chief executive officer s restricted stock grant.

Former employees. In November and December 2003, the Company extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. 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 three months ended March 31, 2004.

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 black-out period. Due to the black-out period, the Company extended the exercisability of any options of terminated employees that would otherwise expire during the black-out period for a period of time equal to a specified period after termination of the black-out 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 exercise price. During the three months ended March 31, 2004, the Company recorded a stock-based compensation charge of approximately $0.1 million.

4. Business Combinations and Divestitures

Foundstone, Inc.

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

Under the transaction, the Company recorded approximately $27.0 million for developed technology, $1.0 million for acquired product rights, including revenue related order backlog and contracts, $0.6 million for trade names/trademarks and non-compete arrangements, $59.3 million for goodwill (none of which is deductible for tax purposes), $2.6 million for net deferred tax liabilities and $5.0 million of tangible assets, net of liabilities. The intangible assets acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to 6.5 years or a weighted average period of 6.4 years. The Company accrued $0.3 million in severance costs for employees terminated at the time of the acquisition, of which less than $0.1 million remains as an accrual as of March 31, 2005.

As part of the Foundstone acquisition, the Company assumed a portion of outstanding vested and unvested Foundstone stock options. The fair value of the Company s stock options exchanged was $7.0 million, of which $4.7 million was reflected as part of the purchase price and $2.3 million was reflected as

MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

unearned compensation to be recognized by the Company through 2008 as employment services are provided. In the three months ended March 31, 2005, the Company expensed $0.2 million related to the Foundstone stock options. At March 31, 2005, unearned compensation to be recognized by the Company in future periods as services are provided was $1.2 million.

The Company cancelled the Foundstone stock options it did not assume, such options being held by four executives, in exchange for a cash payment equal to the intrinsic value of the cancelled stock options based on the purchase price per share. Forty percent of this amount was placed into escrow accounts for the four executives (Key Employee Escrow), along with 40% of the proceeds for the purchase of shares from the four executives. The four executives also received retention bonus payments, which were placed into Key Employee Escrow accounts. The Key Employee Escrow amounts are subject to vesting provisions from the date of acquisition through October 1, 2007. The Company recorded the $5.6 million paid into Key Employee Escrow as prepaid compensation, which is being recognized as compensation expense over the vesting period. In January 2005, the vesting schedule was amended such that a greater portion of the escrow amount vests within one year of the close of the transaction. In the three months ended March 31, 2005, the Company recorded approximately $1.1 million in expense for escrow amounts vesting in the period.

Management determined the preliminary purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques and the assistance of valuation consultants. The following is a summary of the assets acquired and liabilities assumed in the acquisition of Foundstone as adjusted during the current period for resolution of ongoing purchase price valuation procedures:

	(In thousands)
Technology	$ 27,000
Other intangible assets	1,600
Goodwill	59,323
Cash	920
Other assets	12,796
Deferred tax assets	8,721
Total assets acquired	110,360
Liabilities	8,706
Deferred tax liabilities	11,297
Total liabilities assumed	20,003
Net assets acquired	$ 90,357

MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following unaudited pro forma financial information presents the combined results of the Company and Foundstone as if the acquisition had occurred at January 1, 2004 (in thousands except per share amounts):

		Three Months Ended March 31, 2004
		(Unaudited)
Net revenue	$	223,842
Net income	$	55,084
Basic net income per share	$	0.34
Diluted net income per share	$	0.31
Shares used in per share calculation basic		163,423
Shares used in per share calculation diluted		186,564

The above unaudited pro forma financial information includes adjustments for interest income on cash disbursed for the acquisitions, amortization of identifiable intangible assets and adjustments for expenses incurred in conjunction with the acquisitions.

IntruVert Networks, Inc.

On May 14, 2003, the Company acquired 100% of the outstanding capital shares of IntruVert Networks, Inc., (IntruVert) a provider of network-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for $98.1 million in cash and $5.2 million of direct expenses, totaling $103.3 million. The Company acquired IntruVert to enhance its intrusion detection product line, improve its position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company s current product offering, and sell IntruVert products to its existing customer base.

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 as salary expense ratably over the vesting period since the employees are currently providing services to the Company. Payments under the restricted stock plan are paid monthly from an escrow account and will total approximately $3.0 million from the purchase date through the fourth quarter of 2006. The Company recorded expense of approximately $0.2 million and $0.4 million in the three months ended March 31, 2005 and 2004, respectively, for the restricted stock agreements. Payments under the stock option plan are being paid monthly through the Company s payroll, and will total approximately $4.1 million. The Company recorded expense related to the stock option agreements of approximately $0.2 million and $0.4 million in the three months ended March 31, 2005 and 2004, respectively, and will record an additional $1.7 million through the first quarter of 2007. Cash payments that were fully vested at the date of acquisition were included in the purchase price. If a former IntruVert employee ceases employment with the Company, unvested payment amounts will be returned to the Company.

Entercept Security Technologies, Inc.

On April 30, 2003, the Company acquired 100% of the outstanding capital shares of Entercept Security Technologies, Inc. (Entercept), a provider of host-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for $121.9 million in cash

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MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and $3.9 million of direct expenses, totaling $125.8 million. The Company acquired Entercept to enhance its intrusion detection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company s current product offering, and sell Entercept products to its existing customer base. At the acquisition date, the Company accrued $2.8 million for permanently vacated facilities. A summary of activity in the restructuring accrual related to Entercept during the three months ended March 31, 2005 is as follows (in thousands):

Balance, December 31, 2004	$ 594
Cash payments	(89)
Adjustments	
Balance, March 31, 2005	$ 505

McAfee Labs

In December 2004, the Company entered into an agreement for the sale of its McAfee Labs assets to SPARTA, Inc. (SPARTA) for $1.5 million. The transaction closed April 8, 2005. The March 31, 2005 carrying value of McAfee Labs assets and liabilities, which were sold in this agreement, were not significant. As the Company will continue to be involved in the operations of the McAfee Labs business in 2005 until SPARTA obtains government approval as a contractor, its results of operations are included in income from operations in the consolidated statements of income. The cash flows resulting from this continued involvement are not expected to be material to the Company s consolidated financial statements.

The assets and liabilities of McAfee Labs are present in the Company s North American operating region. Revenues related to McAfee Labs were approximately $1.7 million and $1.4 million in the three months ended March 31, 2005 and 2004, respectively.

Sniffer Technologies

In July 2004, the Company completed its sale of the Sniffer product line to Network General Corporation for $213.8 million in cash, net of approximately $4.0 million in direct costs. The Company recorded a gain on sale of $197.4 million in 2004. Revenues related to Sniffer were approximately $42.3 million in the three months ended March 31, 2004.

In conjunction with the sale of Sniffer, the Company entered into a transition services agreement with the Network General Corporation. Under this agreement, the Company provides certain transitional services, including initial order processing, use of facilities, transaction processing services and certain other back office functions. The Company is reimbursed for its costs plus a margin. Operating expenses under this agreement are included in general and administrative expenses, while reimbursements for such expenses are included in the caption Reimbursement from transition services agreement on the accompanying consolidated statements of income. The Company recorded approximately $0.3 million in the three months ended March 31, 2005 of reimbursements under the transition services agreement.

Magic Solutions, Inc.

In December 2003, the Company entered into an agreement for the sale of its Magic Solutions product line to BMC Software for $47.1 million in cash. The Company completed the transaction on January 30, 2004, and recorded a gain of $46.5 million during the three months ended March 31, 2004. In conjunction with the Magic sale, the Company paid a $1.4 million bonus to an executive related to the transaction in the three months ended March 31, 2004. Revenues related to Magic were approximately $2.9 million in the three months ended March 31, 2004.

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5. Goodwill and Other Intangible Assets

The Company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* In lieu of amortization, the Company performs an impairment review of its goodwill on at least an annual basis.

The Company performs its annual goodwill impairment review as of October 1 of its fiscal year. The Company completed its annual goodwill review as of October 1, 2004 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. As a result of the sale of Sniffer and Magic in 2004, the Company tested goodwill, excluding Sniffer and Magic. These impairment tests were performed during the three months ended March 31, 2004 and September 30, 2004, respectively, and no impairment was identified. The Company will continue to test for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of the Company s reporting units below their carrying amounts.

Goodwill information is as follows (in thousands):

	December 31, 2004	Goodwill Acquired	Adjustments	Effects of Foreign Currency Exchange	March 31, 2005
North America	$ 365,124	$	$ 88	$ (54)	$ 365,158
EMEA	41,651			(47)	41,604
Japan	16,397				16,397
Asia-Pacific, excluding Japan	5,567				5,567
Latin America	10,441			(157)	10,284
Total	$ 439,180	$	$ 88	$ (258)	$ 439,010

The adjustment to goodwill in the three months ended March 31, 2005 related to the Foundstone acquisition.

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

		March 31, 2005			December 31, 2004		
	Weighted Average Useful Life	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	6.0 years	$ 139,075	$ (77,819)	$ 61,256	$ 139,509	$ (74,400)	$ 65,109

Trademarks, patents, customer base and other intangibles	6.4 years	90,357	(51,832)	38,525	90,335	(48,311)	42,024
		$ 229,432	$ (129,651)	$ 99,781	$ 229,844	$ (122,711)	$ 107,133

The aggregate amortization expenses for the intangible assets listed above totaled $7.4 million and $7.0 million in the three months ended March 31, 2005 and 2004, respectively.

MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Expected future intangible asset amortization expense as of March 31, 2005 is as follows (in thousands):

Fiscal Years:		
Remainder of 2005	$	20,235
2006		24,896
2007		21,954
2008		16,586
2009		10,727
Thereafter		5,383
	$	99,781

6. Restructuring Charge

2005 Restructuring

During the three months ended March 31, 2005, the Company permanently vacated several leased facilities and recorded a $0.7 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, along with estimated costs associated with subleasing the vacated facility.

The following table summarizes the Company s restructuring accrual established in 2005 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Other Costs	Total
Balance, January 1, 2005	$	$	$
Restructuring accrual	688	13	701
Cash payments	(449)	(13)	(462)
Balance, March 31, 2005	$ 239	$	$ 239

As of March 31, 2005, $0.2 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities.

2004 Restructurings

During 2004, the Company recorded several restructuring charges related to the reduction of employee headcount. In the first quarter of 2004, the Company recorded a restructuring charge of approximately $2.2 million related to the severance of approximately 160 employees, of which $0.7 million and $1.5 million was related to the Company s North America and EMEA operating segments, respectively. The workforce size was reduced primarily due to the Company s sale of Magic in January 2004. In the second quarter of 2004, the Company recorded a restructuring charge of approximately $1.6 million related to the severance of approximately 80 employees in the Company s sales, technical support and general and administrative functions. Approximately $0.6 million of the restructuring charge was related to the EMEA operating segment and the remaining $1.0 million was related to the North America operating segment. In the third quarter of 2004, the Company recorded a restructuring charge related to ten employees which totaled approximately $0.9 million, all of which related to the North America operating segment. In the fourth quarter of 2004, the Company recorded a restructuring charge of $1.3 million related to 111 employees, of which

$0.7 million, $0.2 million, $0.2 million and $0.2 million related to the Latin America, North America, EMEA and Asia-

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Pacific, excluding Japan, operating segments, respectively. All employees were terminated as of December 31, 2004. The reductions in the second, third and fourth quarters were part of the previously announced cost-savings measures being implemented by the Company.

In September 2004, the Company announced the move of the European headquarters to Ireland, which was substantially completed by the end of March 2005. In the third and fourth quarters of 2004, the Company recorded restructuring charges of $0.2 million and $2.2 million, respectively, related to the severance of approximately 80 employees. During the three months ended March 31, 2005, the Company recorded an additional $1.3 million in restructuring charges for severance costs being recognized over the required service period. All of these restructuring charges were related to the EMEA operating segment.

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

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

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

The following table summarizes the Company s restructuring accruals established in 2004 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2004	$	$	$	$
Restructuring accrual	8,685	7,932	480	17,097
Cash payments	(579)	(4,175)	(63)	(4,817)
Adjustment to liability	(222)	(275)		(497)
Accretion	74			74
Balance, December 31, 2004	7,958	3,482	417	11,857
Restructuring accrual		1,303	20	1,323
Cash payments	(679)	(1,039)		(1,718)
Adjustment to liability	11		(62)	(51)
Accretion	69			69

Balance, March 31, 2005	$ 7,359	$ 3,746	$ 375	$ 11,480

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MCAFEE, INC. AND SUBSIDIARIES
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As of March 31, 2005, $5.6 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of $5.9 million has been classified as other long term liabilities, and will be paid through March 2013.

2003 Restructurings

In January 2003, as part of a restructuring effort to gain operational efficiencies, the Company consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into its regional headquarters facility in Plano, Texas. The facility houses employees working in finance, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses. The remaining costs will generally be paid over the remaining lease term ending in 2013.

In 2004, the Company adjusted the restructuring accrual related to lease termination costs previously recorded in 2003. The adjustments decreased the liability by approximately $0.6 million in 2004, due to changes in estimates related to the sublease income to be received over the remaining lease term.

The following table summarizes the Company s restructuring accrual established in 2003 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Total
Balance, January 1, 2004	$ 14,217	$ 317	$ 14,534
Cash payments	(1,841)	(194)	(2,035)
Adjustment to liability	(623)	(123)	(746)
Accretion	548		548
Balance, December 31, 2004	12,301		12,301
Cash payments	(274)		(274)
Adjustment to liability	129		129
Accretion	125		125
Balance, March 31, 2005	$ 12,281	$	$ 12,281

As of March 31, 2005, $1.1 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of $11.2 million has been classified as other long term liabilities and will be paid through March 2013.

The Company s estimate of the excess facilities charges recorded during 2005, 2004 and 2003 may vary significantly depending, in part, on factors which may be beyond the Company s control, such as the Company s success in negotiating with its lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charges in 2005 were primarily allocated to the EMEA and Japan operating segments, and the facility restructuring charges in 2004 and 2003 were primarily allocated to the North America operating segment.

7. Line of Credit

The Company has a $17.0 million credit facility with a bank. The credit facility is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between the Company and the bank at the time of each specific transaction. The credit facility is intended to be used for short-term credit requirements with terms of one year or less. The credit facility can be cancelled at any time. No balances were outstanding as of March 31, 2005 and December 31, 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 (Notes) due 2006. The Notes were issued in August 2001 with an aggregate principal amount of $345.0 million.

The Transactions had a termination date of August 15, 2006, subject to certain early termination provisions if on or after August 20, 2004 and prior to August 15, 2006 the five-day average closing price of the Company s common stock were to equal or exceed $22.59 per share. Depending on the timing of the early termination event, the Banks would be obligated to pay the Company an amount equal to the repurchase premium called for under the terms of the Notes.

The Transactions qualified and were designated as a fair value hedge against movements in the fair value of the Notes due to changes in the benchmark interest rate. Under the fair value hedge model, the derivative is recognized at fair value on the balance sheet with an offsetting entry to the income statement. In addition, changes in fair value of the Notes due to changes in the benchmark interest rate are recognized as a basis adjustment to the carrying amount of the Notes with an offsetting entry to the income statement. The gain or loss from the change in fair value of the Transactions and the offsetting change in the fair value of the Notes are recognized as interest and other expense.

The Notes were fully repaid in August 2004, and the Transactions were left intact and became a speculative investment, with gains and losses being recorded in the consolidated statement of income, until the Transactions terminated in October 2004 when the Company s common stock price exceeded $22.59 for a five-day period.

