NETWORKS ASSOCIATES INC/
Form 10-Q/A
June 28, 2002

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/ A

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

For the quarterly period ended March 31, 2001

or

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

For the transition period from to .

Commission file number 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0316593**
(State of incorporation)	*(IRS Employer Identification Number)*

3965 Freedom Circle

Santa Clara, California 95054
(408) 988-3832
(Address and telephone number of principal executive offices)

Indicate by check mark whether 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, and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

136,665,321 shares of the registrant s common stock, $0.01 par value, were outstanding as of March 31, 2001.

EXPLANATORY NOTE:

THIS 10-Q/ A IS BEING FILED FOR THE PURPOSE OF AMENDING AND RESTATING ITEMS 1, 2 AND 3 OF PART I OF FORM 10-Q TO REFLECT THE RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE PERIODS ENDED MARCH 31, 2001 AND 2000. WE HAVE MADE NO FURTHER CHANGES TO THE PREVIOUSLY FILED 10-Q. ALL INFORMATION IN THE FORM 10-Q/ A IS AS OF MARCH 31, 2001 AND DOES NOT REFLECT ANY SUBSEQUENT INFORMATION OR EVENTS OTHER THAN THE RESTATEMENT.

This document contains 51 pages.

The Exhibit Index is on page 48.

TABLE OF CONTENTS

Table of Contents

NETWORKS ASSOCIATES, INC.

FORM 10-Q/A

March 31, 2001

CONTENTS

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2001	December 31, 2000
	(As restated see Note 2)	(As restated see Note 2)
	(In thousands, except share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 298,354	$ 275,539
Short term marketable securities	70,894	85,721
Accounts receivable, net	80,457	122,315
Prepaid expenses, income taxes and other current assets	43,024	50,346
Deferred taxes	96,963	86,771
Total current assets	589,692	620,692
Long term marketable securities	267,286	332,893
Fixed assets, net	75,348	75,499
Deferred taxes	125,452	120,261
Intangibles and other assets	220,951	242,275
Total assets	$ 1,278,729	$ 1,391,620
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 33,469	$ 46,816
Accrued liabilities	242,935	254,282
Deferred revenue	163,543	151,566
Total current liabilities	439,947	452,664
Deferred taxes	7,161	7,971
Deferred revenue, less current portion	27,779	26,592
Convertible debt	399,858	396,336
Other long term debt and liabilities	861	532
Total liabilities	875,606	884,095
Commitments and contingencies (Note 10)		
Minority Interest	10,576	11,067
Common stock, $0.01 par value; Authorized: 300,000,000; Issued: 139,328,528 shares at March 31, 2001 and December 31, 2000; Outstanding: 136,665,321 shares at March 31, 2001 and 138,089,775 shares at December 31, 2000	1,393	1,381
Treasury stock, at cost: 2,663,207 shares at March 31, 2001 and 1,238,753 shares at December 31, 2000	(65,127)	(23,186)
Additional paid-in capital	687,247	685,423
Accumulated other comprehensive loss unrealized gain (loss) on investments and foreign currency translation	(39,595)	(31,266)

Accumulated Deficit	(191,371)	(135,894)
Total stockholders equity	392,547	496,458
Total liabilities, minority interest, and stockholders equity	$1,278,729	$1,391,620

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

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three Months Ended March 31,	
	2001	2000
	(As reclassified see Note 2)	(As restated and reclassified see Note 2)
	(In thousands, except per share data) (Unaudited)	
Net revenue:		
Product	$ 92,501	$ 139,671
Services and support	63,095	47,517
Total net revenue	155,596	187,188
Cost of net revenue:		
Product	23,460	22,738
Services and support	13,227	9,275
Total cost of net revenue	36,687	32,013
Operating costs and expenses:		
Research and development(1)	39,973	41,175
Marketing and sales(2)	100,817	93,315
General and administrative(3)	22,139	13,413
Amortization of intangibles	15,845	14,430
Total operating cost and expenses	178,774	162,333
Loss from operations	(59,865)	(7,158)
Interest and other income and expense, net	1,362	7,252
Gain (loss) on investments, net		40,373
Income (loss) before provision for income taxes and minority interest	(58,503)	40,467
Provision for (benefit from) income taxes	(10,440)	20,999
Net income (loss) before minority interest	(48,063)	19,468
Minority interest in loss of consolidated subsidiaries	702	1,123
Net income (loss)	$ (47,361)	$ 20,591
Other comprehensive income (loss):		
Unrealized gain (loss) on investments, net	$ (8,013)	$ 5,630
Foreign currency translation loss	(316)	(1,965)
Comprehensive income (loss)	$ (55,690)	$ 24,256

