NETWORKS ASSOCIATES INC/
Form 10-K
March 09, 2004

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-K

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the Fiscal Year Ended December 31, 2003**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the Transition Period from to**

Commission File Number: 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code:

(408) 988-3832

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

None

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

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

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the issuer as of the last business day of the Registrant s most recently completed second fiscal quarter (June 30, 2003) was approximately $2.0 billion. The number of shares outstanding of the issuer s common stock as of January 31, 2004 was 163,239,520.

DOCUMENTS INCORPORATED BY REFERENCE

Items 10, 11, 12, 13 and 14 of Part III are incorporated by reference from the Registrant s Proxy Statement for the Annual Meeting of Stockholders to be held on May 27, 2004.

This document contains 126 pages.

NETWORKS ASSOCIATES INC.

FORM 10-K

For the fiscal year ended December 31, 2003

TABLE OF CONTENTS

		Page
	PART I	
Item 1.	Business	2
Item 2.	Properties	25
Item 3.	Legal Proceedings	25
Item 4.	Submission of Matters to a Vote of Security Holders	25
	PART II	
Item 5.	Market for Registrant s Common Equity and Related Stockholder Matters	27
Item 6.	Selected Financial Data	28
Item 7.	Management s Discussion and Analysis of Financial Condition and Results of Operation	29
Item 7A.	Quantitative and Qualitative Disclosure about Market Risk	55
Item 8.	Financial Statements and Supplementary Data	56
Item 9.	Changes In and Disagreements with Accountants on Accounting and Financial Disclosure	57
Item 9A.	Controls and Procedures	57
	PART III	
Item 10.	Directors and Executive Officers of the Registrant	58
Item 11.	Executive Compensation	58
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	59

Item 13.	Certain Relationships and Related Transactions	59
Item 14	Principal Accountant Fees and Services	59
	PART IV	
Item 15.	Exhibits, Financial Statement Schedules and Reports on Form 8-K	60
Signatures		122
Employment Agreement - Kevin M. Weiss		
Form of Indemnification Agreement		
Computation of Ratio of Earnings to Fixed Charges		
Subsidiaries of the Registrant		
Consent of PricewaterhouseCoopers LLP		
Certification of CEO and CFO Pursuant to Sec. 302		
Certification of CEO and CFO Pursuant to Sec. 906		

Table of Contents

PART I

Item 1. *Business*

General

This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. The statements contained in the Report on Form 10-K 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-K are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, predicts, potential, targets, goals, projects, continue, or similar expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors beginning on page 9 in this document. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Networks Associates, Inc. was formed in December 1997 by the combination of McAfee Associates, Inc. and Network General Corporation. Following the combination, McAfee changed its legal name to Networks Associates, Inc., and we do business under the name Network Associates. In 1999, our subsidiary McAfee.com sold to the public its Class A common stock as a part of its initial public offering. In September 2002, we repurchased the 25% minority interest in McAfee.com and merged McAfee.com into Networks Associates, Inc. McAfee Associates, Inc. was incorporated in 1992 and Network General Corporation was incorporated in 1987.

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

Networks Associates, Inc. is headquartered at 3965 Freedom Circle, Santa Clara, California, 95054, and the telephone number at that location is (408) 988-3832. The Network Associates web site is www.networkassociates.com.

OVERVIEW

We are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. We offer two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. Our computer security solutions are offered primarily to large enterprises, governments, small and medium-sized businesses and consumer users. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific and Latin America. See note 19 to the consolidated financial statements for a description of revenues, operating income and assets by geographic region.

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, including Sniffer Technologies network analysis and availability technologies, network intrusion prevention with McAfee IntruShield and InfiniStream Security Forensics.

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

In 2003, our net revenue was $936.3 million and net income was $70.2 million.

McAfee System Protection Solutions

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

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

Until recently, McAfee System Protection Solutions also included our Magic Service Desk business, offering management and visibility of desktop and server systems. In December 2003, we agreed to sell our Magic Service Desk business to BMC Software. The transaction closed in January 2004.

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 Sniffer and the nPO Solution for network management. Sniffer s products capture data, monitor network traffic and collect and report on key network statistics. These products are also designed to optimize network and application performance and increase network reliability by uncovering and analyzing network problems and network security vulnerabilities and recommending solutions to such problems. Other McAfee Network Protection Solutions products include InfiniStream Security Forensics for security forensics and McAfee IntruShield for network intrusion detection and prevention. Customers for these products include enterprises, government agencies and educational organizations, as well as service providers.

Expert Services and Technical Support

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

Consulting Services support product integrations and deployment with an array of standardized and custom offerings. Consulting Services also offer other services in both the security and networking areas, including early assessment and design work, as well as emergency outbreak and network troubleshooting assistance. Our consulting services organization is organized around our product groups.