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9. Net Income Per Share

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

	Three Months Ended March 31,	
	2005	**2004**
Numerator Basic net income	$ 35,970	$ 57,970
Numerator Diluted net income	$ 35,970	$ 57,970
Interest on convertible debentures, net of tax		2,989
Net income, adjusted	$ 35,970	$ 60,959
Denominator Basic		
Basic weighted average common stock outstanding	162,992	163,423
Denominator Diluted		
Basic weighted average common stock outstanding	162,992	163,423
Effect of dilutive securities:		
Convertible debentures		19,092
Common stock options and shares subject to repurchase(1)	4,347	4,002
Warrants		47
Diluted weighted average shares	167,339	186,564
Net income per share Basic	$ 0.22	$ 0.35
Net income per share Diluted	$ 0.21	$ 0.33

(1) At March 31, 2005 and 2004, approximately 3.0 million and 8.7 million options to purchase common stock, respectively, 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, as well as resellers and distributors. Management measures profitability based on the Company s five geographic regions: North America; Europe, Middle East and Africa (EMEA); Japan; Asia-Pacific, excluding Japan; and Latin America. The regions are evidence of the operating structure of the Company s internal organization.

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

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Following is the summary of the Company s net revenue from external customers and operating income by geographic region (in thousands):

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Net revenue by region:		
North America	$ 142,156	$ 134,121
EMEA	62,818	56,848
Japan	16,117	13,817
Asia-Pacific, excluding Japan	8,647	7,490
Latin America	5,989	6,802
Net revenue	$ 235,727	$ 219,078
Operating income by region:		
North America	$ 58,291	$ 39,369
Europe	24,086	16,917
Japan	8,458	3,822
Asia-Pacific, excluding Japan	2,995	767
Latin America	2,844	1,871
Corporate	(48,553)	12,434
Operating income	$ 48,121	$ 75,180

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

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Support and maintenance	$ 125,452	$ 103,015
On-line subscriptions	59,681	26,466
Software licenses	28,961	57,040
Hardware	9,281	25,229
Retail	5,598	1,462
Consulting	5,367	3,984
Training	1,135	1,882
Other	252	
Total	$ 235,727	$ 219,078

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MCAFEE, INC. AND SUBSIDIARIES
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Net revenue information on a product family basis is as follows (in thousands):

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
McAfee	$ 234,050	$ 172,615
Sniffer		42,253
Magic		2,850
McAfee Labs	1,677	1,360
Total	$ 235,727	$ 219,078

11. Litigation

General

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

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

Securities Cases

In September 2003, the Company entered into a settlement agreement with the plaintiffs in the *In re Network Associates, Inc. II Securities Litigation,* which was originally filed in December 2000. Under the settlement agreement the Company paid $70.0 million, which was recorded as litigation settlement in the consolidated statement of income for 2002. The settlement was approved by the court in February 2004, and the case was dismissed with prejudice to all parties and claims. In 2004, the Company received approximately $25.0 million from its insurance carriers related to this litigation, of which $19.1 million was received in the first quarter of 2004 and was recorded as litigation reimbursement in the consolidated statement of income. The remaining $5.9 million was received in the second quarter of 2004.

Certain investment bank underwriters, the Company, and certain of its directors and officers have been named in a putative class action for violation of the federal securities laws in the United States District Court for the Southern District of New York, captioned *In re McAfee.com Corp. Initial Public Offering Securities Litigation,* 01 Civ. 7034 (SAS). This is one of a number of cases challenging underwriting practices in the initial public offerings (IPOs) of more than 300 companies. These cases have been coordinated for pretrial proceedings as *In re Initial Public Offering Securities Litigation,* 21 MC 92 (SAS). Plaintiffs generally allege that certain underwriters engaged in undisclosed and improper underwriting activities, namely the receipt of excessive brokerage commissions and customer agreements regarding post-offering purchases of stock in exchange for allocations of IPO shares. Plaintiffs also allege that various investment bank securities analysts issued false and misleading analyst reports. The complaint against the Company claims that the purported

MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

improper underwriting activities were not disclosed in the registration statements for McAfee.com s IPO and seeks unspecified damages on behalf of a purported class of persons who purchased the Company s securities or sold put options during the time period from December 1, 1999 to December 6, 2000. On February 19, 2003 the Court issued an Opinion and Order dismissing certain of the claims against the Company with leave to amend. A settlement proposal was accepted by the Company on July 15, 2003 and is awaiting Court approval. Under this settlement proposal, the Company may assign its claims against certain underwriters to the plaintiffs, and the Company would be dismissed from the lawsuit without paying any monetary damages.

Other Matters

On June 6, 2002, Paul Cozza filed a Complaint in the United States District Court, District of Massachusetts alleging breach of contract, fraud and bad faith arising out of a dispute concerning the licensing of certain technology used in the Company s Virex 6.1 product. The Complaint seeks royalties on the Company s sale of Virex 6.1 products from January 1, 2002 to the present. The Company filed papers in opposition to the Complaint and asserted various defenses. The Company also moved to compel arbitration, which was denied by the District Court and the First Circuit Court of Appeals. In September 2004, the parties filed cross-motions for partial summary judgment on liability, but not damages, issues relating to whether the contract claims extend beyond the Virex 6.1 product. The District Court has heard argument on the pending cross-motions for partial summary judgment but has not yet issued any decision.

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

12. Contingencies and Guarantees

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee or indemnification. FIN 45 also requires additional disclosure by a guarantor in its interim and annual consolidated financial statements about its obligations under certain guarantees and indemnifications. The following is a summary of the agreements that the Company has determined are within the scope of FIN 45 as of March 31, 2005:

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

Under the terms of certain vendor agreements, in particular, vendors used as part of the Company s managed services, the Company has agreed that in the event the service provided to the customer by the vendor on behalf of the Company infringes upon any patent, copyright, trademark, or any other proprietary right of a third party, it will indemnify its vendor, against any loss, expense, or liability from any damages that may be awarded against its customer. No maximum liability is stipulated in these

MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

vendor agreements. The Company has recorded no liability associated with this indemnification, as it is not aware of any pending or threatened infringement actions or claims that are probable losses. The Company believes the estimated fair value of these indemnification clauses is minimal.

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

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

Under the terms of the Company s agreement to sell Sniffer in July 2004, the Company agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is $200.0 million. To date, the Company has paid no amounts under the representations and warranties indemnification. The Company has not recorded any accruals related to these agreements.

Under the terms of the Company s agreement to sell McAfee Labs assets in December 2004, the Company agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is $1.5 million. The Company has not recorded any accruals related to these agreements.

Under the terms of the Company s agreements to sell the PGP and Gauntlet assets in 2002, the Company agreed to indemnify the purchasers for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). The maximum potential loss related to the indemnification for breach of representations or warranties is $2.4 million. No maximum liability is stipulated in the agreement related to any undiscovered liabilities. To date, the Company has paid $0.4 million under the representations and warranties indemnification.

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MCAFEE, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. Subsequent Events

In April 2005, our board of directors authorized the repurchase of an additional $175.0 million of our common stock in the open market from time to time until August 2006, depending upon market conditions, share price and other factors.

In December 2004, the Company entered into an agreement for the sale of its McAfee Labs assets to SPARTA, Inc. (SPARTA) for $1.5 million. The transaction closed April 8, 2005. The March 31, 2005 carrying value of McAfee Labs assets and liabilities, which were sold in this agreement, were not significant. As the Company will continue to be involved in the operations of the McAfee Labs business in 2005 until SPARTA obtains government approval as a contractor, its results of operations are included in income from operations in the consolidated statements of income. The cash flows resulting from this continued involvement are not expected to be material to the Company s consolidated financial statements.

The assets and liabilities of McAfee Labs are present in the Company s North American operating region. Revenues related to McAfee Labs were approximately $1.7 million and $1.4 million in the three months ended March 31, 2005 and 2004, respectively.

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

Forward-Looking Statements; Trademarks

Some of the statements contained in this Report on Form 10-Q are forward-looking statements that involve risks and uncertainties. The statements contained in this 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, anticip believes, estimates, predicts, potential, targets, goals, projects, continue, or variations of such words, si 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. 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: McAfee.

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

Overview and Executive Summary

We are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from a large variety of threats and attacks. 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 businesses and consumer users. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, (collectively referred to as 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) services and support revenue, which includes software license maintenance, training, consulting and on-line subscription arrangements revenue and (ii) product revenue, which includes software license, hardware and royalty revenue. In the three months ended March 31, 2005 and 2004, our net revenue was $235.7 million and $219.1 million, respectively, and our net income was $36.0 million and $58.0 million, respectively. Net income in the three months ended March 31, 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 $19.1 million relating to our previously settled class action lawsuit. Our net revenue is impacted by corporate IT, 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 months ended March 31, 2005 and 2004, 40% and 39% of our net revenue, respectively, was generated outside of North America, with North America and EMEA collectively accounting for approximately 87% of our total net revenue in both three-month periods.

Sales by product and customer category

McAfee. Our McAfee products include enterprise, small- and medium-sized businesses (SMB) and consumer products with Enterprise including our Entercept host-based intrusion protection products which were acquired in connection with the Entercept acquisition in 2003, and Foundstone Risk Management products which were acquired in connection with the Foundstone acquisition in October 2004. Enterprise sales increased $14.0 million, or 23.6%, to $73.2 million in the three months ended March 31, 2005 from $59.2 million in the three months ended March 31, 2004. SMB sales decreased $5.9 million, or 9.0%, to $60.5 million in the three months ended March 31, 2005 from $66.4 million in the three months ended March 31, 2004. The year over year increases reflect an increase in corporate IT spending in 2005, partially offset by the impact of our perpetual plus license model, which recognizes less revenue upfront and defers more revenue to future periods.

We continue to experience significant growth in the consumer market. Our consumer market is comprised of our McAfee consumer on-line subscription service and retail-boxed product sales. In the three months ended March 31, 2005, we added 2.5 million net new on-line consumer subscribers.

Revenue from our consumer security market increased $53.4 million, or 113.7%, to $100.4 million in the three months ended March 31, 2005 from $47.0 million in the same prior-year period. At March 31, 2005, we had a total on-line subscriber base of approximately 11.0 million consumer customers, compared to 4.6 million at March 31, 2004 and 8.5 million at December 31, 2004. The main driver of this subscriber growth is our continued strategic relationships with channel partners, such as AOL and Dell.

Sniffer Technologies. Sniffer revenues were $42.3 million in the three months ended March 31, 2004. In July 2004, we sold our Sniffer product line for net cash proceeds of $213.8 million. We have agreed to provide certain post-closing transitional services to Network General. We are reimbursed for our cost plus a profit margin and present these reimbursements as a reduction of operating expenses on a separate line in our income statement. In the three months ended March 31, 2005, we recorded approximately $0.3 million for these transition services.

Magic. In the three months ended March 31, 2004, net revenue from the sale of Magic Solutions products totaled approximately $2.9 million. We sold the assets of our Magic Solutions service desk business to BMC Software, Inc. The sale closed on January 30, 2004 and we received cash proceeds of approximately $47.1 million, net of direct expenses.

McAfee Labs. In December 2004, the Company entered into an agreement for the sale of its McAfee Labs assets to SPARTA, Inc. for $1.5 million. The transaction closed April 8, 2005. Revenues related to McAfee Labs were approximately $1.7 million and $1.4 million in the three months ended March 31, 2005 and 2004, respectively.

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

Deferred revenue balances. Our deferred revenue balance at March 31, 2005 was $614.7 million compared to $601.4 million at December 31, 2004. We believe that the deferred revenue balance improves predictability of future revenues. The approximate 2% increase is attributable to the introduction of our perpetual plus licensing arrangements in the United States in the first quarter of 2004 and in EMEA and Asia-Pacific, excluding Japan, in mid-2003, which has resulted in the allocation of more revenue to service and support due to a change in pricing structure.

Cash, cash equivalents and marketable securities. The balance of cash, cash equivalents and marketable securities at March 31, 2005 was $980.1 million compared to $924.7 million at Decem-

ber 31, 2004. The increase is attributable to net cash provided by operating activities of $100.5 million and cash received from the exercise of stock options and stock purchases under the stock purchase plans of $24.8 million, partially offset by our utilization of cash to repurchase two million shares of common stock for approximately $47.4 million. See the Liquidity and Capital Resources section below.

In 2005, our management is focused, on among other things, (i) continuing to build on the current momentum in the consumer market and to grow faster than the competition in the consumer space; (ii) increasing revenue from the small- to medium-sized business customers by improving our channel distribution relationships; (iii) implementing cost controls and business streamlining measures required to improve operating margins; and (iv) continuing to grow our intrusion prevention business.

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

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

McAfee Network Protection Solutions, which offers products designed to maximize the performance and security of networks and network intrusion prevention with McAfee IntruShield and McAfee Foundstone. Previously, this product line included products designed to capture data, monitor network traffic and collect and report on key network statistics, and comprised a significant portion of our revenue; however, we sold our Sniffer Technologies product line to Network General Corporation in July 2004.

The majority of our net revenue has historically been derived from our McAfee Security anti-virus products and, until the sale of the Sniffer product line, our Sniffer Technologies network fault identification and application performance management products. We have also focused our efforts on building a full line of complementary network and system protection solutions. On the system protection side, we strengthened our anti-virus lineup by adding complementary products in the anti-spam and host intrusion prevention categories. On the network protection side, we have added products in the network intrusion prevention and detection category, and through our October 2004 Foundstone acquisition, vulnerability management products and services. We continuously seek to expand our product lines.

McAfee System Protection Solutions

McAfee System Protection Solutions help large enterprises, small- and medium-sized 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, anti-spyware, managed services, application firewalls 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 spyware and block spam and other undesirable content. Our retail products are sold through retail outlets, including Best Buy, CompUSA, Costco, Dixons, Fry s, Office Depot, Office Max, Staples, Wal-Mart and Yamada, to single users and small home offices in the form of traditional boxed product. These products include 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, such as AOL and Comcast, and original equipment manufacturers, or OEMs, such as Apple, Dell, Gateway/ eMachines and NEC.

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Our McAfee System Protection Solutions previously included our Magic Service Solutions product line, offering management and visibility of desktop and server systems. In January 2004, we sold our Magic Solutions product line 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 IntruShield for network intrusion detection and prevention and Foundstone for intrusion detection and prevention and vulnerability management.

We acquired Foundstone on October 1, 2004. We intend to integrate Foundstone s products with our intrusion prevention technologies and systems management capabilities to deliver enhanced risk management of prioritized assets, automated shielding and risk remediation, and automated policy enforcement and compliance.

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. The majority of our consulting services are now delivered through the consulting resources acquired in the Foundstone acquisition.

Education Services offer customers an extensive curriculum of web and classroom-based training focused on the deployment and operation of McAfee s security products.

The McAfee Technical Support program provides our customers on-line and telephone-based technical support in an effort to ensure that our products are installed and working properly. During the first quarter of 2005, we reorganized our technical support offerings to meet our customer s varying needs. McAfee Technical Support offers a choice of Gold or Platinum support for our customers. In addition, for our legacy support customers only, we offer the on-line ServicePortal or the telephone-based Connect. All Technical Support programs include software updates and upgrades. Technical Support 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.

Gold Support Provides unlimited, toll-free (where available) telephone access to technical support 24 hours a day, 7 days a week and access to the on-line ServicePortal.