Net income (loss) per share basic	$ (0.35)	$ 0.15
Shares used in per share calculation basic	137,140	138,877
Net income (loss) per share diluted	$ (0.35)	$ 0.14
Shares used in per share calculation diluted	137,140	144,372

(1) Includes stock-based compensation charge of $91 and $454 for the three months ended March 31, 2001 and 2000, respectively.

(2) Includes stock-based compensation charge of $144 and $720 for the three months ended March 31, 2001 and 2000, respectively.

(3) Includes stock-based compensation charge of $1,421 and $392 for the three months ended March 31, 2001 and 2000, respectively.

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

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2001	**2000**
		(As restated see Note 2)
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Net income (loss)	$ (47,361)	$ 20,591
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization, and bad debt expense	14,693	18,813
Interest on convertible notes	4,687	4,465
Realized gain (loss) on investments	(3,876)	125
Impairment of strategic investments	5,000	
Minority interest	(702)	(1,123)
Deferred taxes	(17,249)	(10,676)
Stock compensation charges	1,656	1,566
Gain on sale of Goto.com investment		(28,551)
Gain on sale of Network Associates Japan investment		(11,947)
Changes in assets and liabilities:		
Accounts receivable	54,018	13,151
Prepaid expenses, taxes and other	974	(12,654)
Accounts payable and accrued liabilities	(21,307)	35,310
Deferred revenue	16,411	3,728
Net cash provided by operating activities	6,944	32,798
Cash flows from investing activities:		
Purchase of marketable securities	(107,164)	(150,490)
Proceeds from sale of marketable securities	183,277	170,216
Purchase of investments		(4,650)
Proceeds from Goto.com investment		36,750
Proceeds from sale of shares of Network Associates Japan		11,947
Acquisitions by subsidiary		(1,981)
Additions to fixed assets	(8,752)	(11,144)
Net cash provided by investing activities	67,361	50,648
Cash flows from financing activities:		
Repayment of notes payable		(67)
Proceeds from issuance of common stock from option plan and stock purchase plans	4,682	9,440
Repurchase of common stock	(53,800)	(27,442)
Other	(548)	1,330
Proceeds from sale of put options		7,890
Net cash used in financing activities	(49,666)	(8,849)
Effect of exchange rate fluctuations	(1,824)	(22,069)

Net increase in cash and cash equivalents	22,815	52,528
Cash and cash equivalents at beginning of period	275,539	316,784
Cash and cash equivalents at end of period	$ 298,354	$ 369,312
Non cash investing activities:		
Unrealized gain (loss) on investments	$ (8,013)	$ 5,630

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

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The unaudited, condensed consolidated financial statements have been prepared by Networks Associates, Inc. (the Company) without audit in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X. The unaudited, condensed consolidated financial statements include the accounts of the Company and its majority owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The Company has two reportable segments consisting of computer security and management software, and managed security and availability application services to business users on the Internet (Infrastructure) and consumer PC security and management software on the Internet (McAfee.com).

In the opinion of management, all adjustments, consisting only of normal recurring adjustments considered necessary for a fair presentation, have been included. The results of operations for the three month period ended March 31, 2001 are not necessarily indicative of the results to be expected for the full year or for any future periods. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements contained in the Company s Annual Report on Form 10-K/ A filed with the Securities and Exchange Commission on June 28, 2002. The balance sheet at December 31, 2000 has been derived from the audited financial statements as of and for the year ended December 31, 2000, but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements.

Certain reclassifications have been made to the 2000 unaudited condensed consolidated financial statements and related notes to conform to the 2001 presentation.