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

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

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

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

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

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

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

Network Associates Labs

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

Strategic Alliances

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

Table of Contents

a value-added service. We also have alliances with, among others, Cox Communications, Dell, Microsoft, MSN, NEC, NTT DoCoMo, Phoenix Technologies and Telefonica.

Product Licensing Model

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

On-Line Subscriptions and Managed Applications

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

Similarly, our small and medium sized business on-line subscription products and services, or our ASaP offerings, provide these customers the most up-to-date anti-virus software. Our ASaP offerings include VirusScan ASaP, which provides anti-virus protection to desktops and file servers, VirusScreen ASaP, which screens e-mails to detect and quarantine viruses and infected attachments and Desktop Firewall ASaP, which blocks unauthorized network access and stops known network threats. At December 31, 2003, we had 3.7 million McAfee.com subscribers.

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

Sales and Marketing

To augment and capitalize upon our marketing efforts, our sales and marketing activities are directed primarily at large corporate and government customers, small and medium-sized accounts, as well as resellers, distributors, system integrators, internet service providers and Original Equipment Manufacturers worldwide through the channels listed below.

United States Direct Sales

Our United States direct sales force, comprising the majority of our total sales force, is organized by market segment. The direct field force consists of strategic account executives that call upon our large enterprise, and in some cases, global accounts. Their focus is to promote our vision and strategy as well as increase the penetration of our products. Our major account managers have similar responsibilities but are focused on our next tier of large U.S. customers and provide sales leadership and promote all of our product

offerings. Our other named accounts are covered by territory account managers. These accounts are large enough to require face-to-face sales coverage and are led by account managers with McAfee System Protection Solutions or McAfee Network Protection Solutions backgrounds. The small and medium-sized business segment is comprised of accounts not serviced by territory account managers. These accounts are serviced primarily by our telesales representatives and channel partners. We have made a significant investment in our channel partner programs to increase sales and ultimately drive growth in this market segment. The small office, home office and consumer segments are the focus of our McAfee Consumer team.

All of our United States sales representatives are responsible for developing new business as well as the renewal of our existing licenses. Prior to expiration of a license, a sales representative contacts the customer and encourages the customer to renew the expiring license and determines if the number of computers licensed needs adjustment and, additionally, markets new products and product groups to this existing customer. Our account teams are also responsible for maintaining and nurturing long-term customer relationships.

International Sales

We have sales and support operations in EMEA, Japan, North America, Asia-Pacific and Latin America. In 2003, 2002, and 2001 based on net revenue in our regions, international revenues accounted for approximately 35%, 37% and 35% of our net revenues, respectively. Within our international sales regions, sales forces are organized by country when and where local demand and sales force considerations make it advisable.

Resellers and Distributors

To complement our direct sales efforts, we market many of our products through corporate resellers, retailers and, indirectly, through distributors. In addition, our channel efforts include strategic alliances with complementary manufacturers and publishers to expand our reach and scale. We currently utilize corporate resellers, including ASAP Software, CDW, Dell, Insight, Softmart, Software House International and Software Spectrum, as well as network integrators who offer our solutions and sell site licenses of our software to corporate, small business and government customers.

Independent software distributors who currently supply our products include Digital River, Ingram Micro, Merisel America, MOCA and Tech Data. These distributors supply our products primarily to large retailers, value-added resellers, or VARs, mail order and telemarketing companies. Both through our authorized distributors and directly with certain retail resellers through a consignment model, we sell our retail packaged products to several of the larger computer and software retailers, including Best Buy, CompUSA, Dixons, Office Depot, Office Max and Staples. Members of our channel sales force work closely with our major reseller and distributor accounts to manage demand generating activities, training, order flow, and affiliate relationship management.

Our top ten distributors typically account for between 46% and 62% of our net sales in any quarter. Our agreements with our distributors are not exclusive and may be terminated by either party without cause. Terminated distributors may not continue to represent our products. If one of our significant distributors terminated its relationship with us, we could experience a significant interruption in the distribution of our products.

We utilize a sell-through business model for distributors under which we recognize revenue on products sold through distributors at the time our distributors resell the products to their customers. Under this business model, our distributors are permitted to purchase software licenses at the same time they fill customer orders and to pay for hardware and retail products only when these products are resold to the distributors customers. In addition, prior to the resale of our products, our distributors are permitted unlimited, unconditional rights of return. After sale by the distributor to its customer, there is no right of return from the distributor to us with respect to such product, unless we approve the return from the final customer to the distributor.

Original Equipment Manufacturers

OEMs license our products and bundle them with PC hardware or software. For example, we are an anti-virus provider for PC hardware manufacturers such as Apple, Dell, NEC, Phoenix Technologies and Sony. OEMs typically sublicense a single version of our products to end users who must contact us in order to receive their updates. We typically receive a per-copy royalty from, or revenue share with, our OEMs.