Platinum Support Offers proactive, personalized service and includes an assigned technical support engineer from a Platinum support Technical Account Manager (TAM), proactive support contact (telephone or email) with customer-defined frequency, election of five designated customer contacts, access to all the services in Gold Support and access to the on-line ServicePortal.

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

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Research and Development

We are committed to malicious code and vulnerability research through our McAfee Anti-virus and Vulnerability Emergency Response Team (AVERT). AVERT 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.

In December 2004, we agreed to sell the assets of McAfee Labs, our research and development organization focused on exploiting government research, to SPARTA, Inc. The transaction closed April 8, 2005. McAfee will remain as the general contractor on certain of its government contracts until government approval is obtained for SPARTA as the general contractor.

Strategic Alliances

From time to time, we enter into strategic alliances with third parties to support our future growth plans. 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, or AOL, under which, among other things, our on-line PC anti-virus services are offered to AOL members as part of their basic membership. We also provide our host-based email scanning services and personal firewall services as a value-added service to AOL. Other alliances involve Comcast, Dell, NEC, Telecom Italia, Telefonica and Wanadoo. As part of our NTT DoCoMo alliance, we have jointly developed technology to provide built-in anti-virus protection against mobile threats to owners of 3G FOMA handsets.

Product Licensing Model

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

For our largest customers (over 2,000 nodes) and government agencies, 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. We also offer one-year licensing arrangements in Japan. The renewal process 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 www.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 updates and upgrades. Our www.mcafee.com web site also offers customers access to McAfee Personal Firewall Plus, McAfee SpamKiller and McAfee Privacy Service, as well as combinations of these services through bundles. Our on-line subscription services are also available to customers and small business through various relationships with internet service providers (ISP s), such as AOL and Comcast. Our business model allows for ISP s to make McAfee subscription services available as either a premium service or as a feature included in the ISP s service. At March 31, 2005, we had approximately 11.0 million McAfee consumer on-line subscribers, which includes on-line customers obtained through our alliances with ISP s and OEM s.

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Similarly, our small- and medium-sized business on-line subscription products and services, or our Managed VirusScan offerings, provide these customers the most up-to-date anti-virus software. Our Managed VirusScan service provides anti-virus protection for both desktops and file servers. In addition, McAfee Managed Mail Protection screens emails to detect and quarantine viruses and infected attachments, and Spam and Desktop Firewall ASaP 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.

Critical Accounting Policies

Critical Accounting Policies and Estimates

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

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. Management believes the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the consolidated financial statements.

Our critical accounting policies are as follows:

- revenue recognition;
- estimating valuation allowances and accrued liabilities, specifically sales returns and other allowances, the allowance for doubtful accounts, our facility restructuring accrual; and the assessment of the probability of the outcome of litigation against us;
- accounting for income taxes; and
- valuation of goodwill, finite-lived intangibles and long-lived assets.

Revenue Recognition

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

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

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

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

For arrangements with multiple obligations (for example, delivered software and undelivered maintenance and support obligations), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to our company. This means that we defer revenue from the arrangement fee equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for both our two-year time-based licenses and perpetual licenses are based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. This assessment generally includes analyses of the variability of renewal rates by product and region and determination of whether a majority of renewals support our estimated fair value of the maintenance and support obligations. In cases where renewal rates are not quoted in the initial sales contracts, our assessment is critical because if an estimated fair value cannot be established through separate sales then the fee for the entire arrangement is deferred until delivery occurs which for maintenance would be ratably over the service period. Fair value of services, such as training or consulting, is based upon separate sales by us of these services to other customers. Our arrangements do not generally include acceptance clauses. However, if an arrangement includes a specified acceptance provision, recognition occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

We recognize revenue for maintenance services ratably over the contract term. Our training is billed based on established course rates and consulting services are billed based on daily rates, and we generally recognize revenue as these services are performed. However, at the time of entering into a transaction, we assess whether or not any services included within the arrangement require us to perform significant work either to alter the underlying software or to build additional complex interfaces so that the software performs as the customer requests. If these services are included as part of such an arrangement, we recognize the entire

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fee using the percentage of completion method. We estimate the percentage of completion based on our estimate of the total costs estimated to complete the project as a percentage of the costs incurred to date and the estimated costs to complete.

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

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

If our sales returns experience were to increase by an additional 1% of license revenues, our allowance for sales returns at March 31, 2005 would increase and net revenue in the three months ended March 31, 2005 would decrease by approximately $0.3 million.

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

	March 31, 2005	December 31, 2004
	(In millions)	
Allowance for sales return and incentives	$ 28.2	$ 29.2
Allowance for doubtful accounts	1.6	2.5
Total allowance	$ 29.8	$ 31.7

At March 31, 2005, our accounts receivable balance was $94.2 million, net of allowance for doubtful accounts of $1.6 million and our allowance for sales return and incentives amounts to $28.2 million. At December 31, 2004, our accounts receivable balance was $137.5 million, net of allowance for doubtful accounts of $2.5 million and our allowance for sales return and incentives amounts to $29.2 million. If an additional 1% of our gross accounts receivable were deemed to be uncollectible at March 31, 2005, our allowance for doubtful accounts and provision for bad debt expense would increase by approximately $1.2 million.

Restructuring Accrual. During the three months ended March 31, 2005, we permanently vacated several leased facilities and recorded a $0.7 million accrual for estimated lease related costs associated with the permanently vacated facilities. During 2004, we permanently vacated several leased facilities, including an additional two floors in our Santa Clara headquarters building and recorded an $8.7 million restructuring accrual. In 2003, as part of a consolidation of activities into our Plano, Texas facility from our headquarters in Santa Clara, California, we recorded a restructuring charge of $15.8 million. In 2004, we recorded adjustments to the 2004 and 2003 lease termination restructuring accruals of $0.2 million and $0.6 million, respectively. We recorded these facility restructuring charges in accordance with Statement of Financial Accounting Standard No. 146, *Accounting for Exit Costs Associated With*

Exit or Disposal Activities (SFAS 146). In order to determine our restructuring charges and the corresponding liabilities, SFAS 146 required us to make a number of assumptions. These assumptions included estimated sublease income over the remaining lease period, estimated term of subleases, estimated utility and real estate broker fees, as well as estimated discount rates for use in calculating the present value of our liability. We developed these assumptions based on our understanding of the current real estate market in the respective locations as well as current market interest rates. The assumptions used are our management s best estimate at the time of the accrual, and adjustments are made on a periodic basis if better information is obtained. If, at March 31, 2005, our estimated sublease income were to decrease 10%, the restructuring reserve and related expense would have increased by approximately $0.2 million.

The estimates regarding our restructuring accruals affect our current liabilities and other long-term liabilities line items in our consolidated balance sheet, since these liabilities will be settled each year through 2013. These estimates affect our statement of income in the restructuring line item. At March 31, 2005, our North America and EMEA operating segments were primarily affected by these estimates.

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

Accounting for Income Taxes

At the end of each interim period we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year. This effective tax rate is used to determine income taxes on a current year-to-date basis. The effective tax rate may consider, as applicable, tax credits, foreign tax rates, and other available tax-planning alternatives. It also includes the effect of any valuation allowance expected to be necessary at the end of the period for deferred tax assets related to originating deductible temporary differences and carryforwards. In arriving at this effective tax rate applied to interim periods no effect is included for the tax related to significant, unusual, or extraordinary items that may be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate is revised, if necessary, as of the end of each successive interim period during the fiscal year to our best current estimate of our expected annual effective tax rate.

The effective tax rate is our best estimate of the tax expense (or benefit) that will be provided for the calendar year, stated as a percentage of its estimated annual ordinary income (or loss). The tax expense (or benefit) related to ordinary income (or loss) for the interim period is determined using this estimated annual effective tax rate. The tax expense (or benefit) related to other items is individually computed and recognized when the items occur. The estimated tax rate applied to interim ordinary income (or loss) is reliant on the Company s estimates of expected annual operating income (or loss) for the year as well as our projections of the proportion of income (or loss) earned in foreign jurisdictions which may have statutory tax rates significantly lower than tax rates applicable to our earnings in the United States. In each successive interim period, to the extent our operating results year to date and our estimates for the remainder of the fiscal year change from our original expectations regarding the proportion of earnings in various tax jurisdictions we expect that our effective tax rate will change accordingly, affecting tax expense (or benefit) for both that successive interim period as well as year-to-date interim results.

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess and make

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significant estimates regarding the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the statement of income. Estimates related to income taxes affect the deferred tax asset and liability line items and accrued liabilities in our consolidated balance sheet and our income tax expense (or benefit) line item in our statement of income. Income tax estimates affect all of our operating geographies.

The net deferred tax asset as of March 31, 2005 is $427.6 million, net of a valuation allowance of $58.6 million due to uncertainties related to our ability to utilize some of our deferred tax assets related to acquired companies, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire. The valuation allowance is based on our historical experience and estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations.

Tax returns are subject to audit by various taxing authorities. Although we believe that adequate accruals have been made for unsettled issues, additional benefits or expenses could occur in future years from resolution of outstanding matters. We record additional expenses each period on unsettled issues relating to the expected interest we would be required to pay a tax authority if we do not prevail on an unsettled issue. We continue to assess our potential tax liability included in accrued taxes in the consolidated financial statements, and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. We have classified a portion of our tax liability as noncurrent in the consolidated balance sheet based on the expected timing of cash payments to settle contingencies with taxing authorities.

Valuation of Goodwill, Intangibles and Long-lived Assets

We account for goodwill and other indefinite-lived intangible assets in accordance with SFAS 142, *Goodwill and Other Intangible Assets* (SFAS 142). SFAS 142 requires, among other things, the discontinuance of amortization for goodwill and indefinite-lived intangibles and at least an annual test for impairment. An impairment review may be performed more frequently in the event circumstances indicate that the carrying value may not be recoverable.

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

Based on our most recent impairment test, there would have to be a significant change in assumptions used in such calculation in order for an impairment to occur as of March 31, 2005.

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

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

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

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

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

significant negative industry or economic trends;

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

our market capitalization relative to net book value.

Goodwill amounted to $439.0 million and $439.2 million as of March 31, 2005 and December 31, 2004, respectively. We did not hold any other indefinite-lived intangibles as of March 31, 2005 and December 31, 2004. Net finite-lived intangible assets and long-lived assets amounted to $190.9 million and $198.8 million as of March 31, 2005 and December 31, 2004, respectively.

Results of Operations

Three Months Ended March 31, 2005 and 2004

Net Revenue

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

	Three Months Ended March 31,		Percentage of Net Revenue	
	2005	2004	2005	2004
	(In thousands, except percentages)			
Product	$ 44,092	$ 83,731	19%	38%
Services and support	191,635	135,347	81	62
Net revenue	$ 235,727	$ 219,078	100%	100%

Net revenue increased $16.6 million in the three months ended March 31, 2005 compared to the three months ended March 31, 2004. The increase reflects (i) a $33.2 million increase in our McAfee.com consumer business due to on-line subscriber growth from 4.6 million on-line subscribers at March 31, 2004 to 11.0 million subscribers at March 31, 2005, (ii) a $20.3 million increase in retail sales, including contract support, primarily due to higher levels of contract support revenue generated from our increased 2004 retail sales in connection with numerous virus outbreaks in 2003 through 2004 and due to revenue from new product offerings launched subsequent to the first quarter of 2004, such as Spyware, and (iii) a $6.6 million increase in IntruShield product sales due to our increased focus on this product after the sale of Sniffer in 2004. These increases were partially offset by (i) the $42.3 million decrease due to the sale of our Sniffer product line in July 2004, (ii) a decrease in Magic product line revenue of $2.9 million due to the sale of Magic in January 2004 and (iii) the introduction of our perpetual plus licensing arrangements, which experience lower rates of up-front revenue recognition, in the United States in the first quarter of

2004 and in EMEA and Asia-Pacific, excluding Japan, in mid-2003.

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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:

	Three Months Ended March 31,		Percentage of Net Revenue	
	2005	2004	2005	2004
	(In thousands, except percentages)			
Net Revenue:				
North America	$ 142,156	$ 134,121	60%	61%
EMEA	62,818	56,848	27	26
Japan	16,117	13,817	7	6
Asia-Pacific	8,647	7,490	4	4
Latin America	5,989	6,802	2	3
Total net revenue	$ 235,727	$ 219,078	100%	100%

Net revenue outside of North America, consisting of U.S. and Canada, accounted for approximately 40% and 39% of net revenue in the three months ended March 31, 2005 and 2004, respectively. Historically and continuing during the first quarters of 2005 and 2004, net revenue from North America and EMEA has comprised 87% to 91% of our business. We continue to see weakening of the U.S. dollar against many currencies, but most dramatically against the Euro. As a result of the weakening U.S. dollar, we experienced positive impacts on our net revenue in EMEA region.

In the three months ended March 31, 2005, total net revenue in North America increased 6%, or $8.0 million, compared to the three months ended March 31, 2004. The increase in North American revenue is primarily related to (i) a $28.9 million increase in McAfee.com subscription revenue in North America due to on-line subscriber growth, (ii) a $14.9 million increase in retail sales, including contract support, primarily due to higher levels of contract support revenue generated from our increased 2004 retail sales in connection with numerous virus outbreaks in 2003 through 2004 and due to revenue from new product offerings launched subsequent to the first quarter of 2004, such as Spyware, and (iii) a $1.9 million increase in IntruShield revenue in North America. These increases are partially offset by (i) a $30.8 million decrease in Sniffer revenue in North America due to the sale of our Sniffer product line in July 2004 and (ii) a $2.1 million decrease in Magic revenue in North America due to the sale of Magic in 2004.

In EMEA, total net revenue increased 11% or $6.0 million in the three months ended March 31, 2005 compared to the three months ended March 31, 2004. The increase in EMEA revenues is attributable to (i) the strengthening of Euro against the U.S. dollar, (ii) a $4.5 million increase in McAfee Enterprise revenue and (iii) a $4.6 million increase in Retail primarily due to higher levels of contract support revenue generated from our increased 2004 retail sales in connection with numerous virus outbreaks in 2003 through 2004, partially offset by (iv) a $6.9 million decrease in revenues related to the Sniffer and Magic product lines that were sold in July 2004 and January 2004, respectively.

Our Japan, Latin America and Asia-Pacific operations combined have historically been less than 15% of our total business, and we expect this trend to continue. Revenues increased in each of these geographic regions, except Latin America, primarily due to the strengthening of foreign currencies against the U.S. Dollar and increased corporate IT spending.

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

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Product Revenue

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

	Three Months Ended March 31,		Percentage of Product Revenue	
	2005	2004	2005	2004
	(In thousands, except percentages)			
Perpetual licenses	$ 21,886	$ 39,510	50%	47%
Term subscription licenses	7,075	17,530	16	21
Hardware	9,281	25,229	21	30
Retail and other	5,850	1,462	13	2
Total product revenue	$ 44,092	$ 83,731	100%	100%

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. The $39.6 million, or 47%, decrease in product revenue in the three months ended March 31, 2005 compared to the three months ended March 31, 2004 is attributable to (i) the introduction of our perpetual plus licensing arrangements in the United States in the first quarter of 2004 and in EMEA and Asia-Pacific, excluding Japan, in 2003, resulting in reduced product revenues and increased services and support revenues, (ii) our continued shift in focus from retail-boxed products to our on-line subscription model for consumers and SMB s, and (iii) the Sniffer sale in July 2004 and the Magic sale in January 2004, partially offset by (iv) the effects of the strengthening foreign currencies against the U.S. Dollar and increased corporate IT spending. The introduction of the perpetual plus licensing arrangement has resulted in revenue declines in the term subscription license and perpetual license revenues. Our hardware revenue decreased $15.9 million, or 63%, due to the Sniffer sale in July 2004.