2. Restatement and Adoption of New Accounting Pronouncements

On April 25, 2002, the Company announced that it had discovered accounting inaccuracies in certain prior period financial statements requiring restatement of the financial statements for these periods. The Company conducted an internal investigation under the direction of the Audit Committee of its Board of Directors to determine the scope and magnitude of these inaccuracies. On May 17, 2002, the Company announced that the Audit Committee of its Board of Directors had completed its internal accounting investigation. As a result of the internal accounting investigation, the Company s statement of operations, cash flows and stockholders equity for the years ended December 31, 2000, 1999 and 1998 and the balance sheets as of December 31, 2000, 1999 and 1998 are being restated. In addition, to give effect to accumulated prior period adjustments and their related tax impacts, the Company announced the restatement of its December 31, 2001 and March 31, 2002 balance sheets. As a result, the Company is also restating its condensed consolidated statements of operations and cash flows for the three months ended March 31, 2000 and condensed consolidated balance sheet as of March 31, 2001, which are included in this Form 10-Q/A. The statement of operations and cash flows for the year ended March 31, 2001 were not impacted by this restatement.

The Audit Committee s investigation determined that inaccurate accounting entries were made in 2000, 1999 and 1998, which required restatement. In 2000, these entries (a) recorded payments to a distributor in a balance sheet tax liability account instead of reducing Net revenue, (b) reclassified amounts from a tax liability account to the general and administrative and marketing and sales liability accounts, understating general and administrative and marketing and sales expenses, (c) recorded additions to sales return reserves as tax expense rather than as a reduction of Net revenue, (d) increased a tax liability account by reducing Net revenue and (e) adjusted the foreign currency accounts resulting in an overstatement of Net revenue and an understatement of Interest and other income. Additional entries had the effect of overstating Net revenue, overstating Operating costs and expenses, and understating Interest and other income. In the aggregate for 2000, the adjustments for these entries and related tax effects increased previously reported net loss by

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$21.2 million from $102.7 million to $123.9 million, and increased previously reported basic and diluted net loss by $0.16 per share.

Generally, the entries in 1999 reclassified amounts from the tax liability accounts to operating expense liability accounts and sales return reserves. In the aggregate for 1999, the adjustments for these entries and related tax effects reduced previously reported net loss by $3.0 million from $159.9 million to $156.9 million, and reduced previously reported basic and diluted net loss by $0.02 per share.

The entries made during 1998 reclassified amounts from the tax liability accounts to operating expense liability accounts. In the aggregate for 1998, the adjustments for these entries and related tax effects reduced previously reported net income by $4.0 million from $36.4 million to $32.4 million, and reduced previously reported basic and diluted net income by $0.03 per share.

The results of the Audit Committee s investigation and the required restatement are set forth and described in greater detail in Network Associates audited consolidated financial statements contained in the 2001 Annual Report on Form 10-K/A filed with the Securities and Exchange Commission on June 28, 2002.

During the three months ended March 31, 2002, the Company adopted the Financial Accounting Standards Board s Emerging Issues Task Force Statement No. 01-09, entitled Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor s Products (EITF 01-09). EITF 01-09 requires that payments to customers or reductions in their accounts receivable for certain marketing related amounts previously classified as charges to marketing expense be recorded as reductions of revenue. Upon adoption of EITF 01-09, the Company is required to retroactively reclassify amounts recognized for such payments in previously issued financial statements to comply with the income statement display requirements of the consensus.

The condensed consolidated balance sheets as of March 31, 2001 and December 31, 2000 and the condensed consolidated statements of operations for the three months ended March 31, 2000 contained herein have been restated to incorporate the adjustments described herein and the related tax effects. In addition, for the periods ended March 31, 2001 and 2000, the Company reclassified amounts of approximately $14.7 million and $9.0 million, respectively, from marketing and sales expense to revenue upon the adoption of EITF 01-09.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following are reconciliations of the Company s financial position and results of operations from financial statements previously filed to these restated and reclassified financial statements (in thousands, except per share data):