Other Marketing Activities

Channel marketing is the means by which we market, promote, train and incent our resellers and distributors to promote our products to their end-user customers. We offer our resellers and distributors technical and sales training classes, marketing and sales assistance kits. We also provide specific cooperative marketing programs for end-user seminars, catalogs, demand creation and sales events.

One of the principal means of marketing our products and services is through the Internet. In addition to the www.networkassociates.com website, each of our product groups has their own individual websites. A number of these websites are localized to serve the various geographic regions in which we operate. Not only do each of these websites contain various marketing materials and information about our products, but website visitors may download and purchase products or obtain free trials of our products or trial subscriptions for on-line subscription products and services. We also promote our products and services through advertising activities in trade publications, direct mail campaigns and strategic arrangements. In addition, we attend trade shows, sponsor conferences and publish a quarterly newsletter, which is mailed to existing and prospective customers.

We also market our products through the use of rebate programs. Within most countries we typically offer two types of rebate programs, volume incentive rebates to channel partners and promotional rebates to end-users. The channel partner earns a volume incentive rebate primarily based upon its sale of our products to end-users. From time to time, we also make rebates available to individual users of various products purchased through multiple channels.

Customers

We primarily market our products to large corporate and government customers through our direct sales organization and indirectly through resellers and distributors. A majority of our products are distributed indirectly through resellers and distributors. During 2003, one distributor, Ingram Micro, accounted for more than 20% of our net revenue and together with another distributor, TechData, in total accounted for approximately 33% of our net revenue.

We market our products to individual consumers directly through on-line distribution channels and indirectly through traditional distribution channels, such as retail stores, OEMS and on-line partners. McAfee Consumer is responsible for on-line distribution of our products sold to individual consumers over the Internet or for Internet-based products, including products distributed by our on-line partners, and for the licensing of technology to strategic distribution partners for sale to individual consumers, with certain exceptions.

Product Development, Investments, and Acquisitions

We believe that our ability to maintain our competitiveness depends in large part upon our ability to successfully enhance existing products, develop and acquire new products and develop and integrate acquired products. The market for computer software includes low barriers to entry, rapid technological change, and is highly competitive with respect to timely product introductions. As part of our growth strategy, we have made and expect to continue to make investments in complementary businesses, products and technologies.

In addition to developing new products, our internal development staff is focused on developing upgrades and updates to existing products and modifying and enhancing any acquired products. Future upgrades and updates may include additional functionality, respond to user problems or address compatibility problems with new or changing operating systems and environments.

Table of Contents

For 2003, 2002 and 2001, we expensed $184.6 million, $148.8 million and $146.7 million (or, excluding stock based compensation charges, $179.4 million, $144.8 million and $142.1 million), respectively, on research and development. See Management s Discussion and Analysis of Financial Condition and Results of Operations.

Manufacturing and Suppliers

Our manufacturing operations consist primarily of assembly, testing and quality control of materials, components, subassemblies and systems for our Sniffer hardware-based, IntruShield and E-ppliance products. We use a limited number of third-party manufacturers for these manufacturing operations. 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. The loss of one of our third-party manufacturers could disrupt our business. Hardware-based products entail other risks, such as the unavailability of critical components that are supplied by a limited number of parties and greater obsolescence risks.

Competition

The markets for our products are intensely competitive and are subject to rapid changes in technology. We also expect competition to increase in the near-term. We believe that the principal competitive factors affecting the markets for our products include, but are not limited to:

- performance
- quality
- breadth of product group
- integration of products
- brand name recognition
- price
- functionality
- customer support
- frequency of upgrades and updates
- manageability of products
- reputation

We believe that we compete favorably against our competitors in each of these areas. However, some of our competitors have longer operating histories, greater name recognition, stronger relationships with channel partners, larger technical staffs, established relationships with hardware vendors and/or greater financial, technical and marketing resources. These factors may provide our competitors with an advantage in penetrating markets with their network security and management products.

Anti-Virus. Our principal competitors in the anti-virus market are Symantec and Computer Associates. Trend Micro remains the strongest competitor in the Asian anti-virus market. Sophos, Fsecure, Panda, and Dr. Ahn s are also showing growth in their respective markets. As a result of its GeCAD Software acquisition, at some point we may also compete directly against Microsoft.

Network Security and Intrusion Detection and Protection. Our principal competitors in the security market vary by product type. For intrusion detection and prevention products, we compete with Cisco Systems, Computer Associates, Enterasys, Fortinet, Internet Security Systems, NetScreen (which recently agreed to be acquired by Juniper Networks, Inc.), Sourcefire, Symantec and TippingPoint Technologies. The markets for encryption and virtual private network, or VPN, products are highly fragmented with numerous

8

Table of Contents

small and large vendors. VPN competitors include hardware and software vendors, including telecommunications companies and traditional networking suppliers.