Our customers license our software on a perpetual or term subscription basis depending on their preference. We are continuing to see perpetual licenses become a larger percentage of our license revenue in any quarter following the implementation of our perpetual plus licensing model worldwide. Furthermore, support pricing under the perpetual plus model is significantly higher than the subscription model. Thus, revenue is shifting out of the product revenue and into services and support revenue. We expect the remaining mix of product revenue to fluctuate as a percentage of revenue.

Services and Support Revenues

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

	Three Months Ended March 31,		Percentage of Services and Support Revenue	
	2005	2004	2005	2004
	(In thousands, except percentages)			
Support and maintenance	$ 125,452	$ 103,015	65%	76%
On-line subscriptions	59,681	26,466	31	20
Consulting	5,367	3,984	3	3
Training	1,135	1,882	1	1

Total services and support revenue	$ 191,635	$ 135,347	100%	100%

Services and support revenues include revenues from software support and maintenance contracts, consulting, training and on-line subscription arrangements. The $56.3 million, or 42%, increase in service and support revenue is attributable to (i) $33.2 million increase in our on-line subscription arrangements and (ii) a $22.4 million increase in support and maintenance primarily due to our perpetual plus licensing model. The increase in our on-line subscription arrangements is due to an increase in our on-line customer base to approximately 11.0 million subscribers at March 31, 2005 from 4.6 million subscribers at March 31, 2004, as well as an increase in our McAfee ASaP on-line service for small- to medium-sized businesses. The increase in customers was due to our continued OEM relationships with Dell and others.

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 support arrangements as well as our ability to respond successfully to the pace of technological change and expand our customer base. If our renewal rate or our pace of new customer acquisition slows, our net revenues and operating results would be adversely affected. Additionally, support pricing under the perpetual plus model is significantly higher than the previous subscription model. In the event customers choose not to renew their support arrangements or renew such arrangements at other than the contractual rates, revenue recognition under the perpetual plus model could be impacted.

Cost of Net Revenue; Gross Margin.

	Three Months Ended March 31,		Percentage of Cost of Net Revenue	
	2005	**2004**	**2005**	**2004**
	(In thousands, except percentages)			
Cost of net revenue:				
Product	$ 16,646	$ 19,307	43%	52%
Services and support	18,161	14,492	47	39
Amortization of purchased technology	3,850	3,393	10	9
Total cost of net revenue	$ 38,657	$ 37,192	100%	100%
Gross margin	$ 197,070	$ 181,886		
Gross margin percentage	84%	83%		

Cost of Product Revenue. Our cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels, and, with respect to hardware-based anti-virus and security products and network fault and performance products, computer platforms and other hardware components. The $2.7 million decrease in the cost of product revenue is primarily attributable to the sale of Sniffer in July 2004 and the change in the mix of our revenues with a shift from product revenues to service and support revenues.

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

Cost of Services and Support. Cost of services and support revenue consists principally of salaries and benefits related to employees providing customer support and consulting services, and costs related to the sale of on-line subscription arrangements, including revenue sharing arrangements and royalties paid to our on-line strategic partners. Cost of services and support revenue increased $3.7 million due to an increase in revenue sharing arrangements and royalties paid to our on-line strategic partners, which was partially offset by reduced support and consulting headcount as a result of the sale of Magic in January 2004 and Sniffer in July 2004, as well as on-going cost reduction efforts. Cost of services and support have increased as a percentage of total cost of net revenue primarily as a result of the increase in revenue sharing arrangements and royalty payments to our on-line strategic partners. We anticipate that cost of service revenue will continue to fluctuate as a percentage of cost of net revenue.

Amortization of Purchased Technology. Amortization of purchased technology increased $0.5 million, or 13%, due to our acquisition of Foundstone in October 2004, for which we recorded purchased technology of $27.0 million. The purchased technology is being amortized over its estimated useful life of up to seven years. Amortization of purchased technology is expected to be $11.4 million for the remainder of 2005.

Gross Margins. Our gross margins increased slightly from 83% to 84%. Gross margins may fluctuate in the future due to various factors, including the mix of products sold, sales discounts, revenue sharing agreements, material and labor costs and warranty costs.

Operating Costs — Three Months Ended March 31, 2005 and 2004

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

	Three Months Ended March 31,		Percentage of Net Revenue	
	2005	2004	2005	2004
	(In thousands, except percentages)			
Research and development(1)	$ 38,230	$ 45,379	16%	21%
Marketing and sales(2)	71,184	92,958	30	42
General and administrative(3)	33,621	26,714	14	13
Amortization of intangibles	3,528	3,573	2	2
Restructuring charge	2,296	2,336	1	1
Loss (gain) on sale of assets and technology	259	(45,678)		(21)
Provision for doubtful accounts, net	159	525		
Reimbursement from transition services agreement	(328)			
Litigation settlement		(19,101)		(9)
Total operating costs	$ 148,949	$ 106,706	63%	49%

(1) Includes stock-based compensation (benefits) charges of ($2,503) and $1,314 in the three months ended March 31, 2005 and 2004, respectively.

(2) Includes stock-based compensation (benefits) charges of ($735) and $636 in the three months ended March 31, 2005 and 2004, respectively.

(3) Includes stock-based compensation (benefits) charges of ($54) and $276 in the three months ended March 31, 2005 and 2004, respectively.

Research and Development. Research and development expenses consist primarily of salary, benefits and contractors fees for our development and technical support staff, and other costs associated with the enhancements of existing products and services and development of new products and services. Research and development expenses decreased $7.1 million, or 16%, to $38.2 million in the three months ended March 31, 2005 compared to $45.4 million in the three months ended March 31, 2004. The decrease is attributable to (i) headcount reductions totaling $3.5 million due to the Sniffer product line sale in July 2004, (ii) a $3.8 million decrease in stock-based compensation and (iii) a decrease in expenses due to headcount reductions and the movement of research and development headcount to the Bangalore research facility, which has lower salary costs.

We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to remain relatively flat in future periods and continue to fluctuate as a percentage of net revenue.

Marketing and Sales. Marketing and sales expenses consist primarily of salary, commissions and benefits for marketing and sales personnel and costs associated with advertising and promotions. Marketing and sales expenses decreased $21.8 million, or 23%. The decrease reflects (i) headcount reductions totaling $4.1 million due to the

Sniffer product line sale in July 2004 and $0.4 million due to the Magic product line sale in January 2004, (ii) a $1.4 million decrease in stock-based compensation, (iii) general headcount reductions and (iv) reduced spending on marketing programs.

We anticipate that marketing and sales expenses will decrease in absolute dollars compared to the same prior-year periods, and will continue to fluctuate as a percentage of net revenue.

General and Administrative. General and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. General and administrative expenses increased $6.9 million, or 26%, due to (i) a $1.2 million increase in costs incurred to comply with Section 404 of the Sarbanes-Oxley Act, (ii) higher executive salary costs, (iii) increased accounting fees and (iv) retention bonuses paid to key finance employees.

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

Loss (gain) on Sale of Assets and Technology. In January 2004, we recognized a gain of approximately $46.5 million related to our sale of our Magic assets to BMC Software. The loss on sale of assets and technology of $0.3 million in the three months ended March 31, 2005 consists of the write-off of property and equipment.

Litigation Settlement. During the first quarter of 2004, we received insurance reimbursements of approximately $19.1 million from our insurance carriers. The reimbursements were a result of our insurance coverage related to the class action lawsuit we settled in 2003.

Restructuring Charge

2005 Restructuring

During the three months ended March 31, 2005, we permanently vacated several leased facilities and recorded a $0.7 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, along with estimated costs associated with subleasing the vacated facility.

The following table summarizes our restructuring accrual established in 2005 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Other Costs	Total
Balance, January 1, 2005	$	$	$
Restructuring accrual	688	13	701
Cash payments	(449)	(13)	(462)
Balance, March 31, 2005	$ 239	$	$ 239

2004 Restructurings

During 2004, we recorded several restructuring charges related to the reduction of employee headcount. In the first quarter of 2004, we recorded a restructuring charge of approximately $2.2 million related to the severance of approximately 160 employees, of which $0.7 million and $1.5 million was related to our North America and EMEA operating segments, respectively. The workforce size was reduced primarily due to our sale of Magic in January 2004. In the second quarter of 2004, we recorded a restructuring charge of approximately $1.6 million related to the severance of approximately 80 employees in our sales, technical support and general and administrative functions. Approximately $0.6 million of the restructuring charge was related to the EMEA operating segment and the remaining $1.0 million was related to the North America operating segment. In the third quarter of 2004, we recorded a restructuring charge related to ten employees which totaled approximately $0.9 million, all of which related to the North America operating segment. In the fourth quarter of 2004, we recorded a restructuring charge of $1.3 million related to 111 employees, of which $0.7 million, $0.2 million, $0.2 million and $0.2 million related to the Latin America, North America, EMEA and Asia-Pacific, excluding Japan, operating segments, respectively. All employees were terminated as of December 31, 2004. The reductions in the second, third and fourth quarters were part of the previously announced cost-savings measures being implemented by us.

In September 2004, we announced the move of the European headquarters to Ireland, which was substantially completed by the end of March 2005. In the third and fourth quarters of 2004, we recorded restructuring charges of $0.2 million and $2.2 million, respectively, related to the severance of approximately 80 employees. During the three months ended March 31, 2005, we recorded an additional $1.3 million in restructuring charges for severance costs being recognized over the required service period. All of these charges were related to our EMEA operating segment.

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

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

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

The following table summarizes our restructuring accruals established in 2004 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2004	$	$	$	$
Restructuring accrual	8,685	7,932	480	17,097
Cash payments	(579)	(4,175)	(63)	(4,817)
Adjustment to liability	(222)	(275)		(497)
Accretion	74			74
Balance, December 31, 2004	7,958	3,482	417	11,857
Restructuring accrual		1,303	20	1,323
Cash payments	(679)	(1,039)		(1,718)
Adjustment to liability	11		(62)	(51)
Accretion	69			69
Balance, March 31, 2005	$ 7,359	$ 3,746	$ 375	$ 11,480

2003 Restructuring

In January 2003, as part of a restructuring effort to gain operational efficiencies, we consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into our regional headquarters facility in Plano, Texas. The facility houses employees working in finance, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses. The remaining costs will generally be paid over the remaining lease term ending in 2013.

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In 2004, we adjusted the restructuring accrual related to lease termination costs previously recorded in 2003. The adjustments decreased the liability by approximately $0.6 million in 2004, due to changes in estimates related to the sublease income to be received over the remaining lease term.

The following table summarizes our restructuring accrual established in 2003 and activity through March 31, 2005 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Total
Balance, January 1, 2004	$ 14,217	$ 317	$ 14,534
Cash payments	(1,841)	(194)	(2,035)
Adjustment to liability	(623)	(123)	(746)
Accretion	548		548
Balance, December 31, 2004	12,301		12,301
Cash payments	(274)		(274)
Adjustment to liability	129		129
Accretion	125		125
Balance, March 31, 2005	$ 12,281	$	$ 12,281

Our estimates of the excess facilities charges recorded during 2005, 2004 and 2003 may vary significantly depending, in part, on factors which may be beyond our control, such as our success in negotiating with our lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charges in 2005 were primarily allocated to the EMEA and Japan operating segments, and the facility restructuring charges in 2004 were primarily allocated to the North America operating segment.

Stock-Based Compensation

We recorded stock-based compensation (benefits) charges of ($3.3) million and $2.2 million in the three months ended March 31, 2005 and 2004, respectively. These (benefits) charges are comprised of the following (in thousands):

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Exchange of McAfee.com options	$ (1,976)	$ 1,833
Repriced options	(1,699)	
New and existing executives and employees	383	106
Former employees		146
Extended life of vested options held by terminated employees		141
Total stock-based compensation	$ (3,292)	$ 2,226

Exchange of McAfee.com options. In the three months ended March 31, 2005 and 2004, we recorded stock-based compensation (benefits) charges of approximately ($2.0) million and $1.8 million, respectively, related to exchanged options subject to variable accounting. Our stock-based compensation (benefits) charges related to exchanged options subject to variable accounting were based on our closing stock price of $22.56 and $18.00 on March 31, 2005 and 2004, respectively. The benefit in the three months ended March 31, 2005 was due to a decline in our stock price from $28.93 at December 31, 2004 to $22.56 at March 31, 2005. As of March 31, 2005, we had approximately 0.4 million outstanding exchanged options subject to this variable accounting.

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

During the three months ended March 31, 2005, we recorded a benefit of approximately $1.7 million, and did not record any charges or benefits in the three months ended March 31, 2004. The stock-based compensation (benefits) charges for these options were based on closing stock prices as of March 31, 2005 and 2004 of $22.56 and $18.00, respectively. The benefit in the three months ended March 31, 2005 was due to a decline in our stock price from $28.93 at December 31, 2004 to $22.56 as of March 31, 2005. There was no charge or benefit in the three months ended March 31, 2004 as our closing stock price at March 31, 2004 and December 31, 2003 was below $20.375. As of March 31, 2005, we had approximately 0.2 million options outstanding which were subject to variable plan accounting.

New and existing employees and executives. In January 2005, our board of directors granted 75,000 shares of restricted stock to our chief financial officer. The price of the underlying shares is $0.01 per share. We recorded expense of approximately $0.2 million during the quarter ended March 31, 2005 related to the stock-based compensation associated with the chief financial officer s restricted stock grant.

In connection with the acquisition of Foundstone in October 2004, we granted stock options to Foundstone employees which are subject to vesting provisions as the employees provide service to us. We recognized approximately $0.2 million as expense during the three months ended March 31, 2005. An additional $1.2 million will be recognized through 2008, which is subject to reduction based on employees terminating prior to the full vesting of their options.

In January 2002, our board of directors approved a grant of 50,000 shares of restricted stock to our chief executive officer. The price of the underlying shares is $0.01 per share. During the three months ended March 31, 2005 and 2004, we recorded in both periods less than $0.1 million and approximately $0.1 million, respectively, related to stock-based compensation associated with the chief executive officer s 2002 restricted stock grant.

Former employees. In November and December 2003, we extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. As these employees options continued to vest after termination and their exercise period was extended an additional 90 days, the Company recorded a one time stock-based compensation charge of approximately $0.1 million during the three months ended March 31, 2004.

Extended life of vested options held by terminated employees. During a significant portion of 2003, we suspended exercises of stock options until our required public company reports were filed with the SEC. The period during which stock options were suspended is known as the black-out period. Due to the black-out period, we extended the exercisability of any options that would otherwise terminate during the black-out period for a period of time equal to a specified period after termination of the black-out period. Accordingly, we 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 months ended March 31, 2004, we recorded a stock-based compensation charge of approximately $0.1 million.

Recent Accounting Pronouncements

See Note 2 to the condensed consolidated financial statements.