Balance Sheet as of March 31, 2001

	As Previously Reported	Cumulative Effect of Prior Year Changes	As Restated
Cash and cash equivalents	$ 298,354	$	$ 298,354
Short-term marketable securities	70,894		70,894
Accounts receivable, net	80,457		80,457
Prepaid expenses, income taxes and other current assets	43,024		43,024
Deferred taxes	96,963		96,963
Total current assets	589,692		589,692
Long-term marketable securities	267,286		267,286
Fixed assets, net	75,348		75,348
Deferred taxes	118,680	6,772	125,452
Intangible assets and other assets	220,951		220,951
Total assets	$1,271,957	$ 6,772	$1,278,729
Accounts payable	$ 33,469	$	$ 33,469
Accrued liabilities	213,970	28,965	242,935
Deferred revenue	163,543		163,543
Total current liabilities	410,982	28,965	439,947
Deferred taxes	7,161		7,161
Deferred revenue, less current portion	27,779		27,779
Convertible debt	399,858		399,858
Other long term debt and liabilities	861		861
Total liabilities	846,641	28,965	875,606
Minority interest	10,576		10,576
Common stock	1,393		1,393
Treasury stock	(65,127)		(65,127)
Additional paid-in capital	687,247		687,247
Accumulated other comprehensive loss	(39,595)		(39,595)
Accumulated deficit	(169,178)	(22,193)	(191,371)
Total stockholders equity	414,740	(22,193)	392,547
Total liabilities, minority interest and stockholders equity	$1,271,957	$ 6,772	$1,278,729

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Balance Sheet as of December 31, 2000

	As Previously Reported	Cumulative Effect of Prior Year Changes	Inaccuracies	As Restated
Cash and cash equivalents	$ 275,539	$	$	$ 275,539
Short-term marketable securities	85,721			85,721
Accounts receivable, net	122,315			122,315
Prepaid expenses, income taxes and other current assets	50,346			50,346
Deferred taxes	86,771			86,771
Total current assets	620,692			620,692
Long-term marketable securities	332,893			332,893
Fixed assets, net	75,499			75,499
Deferred taxes	113,489	10,403	(3,631)	120,261
Intangible assets and other assets	242,275			242,275
Total assets	$1,384,848	$10,403	$ (3,631)	$ 1,391,620
Accounts payable	$ 46,816	$	$	$ 46,816
Accrued liabilities	225,317	11,391	17,574	254,282
Deferred revenue	151,566			151,566
Total current liabilities	423,699	11,391	17,574	452,664
Deferred taxes	7,971			7,971
Deferred revenue, less current portion	26,592			26,592
Convertible debt	396,336			396,336
Other long term debt and liabilities	532			532
Total liabilities	855,130	11,391	17,574	884,095
Minority interest	11,067			11,067
Common stock	1,381			1,381
Treasury stock	(23,186)			(23,186)
Additional paid-in capital	685,423			685,423
Accumulated other comprehensive loss	(31,266)			(31,266)
Accumulated deficit	(113,701)	(988)	(21,205)	(135,894)
Total stockholders equity	518,651	(988)	(21,205)	496,458
Total liabilities, minority interest and stockholders equity	$1,384,848	$10,403	$ (3,631)	$$1,391,620

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Statement of Operations for the Three Months Ended March 31, 2000

	As Previously Reported	Inaccuracies	EITF No. 01-09 Reclassifications	As Restated and Reclassified
Net revenue:				
Product	$ 166,939	$ (18,288)	$ (8,980)	$ 139,671
Services and support	47,517			47,517
Total net revenue	214,456	(18,288)	(8,980)	187,188
Cost of net revenue:				
Product	23,738	(1,000)		22,738
Services and support	9,275			9,275
Total cost of net revenue	33,013	(1,000)		32,013
Operating costs and expenses:				
Research and development	41,675	(500)		41,175
Marketing and sales	95,995	6,300	(8,980)	93,315
General and administrative	20,876	(7,463)		13,413
Amortization of intangibles	14,430			14,430
Total operating costs and expenses	172,976	(1,663)	(8,980)	162,333
Income (loss) from operations	8,467	(15,625)		(7,158)
Interest and other income and expense, net	4,602	2,650		7,252
Gain (loss) on investments, net	40,373			40,373
Income before provision for income taxes and minority interest	53,442	(12,975)		40,467
Provision for income taxes	25,540	(4,541)		20,999
Net income before minority interest	27,902	(8,434)		19,468
Minority interest in loss of consolidated subsidiaries	1,123			1,123
Net income	$ 29,025	$ (8,434)	$	$ 20,591
Basic and diluted net income per share:				
Net income per share basic	$ 0.21			$ 0.15
Net income per share diluted	$ 0.20			$ 0.14
Basic shares	138,877			138,877
Diluted shares	144,372			144,372