Liquidity and Capital Resources

	Three Months Ended March 31,	
	2005	**2004**
Net cash provided by operating activities	$ 100,450	$ 118,997
Net cash used in investing activities	(55,370)	(40,289)
Net cash provided by (used in) financing activities	(22,535)	22,408

Overview

At March 31, 2005, we had cash and cash equivalents totaling $304.0 million, as compared to $291.2 million at December 31, 2004. In the three months ended March 31, 2005, we generated positive operating cash flows of $100.5 million and received cash of approximately $24.8 million related to our employee stock purchase plan and option exercises under our employee stock option plans. Uses of cash during the quarter included the repurchase of common stock of approximately $47.4 million, net purchases of marketable securities of $46.2 million and purchased of property and equipment of $9.1 million. A more detailed discussion of changes in our liquidity follows.

Operating Activities

Net cash provided by operating activities in the three months ended March 31, 2005 and 2004 was the result of our net income of $36.0 million and $58.0 million, respectively, which is adjusted for non-cash items such as depreciation and amortization, non-cash restructuring charges, deferred taxes, non-cash loss on marketable securities, stock-based compensation and changes in various assets and liabilities such as accounts payable, accounts receivable, other current assets and deferred revenue.

Our historical and primary source of operating cash flow is the collection of accounts receivable from our customers and the timing of payments to our vendors and service providers. One measure of the effectiveness of our collection efforts is average accounts receivable days sales outstanding (DSO). DSOs were 36 days and 45 days at March 31, 2005 and 2004, respectively. We calculate accounts receivable DSO on a net basis by dividing the accounts receivable balance at the end of the quarter by the amount of revenue recognized for the quarter multiplied by 90 days. We expect DSO s to vary from period to period because of changes in quarterly revenue and the effectiveness of our collection efforts. In 2005 and 2004, we have not made any significant changes to our payment terms for our customers, which are generally net 30.

Our balances in accounts payable, accrued taxes and other liabilities decreased $2.5 million. Our operating cash flows, including changes in accounts payable and accrued liabilities, is impacted by the timing of payments to our vendors for accounts payable and taxing authorities. We typically pay our vendors and service providers in accordance with invoice terms and conditions, and take advantage of invoice discounts when available. The timing of future cash payments in future periods will be impacted by the nature of accounts payable arrangements. In the three months ended March 31, 2005 and 2004, we did not make any significant changes to our payment timing to our vendors.

Our cash balances are held in numerous locations throughout the world, including substantial amounts held outside the United States. As of March 31, 2005, approximately $203.6 million was held outside the United States. We utilize a variety of tax planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed. We have provided for U.S. federal income taxes on these amounts for consolidated financial# statement purposes, except for foreign earnings that are considered indefinitely reinvested outside the United States. The American Jobs Creations Act of 2004 (AJCA) introduced a limited time 85% dividends received reduction on the repatriation of certain foreign earnings to a U.S. taxpayer, provided certain criteria are met. We are analyzing the impact of the AJCA and

may repatriate to the United States some or all of our offshore earnings currently characterized as indefinitely reinvested outside the United States. The range of possible amounts we are considering for repatriation under this provision is between $0 and $500 million, and the range of potential additional income taxes is between $0 and $30 million.

Our working capital, defined as current assets minus current liabilities, was $443.1 million and $259.9 million at March 31, 2005 and December 31, 2004, respectively. The increase in working capital of approximately $183.2 million from December 31, 2004 to March 31, 2005 is attributable to a $215.0 million increase in cash and short-term marketable securities balances, offset by a decrease of $43.3 million in accounts receivable due to customer payments and a $16.6 million increase in current deferred revenue. Our perpetual plus licensing model, now introduced worldwide, results in less revenue recognition up-front, therefore causing increases in our deferred revenue.

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

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

Investing Activities

A summary of our investing activities at March 31, 2005 and 2004 is as follows (in thousands). The detail of these line items can be seen in our condensed consolidated statement of cash flows.

	Three Months Ended March 31,	
	2005	**2004**
Net purchases of marketable securities	$ (46,223)	$ (79,073)
Purchases of property and equipment	(9,146)	(8,653)
Proceeds from sale of assets and technology, net		47,565
Changes in restricted cash	(1)	(100)
Other		(28)
Net cash used in investing activities	$ (55,370)	$ (40,289)

Investments

We made net purchases of our marketable securities of $46.2 million and $79.1 million in the three months ended March 31, 2005 and 2004, respectively. We have classified our investment portfolio as available for sale, and our investments are made with a policy of capital preservation and liquidity as the primary objectives. We generally hold investments in money market, fixed income and U.S. government agency securities. We may sell an investment at any time if the quality rating of the investment declines, the yield on the investment is no longer attractive or we are in need of cash. Because we invest only in investment securities that are highly liquid with a ready market, we believe that the purchase, maturity and sale of our investments has no material impact on our overall liquidity.

Property and Equipment

The $9.1 million of property and equipment purchased during the three months ended March 31, 2005 was primarily for upgrades of our existing accounting system and equipment for our new facility in Ireland. In the three months ended March 31, 2004, we purchased $8.7 million of equipment to update hardware for our employees and enhance various back office systems, including the finalization of our customer relationship management system.

We anticipate that we will continue to purchase property and equipment necessary in the normal course of our business. The amount and timing of these purchases and the related cash outflows in future periods is difficult to predict and is dependent on a number of factors including our hiring of employees, the rate of change in computer hardware/ software used in our business and our business outlook.

Proceeds from Sale of Assets and Technology

We completed the sale of Magic to BMC Software in January 2004, and as a result, recognized a gain of approximately $46.5 million. We received net cash proceeds of approximately $47.6 million related to the sale.

Restricted Cash

The restricted cash balance of $0.6 million at March 31, 2005 and December 31, 2004 consists primarily of cash collateral related to Entercept building rent expense and our workers compensation insurance coverage.

Financing Activities

In the three months ended March 31, 2005, net cash used in financing activities totaled $22.5 million, consisting of $47.4 million used to repurchase two million shares of our common stock in the open market partially offset by the receipt of $24.8 million related to exercises of stock options under our employee stock option plans and stock purchases from our employee stock purchase plan. Cash flows from financing activities in the three months ended March 31, 2004 consisted of the receipt of $22.4 million of cash related to exercises of stock options and stock purchases from the employee stock purchase plan.

Historically, our recurring cash flows provided by financing activities have been from the receipt of cash from the issuance of common stock under stock option and employee stock purchase plans. For example, we received cash proceeds from these plans in the amount of $113.8 million and $35.4 million in 2004 and 2003, respectively. While we expect to continue to receive these proceeds in future periods, the timing and amount of such proceeds are difficult to predict and is contingent on a number of factors including the price of our common stock, the number of employees participating in the plans and general market conditions.

As our stock price rises, more participants are in the money in their options, and thus, more likely to exercise their options, which results in cash to us. As our stock price decreases, more of our employees are out of the money or under water in regards to their options, and therefore, are not able to exercise options and results in no cash received by us.

We have a $17.0 million credit facility with a bank. The credit facility is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between us and the bank at the time of each specific transaction. The credit facility is intended to be used for short-term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time. No balances are outstanding as of March 31, 2005.

Off-Balance Sheet Arrangements

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

RISK FACTORS

Investing in our common stock involves a high degree of risk. The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we deem immaterial may also impair our business operations. Any of the following risks could materially adversely affect our business, operating results and financial condition and could result in a complete loss of your investment.

Our Financial Results Will Likely Fluctuate.

Our revenues and operating results have varied significantly in the past. We expect fluctuations in our operating results to continue. As a result, we may not sustain profitability. Also, we believe that period-to-period comparisons of our financial results should not be relied upon as an indicator of our future results. Our expenses are based in part on our expectations regarding future revenues, making expenses in the short term relatively fixed. We may be unable to adjust our expenses in time to compensate for any unexpected revenue shortfall.

Operational Factors

Operational factors that may cause our revenues, gross margins and operating results to fluctuate significantly from period to period, include, but are not limited to:

- introduction of new products, product upgrades or updates by us or our competitors;
- volume, size, timing and contractual terms of new licenses and renewals of existing licenses;
- our perpetual plus licensing program;
- the mix of products we sell and services we offer and whether (i) our products are sold directly by us or indirectly through distributors, resellers, ISP s such as AOL, and others, (ii) the product is hardware or software based and (iii) in the case of software licenses, the licenses are perpetual licenses or time-based subscription licenses;
- system, supply of manufactured products and personnel limitations may adversely impact our ability to process the large number of orders that typically occur near the end of a fiscal quarter;
- costs or charges related to our acquisitions or dispositions, including our acquisition of Foundstone in 2004 and the dispositions of our Magic and Sniffer product lines and McAfee Labs assets;
- the components of our revenue that are deferred, including our on-line subscriptions and that portion of our software licenses attributable to support and maintenance;
- stock-based compensation charges;
- costs and charges related to certain events, including our ongoing cost reduction and profitability plan, Sarbanes-Oxley compliance efforts, litigation, reductions in force, relocation of personnel and previous financial restatements;
- our ability to timely remediate any material weaknesses or significant deficiencies in our internal controls over financial reporting and to maintain adequate internal controls; and
- factors that lead to substantial drops in estimated values of long-lived assets below their carrying value.

Seasonal and Macroeconomic Factors

Our net revenue is typically lower in the first quarter when many businesses experience lower sales, flat in the summer months, due in part to the European holiday season, and higher in the fourth quarter as customers typically complete annual budgetary cycles.

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It Is Difficult for Us to Accurately Estimate Operating Results Prior to the End of a Quarter.

Although a significant portion of our revenue in any quarter comes from previously deferred revenue, a meaningful part of our revenue in any quarter depends on contracts entered into or orders booked and shipped in that quarter. Historically, we have experienced a trend toward more product orders, and therefore, a higher percentage of revenue shipments, in the last month of a quarter. Some customers believe they can enhance their bargaining power by waiting until the end of a quarter to place their order. Because we expect this trend to continue, any failure or delay in the closing of new orders in a given quarter could have a material adverse effect on our quarterly operating results. Furthermore, because of this trend, it is difficult for us to accurately estimate operating results prior to the end of a quarter.

Our Business Transformation, Dispositions and Cost Reduction Plan, Expose Us to Significant Risks.

In 2004, we continued our business transformation with the sale of our Magic Solutions and Sniffer Technologies product lines in January and July 2004, respectively, the Foundstone acquisition in October 2004, the sale of our McAfee Labs assets in April 2005 and the changing of our name back to McAfee. Early in 2004, we also began our ongoing cost reduction and profitability plan with an objective of significantly improving our operating margins by mid-2005. In January 2005 we completed the move of our European finance and sales order operations organization from the Netherlands to Ireland. These activities are intended to, among other things, streamline our business, better leverage the McAfee brand, better position us as the leading provider of intrusion prevention solutions, and help accelerate profit and growth. Risks related to these activities include:

- our growth and/or profitability may not increase in the near-term or at all and we may fail to achieve desired savings or performance targets on a timely basis or at all;

- an increased dependence on our channel and other partners to sell our products, particularly to enterprise and small- to medium-sized business (SMB) customers;

- our strategic positioning may result in our competing more directly with larger, more established competitors, such as Cisco Systems and Microsoft;

- our business, including internal finance and IT operations, has been and may continue to be disrupted and strained due to, among other things, our cost saving measures and personnel losses;

- we have centralized our order processing operations from Latin America to Plano, Texas and we have also moved the EMEA shared services center and localization operations from Amsterdam to Cork, Ireland. We have also transitioned a significant portion of our research and development personnel to our research facility in Bangalore, India. These events could result in reduced service levels due to time zone differences, difficulties in finding personnel with sufficient language capabilities and loss of direct, on-the-ground finance and accounting oversight in the sales regions being serviced on a remote basis;

- we may experience an undesired loss of sales, research and development, finance and other personnel and it may be difficult for us to find suitable replacements;

- we have installed a new customer relationship management system, providing our finance and sales teams information in a different format than previously available and, in some cases, with less information. During the transition period to our new system, we may experience, among other things, related reduced operational efficiencies, losses of information and a decreased ability to monitor or forecast our business;

- we may be unable to successfully expand our McAfee brand significantly beyond our anti-virus products;

many of our products and service capabilities were recently acquired and the income potential for these products and services is unproven and the market for these products is volatile; and

there may be customer confusion around our strategy.

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We Are Subject to Intense Competition in the System and Network Protection Markets, and We Expect to Face Increased Competition in the Future.

The markets for our products are intensely competitive and we expect both product and pricing competition to increase. Some of our competitors have longer operating histories, greater name recognition, larger technical staffs, established relationships with hardware vendors and/or greater financial, technical and marketing resources. We face competition in specific product markets. Principal competitors include:

in the anti-virus product market, Symantec and Computer Associates. Trend Micro remains the strongest competitor in the Asian anti-virus market. F-Secure, Dr. Ahn s, Panda and Sophos are also showing growth in their respective markets. Microsoft has continued to make acquisitions and has announced its intention to enter all segments of the anti-virus market by the end of 2005; and

in the market for our other intrusion detection and protection products, Cisco Systems, Computer Associates, Internet Security Systems, Juniper Networks, Symantec and 3Com Corporation.

Other competitors for our various products could include large technology companies. We also face competition from numerous smaller companies and shareware authors that may develop competing products.

Increasingly, our competitors are large vendors of hardware or operating system software. These competitors are continuously developing or incorporating system and network protection functionality into their products. For example, Juniper Networks acquired Netscreen and, through its acquisitions of Okena, Riverhead and NetSolv, Cisco Systems may incorporate functionality that competes with our content filtering and anti-virus products. Similarly, Microsoft continues to execute on its announced plans to boost the security of its Windows platform with related acquisitions including its acquisition of anti-virus providers GeCAD Software and Sybari Software and anti-spyware provider Giant Company Software. The widespread inclusion of products that perform the same or similar functions as our products within computer hardware or other companies software products could reduce the perceived need for our products or render our products obsolete and unmarketable. Furthermore, even if these incorporated products are inferior or more limited than our products, customers may elect to accept the incorporated products rather than purchase our products. In addition, the software industry is currently undergoing consolidation as firms seek to offer more extensive suites and broader arrays of software products, as well as integrated software and hardware solutions. This consolidation may negatively impact our competitive position.

We Face Risks in Connection With Material Weaknesses Identified in Our Sarbanes-Oxley Section 404 Management Report and Any Related Remedial Measures That We Undertake.

In the first quarter of 2004, we restated previously reported quarters of 2003; and in the second quarter of 2004, we restated the previously reported first quarter of 2004. These matters were identified by us and reported to our auditors. In conjunction with these restatements, our former auditors and our current auditors, respectively, reported that the underlying control issues giving rise to the respective restatement should be considered a material weakness under standards established by the Public Company Accounting Oversight Board. In response to these restatements, we implemented additional controls over financial reporting.

In conjunction with (i) our ongoing reporting obligations as a public company and (ii) the requirements of Section 404 of the Sarbanes-Oxley Act that management report as of December 31, 2004 on the effectiveness of our internal control over financial reporting and identify any material weaknesses in our internal control over financial reporting, we engaged in a process to document, evaluate and test our internal controls and procedures, including corrections to existing controls and additional controls and procedures that we may implement. As a result of this evaluation and testing process, our management identified material weaknesses in our internal control over financial reporting relating to accounting for income taxes, revenue accounting and the financial close and reporting process. See Item 9A in the Annual Report on Form 10-K for the year ended December 31, 2004 for additional disclosure about these material weaknesses. In response to these material weaknesses in our internal control over financial reporting, we have implemented and may be required to further implement, additional controls and procedures. In addition, in response to these material weaknesses, we are committed to hiring additional personnel, which may result in additional expense to us. As

a result of the identified material weaknesses, even though our management believes that our efforts to remediate and re-test certain internal control deficiencies have resulted in the improved operation of our internal control over financial reporting, we cannot be certain that the measures we have taken or that are planning to take will sufficiently and satisfactorily remediate the identified material weaknesses in full. Furthermore, we intend to continue improving our internal control over financial reporting and the implementation and testing of these continued improvements could result in increased cost and could divert management attention away from operating our business.

In future periods, if the process required by Section 404 of the Sarbanes-Oxley Act reveals further material weaknesses or significant deficiencies, the correction of any such material weakness or significant deficiency could require additional remedial measures which could be costly and time-consuming. In addition, the discovery of further material weaknesses could also require the restatement of prior period operating results. If a material weakness exists as of a future period year-end (including a material weakness identified prior to year-end for which there is an insufficient period of time to evaluate and confirm the effectiveness of the corrections or related new procedures), our management will be unable to report favorably as of such future period year-end to the effectiveness of our control over financial reporting. If we are unable to assert that our internal control over financial reporting is effective in any future period (or if our independent auditors are unable to express an opinion on the effectiveness of our internal controls), or if we continue to experience material weaknesses in our internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which would have an adverse effect on our stock price and potentially subject us to litigation.

We Face Risks Related to the Pending Formal Securities and Exchange Commission and Department of Justice Investigations and Our Accounting Restatements.

In the first quarter of 2002, the SEC commenced a Formal Order of Private Investigation into our accounting practices. In the first quarter of 2003, we became aware that the DOJ had commenced an investigation into our consolidated financial statements. In April and May 2002, we announced our intention to file, and in June 2002 we filed with the SEC, restated consolidated financial statements for 2000, 1999 and 1998 to correct certain discovered inaccuracies for these periods.

As a result of information obtained in connection with the ongoing SEC and DOJ investigations, we concluded in March 2003, that we would restate our consolidated financial statements to, among other things, reflect revenue on sales to our distributors for 1998 through 2000 on a sell-through basis (which is how we reported sales to distributors since the beginning of 2001).

The filing of our restated consolidated financial statements in October 2003 did not resolve the pending SEC inquiry or DOJ investigation into our accounting practices. We are engaged in ongoing discussions with, and continue to provide information regarding our consolidated financial statements for calendar year 2000 and prior periods. The resolution of the SEC inquiry and DOJ investigation into our prior accounting practices could involve the imposition of fines or penalties or other remedies.

Critical Personnel May Be Difficult to Attract, Assimilate and Retain.

Our success depends in large part on our ability to attract and retain senior management personnel, as well as technically qualified and highly-skilled sales, consulting, technical, finance and marketing personnel. Personnel related issues include:

Competition for Personnel; Need for Competitive Pay Packages

Competition for qualified individuals in our industry is intense. To attract and retain critical personnel, we believe that we must maintain an open and collaborative work environment. We also believe we need to provide a competitive compensation package, including stock options. Increases in shares available for issuance under our stock option plans require stockholder approval. Institutional stockholders, or our other stockholders generally, may not approve future requests for option pool increases. For example, at our 2003 annual meeting held in December 2003, our stockholders did not approve a proposed increase in shares

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available for grant under our employee stock option plans. Additionally, beginning in January 2006, accounting standards will require corporations to include a compensation expense in their statement of income relating to the issuance of employee stock options. As a result, we may decide to issue fewer stock options, possibly impairing our ability to attract and retain necessary personnel. Conversely, issuing a comparable number of stock options could adversely impact our results of operations when compared with periods prior to the effectiveness of these new rules.

Impact of Personnel Reductions

In recent periods, we have sought to rationalize the size of our employee base (including through the Sniffer sale). On March 31, 2005, we had approximately 2,900 employees, down from approximately 2,950 and 3,700 at December 31, 2004 and 2003, respectively. Reductions in personnel, including as a result of the Sniffer sale, may harm our business, employee retention or our ability to attract new personnel by, among other things, reducing overall employee morale, requiring remaining personnel to perform a greater amount of, or new and different, responsibilities or result in the loss of personnel otherwise critical to our business.

Reduced Productivity of New Hires; Senior Management Additions

Notwithstanding our ongoing efforts to reduce our general personnel levels, we continue to hire in key areas and have added a number of new employees in connection with our acquisitions. We have also increased our hirings in Bangalore, India in connection with the relocation of a significant portion of our research and development operations to India.

Several members of our senior management were only added in the last year, and we may add new members to senior management. In January 2005, we hired Eric Brown as our new executive vice president and chief financial officer, and in 2004, we promoted Jake Pyles to the position of vice president of finance. In June 2004, we promoted Christopher Bolin to the position of executive vice president and chief technology officer.

For new employees or management additions, there also may be reduced levels of productivity as recent additions or hires are trained or otherwise assimilate and adapt to our organization and culture.

Senior Management and Critical Personnel Losses

Other than executive management who have at will employment agreements, our employees are not typically subject to an employment agreement or non-competition agreement. In December 2004, Stephen Richards, our previous chief operating officer and chief financial officer, retired and in November 2004, our controller resigned to pursue other opportunities. In addition, in recent months we have experienced significant turnover in our finance organization worldwide and replacing these personnel remains difficult given the competitive market for these skill sets.

It could be difficult, time consuming and expensive to replace any key management member or other critical personnel. Integrating new management and other key personnel also may be difficult and costly. Changes in management or other critical personnel may be disruptive to our business and might also result in our loss of unique skills and the departure of existing employees and/or customers. It may take significant time to locate, retain and integrate qualified management personnel.

We Face Risks Associated with Past and Future Acquisitions.

We may buy or make investments in complementary companies, products and technologies. For example, in October 2004, we acquired Foundstone to bolster our risk assessment and vulnerability management capabilities. We have not previously acquired a company such as Foundstone, which offers high-end security consulting services as part of their business model. We may not realize the anticipated benefits from the Foundstone acquisition. In addition to the risks described below, acquisitions of professional services organizations present unique employee retention and integration challenges as well as customer retention challenges.

Integration

Integration of an acquired company or technology is a complex, time consuming and expensive process. The successful integration of an acquisition requires, among other things, that we:

- integrate and retain key management, sales, research and development and other personnel;
- integrate the acquired products into our product offerings both from an engineering and sales and marketing perspective;
- integrate and support preexisting supplier, distribution and customer relationships;
- coordinate research and development efforts; and
- consolidate duplicate facilities and functions and integrate back office accounting, order processing and support functions.

The geographic distance between the companies, the complexity of the technologies and operations being integrated and the disparate corporate cultures being combined may increase the difficulties of integrating an acquired company or technology. Management s focus on the integration of operations may distract attention from our day-to-day business and may disrupt key research and development, marketing or sales efforts. In addition, it is common in the technology industry for aggressive competitors to attract customers and recruit key employees away from companies during the integration phase of an acquisition.

Internal Controls, Policies and Procedures

Acquired companies or businesses are likely to have different standards, controls, contracts, procedures and policies, making it more difficult to implement and harmonize company-wide financial, accounting, billing, information and other systems.

Open Source Software

Products or technologies acquired by us may include so-called open source software. Open source software is typically licensed for use at no initial charge, but imposes on the user of the open source software certain requirements to license to others both the open source software as well as the software that relates to, or interacts with, the open source software. Our ability to commercialize products or technologies incorporating open source software or otherwise fully realize the anticipated benefits of any such acquisition may be restricted because, among other reasons:

- open source license terms may be ambiguous and may result in unanticipated obligations regarding our products;
- competitors will have improved access to information that may help them develop competitive products;
- open source software cannot be protected under trade secret law;
- it may be difficult for us to accurately determine the developers of the open source code and whether the acquired software infringes third party intellectual property rights; and
- open source software potentially increases customer support costs because licensees can modify the software and potentially introduce errors.

Use of Cash and Securities

Our available cash and securities may be used to acquire or invest in companies or products, possibly resulting in significant acquisition-related charges to earnings and dilution to our stockholders. For example, in October 2004 we used approximately $84.7 million, net of cash assumed, to acquire Foundstone. Moreover, if we acquire a company, we may have to incur or assume that company s liabilities, including liabilities that may not be fully known at the time of acquisition.

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We Face Risks Related to Our International Operations.

In the three months ended March 31, 2005 and the year ended December 31, 2004, net revenue in our operating regions outside of North America represented approximately 40% and 39% of our net revenue, respectively. We intend to focus on international growth and expect international revenue to remain a significant percentage of our net revenue.

Related risks include:

- longer payment cycles and greater difficulty in collecting accounts receivable;
- increased costs and management difficulties related to the building of our international sales and support organization;
- the acceptance of our business strategy and the reorganization of our international sales forces by regions;
- the ability to successfully localize software products for a significant number of international markets;
- our ability to effectively provide service and support for our hardware based products from the U.S.;
- our ability to successfully establish, manage and staff shared service centers for worldwide sales finance and accounting operations centralized from locations in the U.S. and Europe;
- our ability to adapt to sales practices and customer requirements in different cultures;
- compliance with more stringent consumer protection and privacy laws;
- currency fluctuations, including recent weakness of the U.S. dollar relative to other currencies, or the strengthening of the U.S. dollar in future periods that may have an adverse impact on revenues and risks related to hedging strategies;
- political instability in both established and emerging markets;
- tariffs, trade barriers and export restrictions;
- a high incidence of software piracy in some countries; and
- international labor laws and our relationship with our employees and regional work councils.

Additionally, our sales forces are organized by geographic region. This structure may lead to sales force competition for sales to multinational customers and may reduce our ability to effectively market our products to multinational customers.

We May Incur Significant Stock-Based Compensation Charges Related to Repriced Options, Assumed McAfee.com Options, IntruVert Restricted Stock and Options, Foundstone Options and Compensation Expenses Related to the Sniffer Bonus Plan and Foundstone Retention Payments.

We may incur stock-based compensation charges related to (i) employee options repriced in April 1999 (Repriced Options), (ii) McAfee.com options we assumed in the acquisition of the publicly traded McAfee.com shares in September 2002 (McAfee.com Options) (iii) unvested IntruVert options that were cancelled in May 2003 related to this acquisition (the IntruVert Options) and exchanged for cash placed in escrow, (iv) unvested IntruVert restricted stock that was cancelled in May 2003 related to this acquisition (the IntruVert Restricted Stock), and exchanged for monthly cash payments as the former employees provide services to us, (v) unvested Foundstone options assumed by us as part of the acquisition, (vi) the Sniffer Bonus Plan and (vii) Foundstone Key Employee retention payments. The size of the charges related to the Repriced Options and McAfee.com Options could be significant depending on the movements in the market value of our common stock. As a result of Financial Accounting Standards Board Interpretation No. 44, effective July 1, 2000, Repriced Options and McAfee.com Options are subject to variable accounting treatment. The stock-based compensation charge (or benefit) for the Repriced Options is determined by the excess of our closing stock price at the end of a reporting period over the fair value of our common stock on

July 1, 2000, equivalent to $20.375. The stock-based compensation charge (or benefit) for the McAfee Options is determined by the excess of our closing stock price over the exercise price of the option minus $11.85 payable upon exercise of the option. Remeasurement of the charge continues until the earlier of the date of exercise, forfeiture or cancellation without replacement. The resulting compensation charge (or benefit) to earnings will be recorded over the remaining life of the options subject to variable accounting treatment.

During the three months ended March 31, 2005 and 2004, the Company recorded a benefit of approximately $2.0 million and a charge of approximately $1.8 million, respectively, related to McAfee.com exchanged options, and a stock-based compensation charge of approximately $1.7 million was recorded in the three months ended March 31, 2005 for the McAfee.com repriced options.

During the remaining life of both the McAfee.com Options and Repriced Options, we may record additional stock-based compensation charges or benefits. Such charges or benefits cannot be forecasted. We estimate that a $1 increase in our stock price at March 31, 2005 would increase our future stock compensation charge by approximately $0.6 million.

For the cash paid to cancel the IntruVert Options that was placed in escrow, we have been recognizing compensation expense as the former IntruVert employees provide services to us. For the remainder of 2005, we expect to recognize $1.0 million in expense related to these payments, and an additional $0.8 million through 2007. For the IntruVert Restricted Stock, we have been recognizing compensation expense monthly since the acquisition and will continue to do so through 2006 as the former IntruVert employees provide services to us. For the remainder of 2005, we expect the expense to be approximately $0.3 million with respect to the IntruVert Restricted Stock.

In connection with the Foundstone acquisition, we exchanged McAfee stock options for Foundstone stock options. Approximately $1.2 million in compensation expense may be recorded through 2008 related to unvested McAfee options which were exchanged for unvested Foundstone options. We expect to record approximately $0.4 million in compensation expense during the remainder of 2005.

In connection with the Sniffer disposition, we implemented the Sniffer Bonus Plan primarily to encourage Sniffer s management to assist us in the sales process and remain with the business through the sale. Subject to reduction in certain cases, we expect total related cash payments of approximately $7.7 million, of which approximately $5.3 million was paid in 2004 and the balance is payable in the first quarter of 2006.

Approximately $25.0 million of the amount paid to acquire Foundstone was placed into escrow accounts. Of this amount, approximately $5.6 million was placed into a key employee escrow account and is being paid to four Foundstone employees as they provide services to us through September 2007. The Foundstone employees forfeit any unvested amounts if their employment is terminated under provisions in the escrow agreements. Any forfeited amounts will be returned to us. We recognized compensation expense of approximately $1.1 million in the three months ended March 31, 2005.

Customers May Cancel or Delay Purchases.

Weakening economic conditions, new product introductions and expansions of our business may increase the time necessary to sell our products and services and require us to spend more on our sales efforts. Our products and services may be considered to be capital purchases by our current or prospective customers. Capital purchases are often discretionary and, therefore, are canceled or delayed if the customer experiences a downturn in its business prospects or as a result of economic conditions in general.

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We Face Product Development Risks Associated with Rapid Technological Changes in Our Market.

The markets for our products are highly fragmented and characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements. Our success depends on our ability to timely and effectively:

- offer a broad range of network and system protection products;
- enhance existing products and expand product offerings;
- extend security technologies to additional digital devices;
- respond promptly to new customer requirements and industry standards;
- provide frequent, low cost upgrades and updates for our products; and
- remain compatible with popular operating systems such as Linux, NetWare, Windows XP, Windows 2000, Windows 98 and Windows NT, and develop products that are compatible with new or otherwise emerging operating systems.

We may experience delays in product development as we have at times in the past. Complex products like ours may contain undetected errors or version compatibility problems, particularly when first released, which could delay or harm market acceptance. Furthermore, Microsoft continues to execute on its announced plans to boost the security of its Windows platform with related acquisitions, including its acquisition of anti-virus providers GeCAD Software and Sybari Software and anti-spyware provider Giant Company Software. The widespread inclusion of products that perform the same or similar functions as our products within the Windows platform could reduce the perceived need for our products. Furthermore, even if these incorporated products are inferior or more limited than our products, customers may elect to accept the incorporated products rather than purchase our products. The occurrence of these events could negatively impact our revenue.

We Face a Number of Risks Related to Our Product Sales Through Distributors.

We sell a significant amount of our products through intermediaries such as distributors and other channel partners, referred to collectively as distributors. Our top ten distributors typically represent approximately 49% to 63% of our net sales in any quarter. We expect this percentage to increase as we continue to focus our sales efforts through the channel and other partners. Our two largest distributors, Ingram Micro and Tech Data, together accounted for approximately 27% of our net revenue in the three months ended March 31, 2005.