3. Business Segment Information

In 2000, the Company established a subsidiary, McAfee.com, as a separate business entity. The Company evaluated its product segments in 2001 and concluded that its reportable segments were computer security and management software, including managed security and availability applications services on the Internet (Infrastructure) and consumer PC security and management software on the Internet (McAfee.com).

Management measures profitability for its business based on these two segments.

The Infrastructure segment consists of anti-virus, network management, security and help desk software. These products are marketed and sold through a direct sales force to distributors, retailers, and end users

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

world-wide. In addition, the Infrastructure segment includes managed security and availability applications services on the Internet.

The McAfee.com segment is a one-stop destination for consumer PC security and management needs on the Internet. The McAfee.com web site provides a suite of online products and services personalized for the user based on the user s PC configuration, attached peripherals and resident software.

Summarized pre-tax financial information concerning the Company s reportable segments is provided as follows (in thousands):

	Three Months Ended March 31,	
	2001	2000
	(As reclassified see Note 2)	(As restated and reclassified see Note 2)
Infrastructure:		
Net revenues	$142,780	$176,930
Segment operating income (loss)	(57,147)	772
McAfee.com:		
Net revenues	12,816	10,258
Segment operating loss	(2,718)	(7,930)

	March 31, 2001	December 31, 2000
	(As restated see Note 2)	(As restated see Note 2)
Infrastructure:		
Total assets	$1,180,645	$1,293,488
McAfee.com:		
Total assets	98,084	98,132

4. Stock Option Repricing and Stock Repurchase Plan

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 exercise prices at the current fair market value of the stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted at an exercise price of $11.063, which was based on the closing price of the Company s common stock on April 22, 1999. The new options vest at the same rate that they would have vested under previous option plans. As a result, options to purchase approximately 3.2 million shares at $11.063 were vested and outstanding at March 31, 2001.

In accordance with Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, the Company incurred an initial stock based compensation charge in connection with this repricing. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately $314,000 was expensed in the three months ended March 31, 2001.

In March 2000, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25 (Interpretation). Among other issues, this Interpretation clarifies (a) the definition of employee for purposes of applying Opinion 25, (b) the criteria for determining whether a plan qualifies as a

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

non-compensatory plan, (c) the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in a business combination. This guidance was effective as of July 1, 2000.

As a result of the introduction of this Interpretation, stock options repriced by the Company on April 22, 1999 are subject to variable plan accounting treatment from July 1, 2000. Accordingly, the Company has and will continue to remeasure compensation cost for the repriced options until these options are exercised, cancelled, or forfeited without replacement. The first valuation period began with the effective date of the Interpretation which was July 1, 2000. The valuation has and will be based on any excess of the closing stock price at the end of the reporting period or date of exercise, forfeiture or cancellation without replacement, if earlier, over the fair value of the Company s common stock on July 1, 2000, which was $20.375. The resulting compensation charge to earnings will be recorded over the remaining vesting period, using the accelerated method of amortization discussed in FASB Interpretation No. 28. When options are fully vested, the charge will be recorded to earnings immediately. Depending upon movements in the market value of the Company s common stock, this accounting treatment may result in significant additional compensation charges in future periods.

In addition, variable plan accounting as described above, applied to options issued to employees of McAfee.com and myCIO.com as a replacement for Company options which were subject to the repricing described above. As a result, the Company will record variable charges based on the movements in the fair value of McAfee.com and myCIO.com common stock from July 1, 2000. Because myCIO.com employees were reintegrated into the Company s Infrastructure segment, the Company will record charges for McAfee.com and the Infrastructure segment.