Sale of Competing Products

Our distributors may sell other vendors products that are complementary to, or compete with, our products. While we have instituted programs designed to motivate our distributors to focus on our products, these distributors may give greater priority to products of other suppliers, including competitors. Our ability to meaningfully increase the amount of our products sold through our distributors depends on our ability to adequately and efficiently support these distributors with, among other things, appropriate financial incentives to encourage pre-sales investment and sales tools, such as online sales and technical training as product collateral needed to support their customers and prospects. Any failure to properly and efficiently support our distributors may result in our distributors focusing more on our competitor s products rather than our products and thus in lost sales opportunities.

Loss of a Distributor

Our distributor agreements may be terminated by either party without cause. If one of our significant distributors terminates its distribution agreement, we could experience a significant interruption in the distribution of our products.

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Delayed Effectiveness

We recently began offering several of the Foundstone risk management products through distributors. We may not see immediate results from our distributors efforts as they introduce these and other new products to their customers.

Need for Accurate Distributor Information

We recognize revenue on products sold by our distributors when distributors sell our products to their customers. To determine our business performance at any point in time or for any given period, we must timely and accurately gather sales information from our distributors information systems at an increased cost to us. Our distributors information systems may be less accurate or reliable than our internal systems. We may be required to expend time and money to ensure that interfaces between our systems and our distributors systems are up to date and effective. In addition, as our reliance upon interdependent automated computer systems continues to increase, a disruption in any one of these systems could interrupt the distribution of our products and impact our ability to accurately and timely recognize and report revenue.

Payment Difficulties

Some of our distributors may experience financial difficulties, which could adversely impact our collection of accounts receivable. Our allowance for doubtful accounts was approximately $1.6 million at March 31, 2005. We regularly review the collectibility and credit-worthiness of our distributors to determine an appropriate allowance for doubtful accounts. Our uncollectible accounts could exceed our current or future allowances.

We Face the Risk of Future Charges in the Event of Impairment and Will Experience Significant Amortization Charges Related to Purchased Technology.

We adopted Statement of Financial Accounting Standard (SFAS) No. 142 (SFAS 142) beginning in 2002 and, as a result, we no longer amortize goodwill. However, we continue to have significant amortization related to purchased technology, trademarks, patents and other intangibles. Our amortization charge for purchased technology and other intangibles was approximately $7.4 million and $7.0 million in the three months ended March 31, 2005 and 2004. In addition, we must evaluate our goodwill, at least annually for impairment according to the guidance provided by SFAS 142. We completed the annual impairment review during the fourth quarter of 2004. Additionally, as required by SFAS 142, we also performed an additional goodwill impairment tests in conjunction with the sale of the Sniffer product line and the sale of the Magic product line. As a result of these reviews, goodwill was determined not to be impaired. If during subsequent testing, we determine that goodwill is impaired, we will be required to take a non-cash charge to earnings.

In addition, we will continue to evaluate potential impairments of our long lived assets, including our property and equipment and amortizable intangibles under SFAS 144 *Accounting for Impairment or Disposal of Long-Lived Assets.* For 2004, we determined that we had no impairment of our property and equipment and amortizable intangibles.

We Face Risks Related to Our Strategic Alliances.

We may not realize the desired benefits from our strategic alliances on a timely basis or at all. We face a number of risks relating to our strategic alliances, including the following:

- Our strategic alliances are generally terminable by either party with no or minimal notice or penalties. We may expend significant time, money and resources to further strategic alliances that are thereafter terminated.

- Business interests may diverge over time, which might result in conflict, termination or a reduction in collaboration. For example, our alliance with Internet Security Systems was terminated following the announcement of our acquisition in 2003 of Entercept and IntruVert.

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Strategic alliances require significant coordination between the parties involved. To be successful, our alliances may require the integration of other companies   products with our products, which may involve significant time and expenditure by our technical staff and the technical staff of our strategic allies.

Our sales and marketing force may require additional training to market products that result from our strategic alliances. The marketing of these products may require additional sales force efforts and may be more complex than the marketing of our own products.

The integration of products from different companies may be more difficult than we anticipate, and the risk of integration difficulties, incompatible products and undetected programming errors or bugs may be higher than that normally associated with new products.

Our strategic alliances may involve providing professional services, which might require significant additional training of our professional services personnel and coordination between our professional services personnel and other third-party professional service personnel.

We may be required to share ownership in technology developed as part of our strategic alliances.

Due to the complex nature of our products and of those parties with whom we have strategic alliances, it may take longer than we anticipate to successfully integrate and market our respective products.

Our Products Face Manufacturing, Supply, Inventory, Licensing and Obsolescence Risks.

Third-Party Manufacturing

We rely on a small number of third parties to manufacture some of our hardware-based network protection and system protection products. We expect the number of our hardware-based products and our reliance on third-party manufacturers to increase as software-only network and system security solutions become less viable. Reliance on third-party manufacturers, including software replicators, involves a number of risks, including the lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. If any of our third party manufacturers cannot or will not manufacture our products in required volumes on a cost-effective basis, in a timely manner, at a sufficient level of quality, or at all, we will have to secure additional manufacturing capacity. Even if this additional capacity is available at commercially acceptable terms, the qualification process could be lengthy and could cause interruptions in product shipments. The unexpected loss of any of our manufacturers would be disruptive to our business.

Sourcing

Our products contain critical components supplied by a single or a limited number of third parties. Any significant shortage of components or the failure of the third-party supplier to maintain or enhance these products could lead to cancellations of customer orders or delays in placement of orders.

Third-Party Licenses

Some of our products incorporate software licensed from third parties. We must be able to obtain reasonably priced licenses and successfully integrate this software with our hardware. In addition, some of our products may include   open source   software. Our ability to commercialize products or technologies incorporating open source software may be restricted because, among other reasons, open source license terms may be ambiguous and may result in unanticipated obligations regarding our products.

Obsolescence

Hardware based products may face greater obsolescence risks than software products. We could incur losses or other charges in disposing of obsolete inventory.

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We Face Risks Related to Customer Outsourcing to System Integrators.

Some of our customers have outsourced the management of their information technology departments to large system integrators. If this trend continues, our established customer relationships could be disrupted and our products could be displaced by alternative system and network protection solutions offered by system integrators. Significant product displacements could impact our revenue and have a material adverse effect on our business.

We Rely Heavily on Our Intellectual Property Rights Which Offer Only Limited Protection Against Potential Infringers.

We rely on a combination of contractual rights, trademarks, trade secrets, patents and copyrights to establish and protect proprietary rights in our software. However, the steps taken by us to protect our proprietary software may not deter its misuse or theft. We are aware that a substantial number of users of our anti-virus products have not paid any registration or license fees to us. Competitors may also independently develop technologies or products that are substantially equivalent or superior to our products. Certain jurisdictions may not provide adequate legal infrastructure for effective protection of our intellectual property rights. Changing legal interpretations of liability for unauthorized use of our software or lessened sensitivity by corporate, government or institutional users to avoiding infringement of intellectual property could also harm our business.

Intellectual Property Litigation in the Network and System Security Market Is Common and Can Be Expensive.

Litigation may be necessary to enforce and protect trade secrets and other intellectual property rights that we own. Similarly, we may be required to defend against claimed infringement by others.

In addition to the expense and distractions associated with litigation, adverse determinations could:

- result in the loss of our proprietary rights;
- subject us to significant liabilities, including monetary liabilities;
- require us to seek licenses from third parties; or
- prevent us from manufacturing or selling our products.

The litigation process is subject to inherent uncertainties. We may not prevail in these matters, or we may be unable to obtain licenses with respect to any patents or other intellectual property rights that may be held valid or infringed upon by our products or us.

If we acquire a portion of software included in our products from third parties, our exposure to infringement actions may increase because we must rely upon these third parties as to the origin and ownership of any software being acquired. Similarly, notwithstanding measures taken by our competitors or us to protect our competitors intellectual property, exposure to infringement claims increases if we employ or hire software engineers previously employed by competitors. Further, to the extent we utilize open source software we face risks. For example, the scope and requirements of the most common open source software license, the GNU General Public License (GPL), have not been interpreted in a court of law. Use of GPL software could subject certain portions of our proprietary software to the GPL requirements. Other forms of open source software licensing present license compliance risks, which could result in litigation or loss of the right to use this software.

Pending or Future Litigation Could Have a Material Adverse Impact on Our Results of Operation and Financial Condition.

In addition to intellectual property litigation, from time to time, we have been subject to other litigation. Where we can make a reasonable estimate of the liability relating to pending litigation and determine that it is probable, we record a related liability. As additional information becomes available, we assess the potential liability and revise estimates as appropriate. However, because of uncertainties relating to litigation, the amount of our estimates could be wrong. In addition to the related cost and use of cash, pending or future litigation could cause the diversion of management s attention and resources.

Our Stock Price Has Been Volatile and Is Likely to Remain Volatile.

During 2004, our stock price was highly volatile ranging from a per share high of $33.55 to a low of $14.96. On March 31, 2005, our stock s closing price per share price was $22.56. Announcements, business developments, such as a material acquisition or disposition, litigation developments and our ability to meet the expectations of investors with respect to our operating and financial results, may contribute to current and future stock price volatility. Certain types of investors may choose not to invest in stocks with this level of stock price volatility. Further, we may not discover, or be able to confirm, revenue or earnings shortfalls until the end of a quarter. This could result in an immediate drop in our stock price.

We Face the Risk of a Decrease in Our Cash Balances and Losses in Our Investment Portfolio.

Our cash balances are held in numerous locations throughout the world. A portion of our cash is invested in marketable securities as part of our investment portfolio. We rely on third party money managers to manage our investment portfolio. Among other factors, changes in interest rates, foreign currency fluctuations and macro economic conditions could cause our cash balances to fluctuate and losses in our investment portfolio. Most amounts held outside the United States could be repatriated to the United States, but, under current law, would be subject to U.S. federal income tax, less applicable foreign tax credits.

Product Liability and Related Claims May Be Asserted Against Us.

Our products are used to protect and manage computer systems and networks that may be critical to organizations. Because of the complexity of the environments in which our products operate, an error, failure or bug in our products, including a security vulnerability, could disrupt or cause damage to the networks of our customers, including disruption of legitimate network traffic by our intrusion prevention products. Failure of our products to perform to specifications, disruption of our customers network traffic or damages to our customer s networks caused by our products could result in product liability damage claims by our customers. Our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that the limitation of liability provisions may not be effective under the laws of certain jurisdictions, particularly in circumstances involving unsigned licenses.

Computer Hackers May Damage Our Products, Services and Systems.

Due to our high profile in the network and system protection market, we have been a target of computer hackers who have, among other things, created viruses to sabotage or otherwise attack our products and services, including our various websites. For example, we have seen the spread of viruses, or worms, that intentionally delete anti-virus and firewall software. Similarly, hackers may attempt to penetrate our network security and misappropriate proprietary information or cause interruptions of our internal systems and services. Also, a number of websites have been subject to denial of service attacks, where a website is bombarded with information requests eventually causing the website to overload, resulting in a delay or disruption of service. If successful, any of these events could damage users or our computer systems. In addition, since we do not control CD duplication by distributors or our independent agents, CDs containing our software may be infected with viruses.

False Detection of Viruses and Actual or Perceived Security Breaches Could Adversely Affect Our Business.

Our anti-virus software products have in the past, and these products and our intrusion protection products may at times in the future, falsely detect viruses or computer threats that do not actually exist. These false alarms, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. In addition, we have in the past been subject to

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litigation claiming damages related to a false alarm, and similar claims may be made in the future. An actual or perceived breach of network or computer security at one of our customers, regardless of whether the breach is attributable to our products, could adversely affect the market s perception of our security products.

We Face Risks Related to Our Anti-Spam and Anti-Spyware Software Products.

Our anti-spam and anti-spyware products may falsely identify emails or programs as unwanted spam or potentially unwanted programs, or alternatively fail to properly identify unwanted emails or programs, particularly as spam emails or spyware are often designed to circumvent anti-spam or spyware products. Parties whose emails or programs are blocked by our products may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or programs as unwanted spam or potentially unwanted programs may reduce the adoption of these products.

Business Interruptions May Impede Our Operations and the Operations of Our Customers.

We have implemented a new customer relationship management information system. Our ability to continue to obtain support from the manufacturer of this system is critical to the ultimate success of the implementation. We are also in the process of transitioning finance and sales order processing to a new shared services center in Cork, Ireland and are planning modifications to our accounting systems which we expect to complete in 2005. Implementation and modifications of these types of computer systems are often disruptive to business and may cause us to incur higher costs than we anticipate. Failure to manage a smooth transition to the new shared services center and the implementation of a new customer relationship management could materially harm our business operations. In addition, we and our customers face a number of potential business interruption risks that are beyond our respective control. Natural disasters or other events could interrupt our business or the business of our customers, and each of us is reliant on external infrastructure that may be antiquated. Also, an outbreak of SARS, bird flu or other highly contagious illnesses could have an adverse impact on our operations and the operations of our customers. Our corporate headquarters are located near a major earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure and overall operations is not known. Despite safety precautions that have been implemented, there is no guarantee that an earthquake would not seriously disturb our entire business process. We are largely uninsured for losses and business disruptions caused by an earthquake and other natural disasters.

Potential Terrorist Attacks and Any Governmental Response Could Have a Material Adverse Effect on the U.S. and Global Economies and Could Adversely Impact the Internet and Our Products and Business.

The U.S. military global presence, coupled with the possibility of potential terrorist attacks, could have a continued adverse effect upon an already weakened world economy and could cause U.S. and foreign businesses to slow spending on products and services, delay sales cycles and otherwise negatively impact consumer and business confidence. Terrorists may also seek to interfere with the operation of the Internet, the operation of our customers computer systems and networks, and the operation of our systems and networks, particularly given our status as an American company providing security products. Any significant interruption of the Internet could adversely impact our ability to rapidly and efficiently provide anti-virus and other product updates to our customers.

Cryptography Contained in Our Technology is Subject to Export Restrictions.

Some of our computer security solutions, particularly those incorporating encryption, may be subject to export restrictions. As a result, some products may not be exported to international customers without prior U.S. government approval. The list of products and end users for which export approval is required, and the regulatory policies with respect thereto, are subject to revision by the U.S. government at any time. The cost of compliance with U.S. and international export laws and changes in existing laws could affect our ability to sell certain products in certain markets and could have a material adverse effect on our international revenues.

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Our Charter Documents and Delaware Law and Our Rights Plan May Impede or Discourage a Takeover, Which Could Lower Our Stock Price.

Our Charter Documents and Delaware Law

Pursuant to our charter, our board of directors has the authority to issue up to 5.0 million shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by our stockholders. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock.

Our classified board and other provisions of Delaware law and our certificate of incorporation and bylaws, could also delay or make a merger, tender offer or proxy contest involving us more difficult. For example, any stockholder wishing to make a stockholder proposal (including director nominations) at our 2005 annual meeting, must meet the qualifications and follow the procedures specified under both the Exchange Act of 1934 and our bylaws.

Our Rights Plan

Our board of directors has adopted a stockholders rights plan. The rights will become exercisable the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer the consummation of which would result in ownership by the person or group of 15% or more of our common stock. If the rights become exercisable, the holders of the rights (other than the person acquiring 15% or more of our common stock) will be entitled to acquire in exchange for the rights exercise price, shares of our common stock or shares of any company in which we are merged with a value equal to twice the rights exercise price.

Item 3. *Quantitative and Qualitative Disclosure About Market Risk*

Our market risks at March 31, 2005, have not changed significantly from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

Item 4. *Controls and Procedures*

Our management evaluated, with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f) as of the end of the period covered by this quarterly report on Form 10-Q.

A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all error and fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdown can occur because of simple error or mistake. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Based upon the material weaknesses described in Item 9A of our Annual Report on Form 10-K filed on March 31, 2005, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, and internal controls over financial reporting, were ineffective as of

March 31, 2005. In addition, described below are changes in internal controls over financial reporting made during the quarter ended March 31, 2005. Except as described below, there has been no change in our internal control over financial reporting that occurred during the quarter ended March 31, 2005, which materially affected, or is reasonably likely to affect, our internal controls over financial reporting.

Changes in Internal Control over Financial Reporting

During the first quarter of 2005, we did not make any material changes to our disclosure controls and procedures or internal controls over financial reporting. We have undertaken significant efforts in 2004 and during the first quarter of 2005 to establish a framework to improve internal controls over financial reporting. We have committed considerable resources to the design, implementation, documentation and testing of our internal controls. Additional resources have been assigned to remediate and re-test certain internal control deficiencies, such as the material weaknesses described above, identified during our first annual assessment of our internal controls. While these steps have helped address some of the internal control deficiencies noted in our assessment of internal controls as of December 31, 2004, due to the limited amount of time that has transpired since completion of our annual assessment, the steps taken have not been sufficient to fully remedy the control issues that existed as of December 31, 2004. We have either performed or are in process of performing the following actions to remediate the deficiencies in our internal controls:

Accounting for Income Taxes

We retained consultants to assist with the first quarter tax processes to provide sufficient personnel for the timely completion of account reconciliation procedures, preparation and analyses of documentation on key judgments, additional levels of review and enhanced documentation of the analyses and internal controls performed.

In connection with developing our effective tax rate estimates we modified our procedures used to estimate the proportion of expected earnings in the United States and other foreign jurisdictions to enable more detailed estimates to be performed. Additionally, we added disclosures in our critical accounting policies section in *Management s Discussion and Analysis of Financial Condition and Results of Operations* to more fully explain the nature of our interim period tax estimates.

We have expanded our analyses of our tax accounts at interim periods which we believe will enable our year end procedures to be performed more timely, including but not limited to, reperformance of reconciliations that were historically deemed ineffective.

We have implemented a quarterly review of our tax reserves and related exposures to ensure that any related liabilities or discrete releases are identified and recorded timely .

We have increased the level of reporting and analysis provided to our senior financial executives and in turn have benefited from resulting improvements in our documentation, analyses and estimates.

We completed our performance of our key interim tax controls in a timely manner as determined by our internal closing schedule and published timetable for issuing our first quarter earnings release.

Revenue Accounting

We have centralized our order processing operations and related revenue accounting processes from Latin America to Plano, Texas to address difficulties experienced by certain regions in performing internal controls related to revenue recognition matters.

We have begun implementing automated controls to compare prices in our invoice register resulting from the automated revenue recognition process performed by our systems to the published prices in our price lists to detect and correct improper system set up and/or processing of product stock keeping units.

We have hired a director of revenue as well as formalized a hiring plan for additional personnel in our revenue recognition group to enable improved review and analysis of evidence of fair value of our post contract support provided to different customer groups as well as analysis and review of complex terms in our OEM and large contractual customer arrangements.

Financial Close and Reporting Process

We continue to utilize consultants to assist with technical accounting matters as we continue to recruit and hire both replacement personnel in response to ongoing attrition as well as hiring additional corporate accounting staff in response to the deficiencies noted in the annual assessment.

While we believe we have taken many positive steps towards remediating the deficiencies noted in the above areas, due to the limited amount of time that has transpired from the completion of our first annual internal controls assessment, there remain significant additional actions necessary over the remainder of 2005 and potentially subsequent periods, as follows:

- Increasing the number of internal general ledger and tax accounting personnel trained in reporting under accounting principles generally accepted in the United States (GAAP)
- Improving the documentation, communication and periodic review of our accounting policies throughout our domestic and international locations for consistency and application with GAAP at each of our operating locations
- Improving the interim review and reconciliation process for certain key account balances
- Enhancing the training and education for our international finance and accounting personnel and new hire additions to the worldwide finance team
- Implementing more stringent policies and procedures regarding revenue accounting and change management of our product catalogue
- Directing more internal audit time and attention to sales order processing and revenue accounting activities
- Increasing diligence regarding user access and change management to our network, databases and applications
- Automating certain controls that are currently performed manually
- Simplifying and integrating systems

Other Changes in Internal Control over Financial Reporting

We have moved the EMEA shared services center and localization operations from Amsterdam to Cork, Ireland. This event has resulted in the loss of experienced personnel unwilling to relocate. We have hired new personnel who are in the process of being trained in our operations and our review and control procedures. As a result, we have increased our review of accounting information processed in our EMEA shared service center and expect to take further steps to increase (i) training and (ii) internal controls documentation and testing under our 2005 internal controls assessment plans.

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PART II: OTHER INFORMATION

Item 1. ***Legal Proceeding***

Information with respect to this item is incorporated by reference to Note 11 of the notes to the condensed consolidated financial statements included in this Report on Form 10-Q.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

Stock Repurchases

The table below sets forth all repurchases by us of our common stock during the quarter ended March 31, 2005 whether or not pursuant to a publicly announced plan or program (in thousands, except price per share):

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Repurchase Program(1)	Approximate Dollar Value of Shares That May yet Be Purchased Under Our Stock Repurchase Program(1)
January 1, 2005 through January 31, 2005		$		$ 123,556
February 1, 2005 through February 28, 2005				123,556
March 1, 2005 through March 31, 2005	2,000	23.66	2,000	76,245
Total	2,000	$ 23.66	2,000	

(1) In August 2004, our board of directors authorized the repurchase of $200.0 million of our common stock in the open market from time to time over the next two years. As of December 31, 2004, we had remaining authorization to repurchase $123.6 million of our common stock. In April 2005, our board of directors authorized the repurchase of an additional $175.0 million of our common stock in the open market from time to time until August 2006, depending upon market conditions, share price and other factors. After this $175.0 million increase in our announced stock repurchase program, the approximate dollar value of shares that may yet be purchased under this program is $251.2 million.

Item 3. ***Defaults upon Senior Securities***

None.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

Item 5. ***Other Information***

On March 31, 2005, we filed with the SEC our Annual Report on Form 10-K for the year ended December 31, 2004. In connection with the preparation of this quarterly report on Form 10-Q, we discovered errors contained in our Form 10-K, specifically relating to our future operating lease obligations. The errors were contained in Note 11 to the

Consolidated Financial Statements and the Contractual Obligations section of Management s Discussion and Analysis of Financial Condition and Results of Operations. The errors related to our operating lease obligations and resulted in an overstatement in the dollar amount of the future minimum obligations for the years 2005 through 2009 and thereafter.

The error in the future operating lease obligations disclosure will not affect our consolidated balance sheet, consolidated statements of income, consolidated statements of stockholders equity, or consolidated statements of cash flow for the year ended December 31, 2004.

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Upon identification of the errors in the operating lease disclosure, our management and Audit Committee discussed this matter and its effect on our financial statements. Our Audit Committee of our Board of Directors concluded on May 6, 2005 that our Annual Report on Form 10-K for the year ended December 31, 2004, should be amended to correct the above-described errors. Therefore, Note 11 to the Consolidated Financial Statements and the Contractual Obligations section of Management s Discussion and Analysis of Financial Condition and Results of Operations should no longer be relied upon. Our Audit Committee and executive officers discussed the matters disclosed in this Item 5 with our independent registered public accounting firm, Deloitte & Touche, LLP.

As a result of the errors described above, we are filing an amendment to our Annual Report on Form 10-K for the year ended December 31, 2004. We expect to file the amendment to our Form 10-K by no later than May 31, 2005.

Item 6. *Exhibits*

(a) *Exhibits.* The exhibits listed in the accompanying Exhibit Index are filed or incorporated by reference as part of this Report.

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SIGNATURES

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

McAfee Inc.

/s/ Eric F. Brown

Eric F. Brown
Chief Financial Officer

May 10, 2005

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EXHIBIT INDEX

Exhibit Number	Description
2.1	Asset Purchase Agreement made and entered into as of April 22, 2004, by and among, Network General Corporation (formerly named Starburst Technology Holdings, Inc.), on the one hand; and (ii) McAfee, Inc. (formerly named Networks Associates, Inc.), Network Associates Technology, Inc., Network Associates International BV, Network Associates (India) Private Limited, McAfee Japan Co., Ltd. (formerly named Network Associates Japan Co., Ltd.), on the other hand, as amended by Amendment No. 1 thereto dated as of July 15, 2004.(1)
3.1	Second Restated Certificate of Incorporation of the Registrant, as amended on December 1, 1997.(3)
3.2	Certificate of Ownership and Merger between Registrant and McAfee, Inc.(2)
3.3	Amended and Restated Bylaws of the Registrant.(2)
3.4	Certificate of Designation of Series A Preferred Stock of the Registrant.(5)
3.5	Certificate of Designation of Series B Participating Preferred Stock of the Registrant.(6)
4.3	Indenture dated as of August 17, 2001 between the Registrant and State Street Bank and Trust Company of California.(7)
10.1	Lease Assignment dated November 17, 1997 for facility at 3965 Freedom Circle, Santa Clara, California by and between Informix Corporation and McAfee Associates, Inc.(8)
10.2	Consent to Assignment Agreement dated December 19, 1997 by and among Birk S. McCandless, LLC, Guaranty Federal Bank, F.S.B., Informix Corporation and the Registrant.(8)
10.3	Subordination, Nondisturbance and Attornment Agreement dated December 18, 1997, between Guaranty Federal Bank, F.S.B., the Registrant and Birk S. McCandless, LLC.(8)
10.4	Lease dated November 22, 1996 by and between Birk S. McCandless, LLC and Informix Corporation for facility at 3965 Freedom Circle, Santa Clara, California.(8)
10.5*	2002 Employee Stock Purchase Plan.(9)
10.6*	1997 Stock Incentive Plan, as Amended.(9)
10.7*	Amended and Restated 1993 Stock Option Plan for Outside Directors.(4)
10.8*	2000 Nonstatutory Stock Option Plan.(10)
10.9*	Amended and Restated Employment Agreement between George Samenuk and the Registrant, dated October 9, 2001.(11)
10.10*	Employment agreement between Stephen C. Richards and the Registrant, dated April 3, 2001.(12)
10.11	1st Amendment to Lease dated March 20, 1998 between Birk S. McCandless, LLC and the Registrant.(13)
10.12	Confirmation, Amendment and Notice of Security Agreement dated March 20, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
10.13	Second Amendment to Lease dated September 1, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
10.14	Subordination, Nondisturbance and Attornment Agreement dated June 21, 2000, among Column Financial, Inc., Informix Corporation, Birk S. McCandless, LLC, and the Registrant.(13)
10.15	Lease Agreement dated November 14, 1996 between Blue Lake Partners and McAfee Associates, Inc.(13)

10.16	Lease Amendment dated November 24, 1997 between Blue Lake Partners and McAfee Software, Inc.(13)
10.17	Lease Amendment dated March 17, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.18	Lease Amendment dated March 27, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.19	Lease Amendment dated June 4, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.20	Lease Amendment dated July 21, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.21	Lease Amendment dated November 20, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)

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Exhibit Number	Description
10.22	Lease Amendment dated March 18, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.23	Lease Amendment dated June 3, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.24	Lease Amendment dated October 7, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.25	Lease Amendment dated March 25, 2000 between Daltex Centre LP and the Registrant.(13)
10.26	Lease Amendment dated July 31, 2000 between Daltex Centre LP and the Registrant.(13)
10.27	Lease Amendment dated January 24, 2001 between Daltex Centre LP and the Registrant.(13)
10.28	Lease Amendment dated May 31, 2001 between Daltex Centre LP and the Registrant.(13)
10.29*	Employment Agreement between Kent H. Roberts and the Registrant, dated October 9, 2001.(14)
10.30*	Employment Agreement between Vernon Gene Hodges and the Registrant, dated December 3, 2001.(14)
10.31	Intentionally Omitted
10.32*	Employment Agreement between Kevin M. Weiss and the Registrant Dated October 15, 2002.(17)
10.33	Form of Indemnification Agreement between the Registrant and its Executive Officers(17)
10.34*	Summary of Pay for Performance Plan.(4)
10.35*	Network Associates, Inc. Tax Deferred Savings Plan.(16)
10.36	Umbrella Credit Facility of Registrant dated April 15, 2004.(18)
10.37	Fifth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(18)
10.38	Amendment to Employment Agreement of George Samenuk effective as of January 20, 2004.(18)
10.39	Amendment to Employment Agreement of Stephen C. Richards effective as of January 20, 2004.(18)
10.40	Sixth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(20)
10.41	Transition Agreement by and between Registrant and Stephen C. Richards.(19)
10.42	Employment Agreement between Registrant and Eric F. Brown dated December 10, 2004 (22)
10.43*	2005 Independent Director Cash Compensation Plan (23)
10.44*	Executive Officer Annual Compensation for Fiscal Year Ending December 31, 2005(24)
31.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference from the Registrant s Report on Form 8-K filed with the Commission on July 16, 2004.

(2) Incorporated by reference from the Registrant s Report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.

(3) Incorporated by reference from the Registrant s Registration Statement on Form S-4 filed with the Commission on March 25, 1998.

(4) Incorporated by reference from the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002, filed with the Commission on October 31, 2003.

(5) Incorporated by reference from the Registrant s Report on Form 10-Q for the quarter ended September 30, 1996, filed with the Commission on November 14, 1996.

(6) Incorporated by reference from the Registrant s Report on Form 8-A filed with the Commission on October 22, 1998.

(7) Incorporated by reference from the Registrant s Registration Statement on Form S-3 filed with the Commission on November 9, 2001.

(8) Incorporated by reference from the Registrant s Registration Statement on Form S-3, filed with the Commission on February 11, 1998.

(9) Incorporated by reference from the Registrant s Registration Statement on Form S-8 filed with the Commission on June 28, 2002.

(10) Incorporated by reference from the Registrant s report on Form 10-K for the year ended December 31, 2000, filed with the Commission on April 2, 2001.

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

(12) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended March 31, 2001, filed with the Commission on May 15, 2001.

(13) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended September 30, 2001, filed with the Commission on November 13, 2001.

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

(15) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended September 30, 2002, filed with the Commission on November 12, 2002.

(16) Incorporated by reference from the Registrant s Registration Statement on Form S-8 filed with the Commission on November 5, 2003.

(17) Incorporated by reference from the Registrant s report on Form 10-K for the year ended December 31, 2003, filed with the Commission on March 9, 2004.

(18) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended March 31, 2004, filed with the Commission on May 10, 2004.

(19) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on September 7, 2004.

(20) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended June 30, 2004, filed with the Commission on August 9, 2004.

(21) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.

(22) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on December 14, 2004.

(23) Incorporated by reference from the Registrant s report on Form 10-K for the year ended December 31, 2004, filed with the Commission on March 31, 2005.

(24) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on April 22, 2005.

* Management contracts or compensatory plans or arrangements covering executive officers or directors of McAfee, Inc.