During the three months ended March 31, 2001, the Company did not incur charges to earnings related to options subject to variable plan accounting as the Company s stock price was below the July 1, 2000 closing price of $20.375. As of March 31, 2001 the Company and McAfee.com had options, outstanding and subject to variable plan accounting, amounting to 4.3 million and 59,542, respectively. Depending on movements in the market value of the Company s common stock, the accounting treatment may result in significant additional compensation charges in future periods.

In May 1999, the Board of Directors authorized the Company to repurchase up to $100 million of its common stock in the open market over a two-year period. In July 2000, the Board of Directors authorized the Company to repurchase additional common stock of up to $50 million in the open market over a two-year period. Through March 31, 2001, the Company repurchased approximately 7.0 million shares of its common stock, including the repurchase of 2 million shares on February 2, 2001 relating to the settlement of the outstanding put options. Cash outlay, net of proceeds from put options described below, to date is approximately $147.5 million. The timing and size of any future stock repurchases are subject to market conditions, stock prices, the Company s cash position and other cash requirements.

On August 3, 1999, February 16, 2000 and May 31, 2000, Network Associates sold European style put options for 3 million shares of the Company s common stock as part of its stock repurchase plan. The strike price for these put options was $20.00, $30.00 and $24.07, respectively. The Company received total proceeds of approximately $19.1 million from the sale. In August 2000, put options sold on August 2, 1999 for 1 million shares were exercised in the Company s stock. The strike price for these put options was $20.00. In February 2001, the Company settled the remaining put options which resulted in the purchase of 2 million shares of the Company s common stock for approximately $53.8 million.

On January 3, 2001, the Company s board of directors appointed George Samenuk as the company s chief executive officer and president. As part of this appointment, William Larson, former chief executive officer, and Prabhat Goyal, former chief financial officer, and Peter Watkins, former president and chief operating offer, became special advisors to the Company. Options held by Mr. Larson, Mr. Goyal, and

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Mr. Watkins continue to vest while they each serve one-year terms as special advisors to the Company. As a result, the Company recorded stock compensation charges of approximately $603,000 in the three months ended March 31, 2001.

On January 3, 2001, the Company entered into an employment agreement with George Samenuk. In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. The Company s right to repurchase such shares will lapse as follows: 12.5% on the first four quarterly anniversaries of Mr. Samenuk s employment with the Company with the remaining 50% on the second year anniversary of Mr. Samenuk s employment with the Company. The fair value of the restricted stock was determined to be approximately $1.7 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of the Company s common stock on Mr. Samenuk s employment commencement date. In the three months ended March 31, 2001, the Company recognized $209,000 related to stock compensation associated with Mr. Samenuk s restricted stock.

5. Stockholders Equity

Stock Option Plans

On January 24, 2001, the Company s board of directors authorized the reservation of an additional 3 million options for the 2000 Nonstatutory Stock Option Plan.

Warrants

On January 3, 2001, the Company s board of directors appointed George Samenuk as the company s chief executive officer. In January 2001, upon completion of the search for the Company s CEO, the Company issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 166,667 shares of the Company s common stock. The weighted-average exercise price of the underlying shares is $2.97 per share. The warrants are immediately exercisable and expire in January 2004. The combined fair value of the warrants was determined to be approximately $530,000 and was estimated using the Black-Scholes model with the following assumptions: risk free interest rate of 4.82%; expected life of 3 years; dividend yield of 0; and expected volatility of 91%. This amount was charged against earnings in the current period and included in general and administrative expenses in the accompanying financial statements.

6. Recent Accounting Pronouncements

In June of 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities, which establishes accounting and reporting standards for derivative instruments and hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. In June, 1999, the FASB issued SFAS No. 137, Accounting for Derivative Instruments Deferral of the Effective date of SFAS Statement No. 133. SFAS No. 137 deferred the effective date of SFAS No. 133 until June 15, 2000. The Company has adopted SFAS No. 133 as required for its first quarterly filing of fiscal year 2001. SFAS 133 shall be effective for all subsequent quarters and annual filings. The adoption of SFAS No. 133 did not have a material effect on the financial position or results of operations of the Company.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

7. Net Income (Loss) Per Share

In accordance with the disclosure requirements of SFAS 128, a reconciliation of the numerator and denominator of basic and diluted net income (loss) per share is provided as follows (in thousands, except per share amounts):

Three Months Ended