Network Fault Identification and Application Performance Management. Our principal competitors in the network fault identification and application performance management market are NetScout and WildPackets. Other competitors include Agilent, Cisco Systems, Compuware Corporation, Concord Communications, Finisar, Fluke Networks, Network Instruments and Niksun.

Other Competitors. In addition to competition from large technology companies such as HP, IBM, Intel, Microsoft, and Novell that may offer network and system protection products as enhancements to their operating systems, we also face competition from smaller companies and shareware authors that may develop competing products.

Proprietary Technology

Our success depends significantly upon proprietary software technology. We rely on a combination of contractual rights, trademarks, trade secrets and copyrights to establish and protect proprietary rights to our software. However, these protections may be inadequate or competitors may independently develop technologies or products that are substantially equivalent or superior to our products. Often, we do not obtain signed license agreements from customers who license products from us. In these cases, we include an electronic version of an end-user license in all of our electronically distributed software and a printed license in the box for our products. Since none of these licenses are signed by the licensee, many legal authorities believe that such licenses may not be enforceable under the laws of many states and foreign jurisdictions. In addition, the laws of some foreign countries either do not protect these rights at all or offer only limited protection for these rights. The steps taken by us to protect our proprietary software technology may be inadequate to deter misuse or theft of this technology. For example, we are aware that a substantial number of users of our anti-virus products have not paid any registration or license fees to us.

Employees

As of December 31, 2003, we employed approximately 3,700 individuals worldwide including approximately 1,000 in research and development, approximately 2,000 in sales and marketing, and approximately 700 in finance and administration. Approximately 1,600 employees are in locations outside the United States. With limited exceptions, none of our employees are represented by a labor union. We consider the relationships with our employees to be positive. Competition for qualified management and technical personnel is intense in the software industry. Our continued success depends in part upon our ability to attract and retain qualified personnel. To date, we believe that we have been successful in recruiting qualified employees, but there is no assurance that we will continue to be successful in the future.

Table of Contents

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 and in the short term are 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:

- volume, size, timing and contractual terms of new licenses and renewals of existing licenses;
- introduction of new products, product upgrades or updates by us or our competitors;
- 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 and others, (ii) the product is hardware or software based and (iii) in the case of software licenses, the licenses are time-based subscription licenses or perpetual licenses;
- costs or charges related to our acquisitions or dispositions, including our acquisition of the publicly held shares of McAfee.com in September 2002, our acquisitions of Entercept Security Technologies and IntruVert Networks in 2003 and the dispositions of our Magic business at the beginning of 2004 and PGP and Gauntlet businesses in 2002;
- the components of our revenue that are deferred, including our on-line subscriptions and that portion of our perpetual and subscription software licenses attributable to support and maintenance;
- stock-based compensation charges; and
- costs related to extraordinary events, including litigation, reductions in force, relocation of personnel and restatement of our consolidated financial statements, 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. In recent periods, continued poor economic conditions throughout the world have hurt our business.

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

We do not maintain significant levels of backlog. Product revenues in any quarter are dependent, in significant part, 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.

Table of Contents

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 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). Although we filed these restated consolidated financial statements on October 31, 2003, the SEC and DOJ inquiries have resulted, and may continue to result in, a diversion of management s attention and resources and may contribute to current and future stock price volatility.

The filing of our restated consolidated financial statements does not resolve the pending SEC inquiry into our accounting practices. We are engaged in ongoing discussions with, and continue to provide information to, the SEC regarding our consolidated financial statements for calendar year 2000 and prior periods. The resolution of the SEC inquiry into our prior accounting practices could require the filing of additional material restatements of our prior consolidated financial statements or require that we take other actions not presently contemplated, including actions resulting from the SEC s inquiry into the nature and manner of our recent restatement.

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. Sophos, Fsecure, Panda, and Dr. Ahn s are also showing growth in their respective markets. As a result of its GeCAD Software acquisition, at some point we may also compete directly against Microsoft;

- in the network fault identification and application performance management product market, Netscout and WildPackets, with other competitors including Agilent, Cisco Systems, Compuware Corporation, Concord Communications, Finisar, Fluke Networks, Network Instruments and Niksun; and

- in the market for our other intrusion detection and protection products, Cisco Systems, Computer Associates, Enterasys Internet Security Systems, Netscreen (which recently agreed to be acquired by Juniper Networks, Inc.), Sourcefire, Symantec and TippingPoint Technologies.

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 recently agreed to acquire Netscreen and, through its acquisition of Okena, Cisco Systems may incorporate functionality that competes with our content filtering and anti-virus products. Similarly, following its acquisition of GeCAD Software, Microsoft indicated its plans to boost security of its Windows platform. 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 Related to Our Recent Product Reorganization and Our Intrusion Prevention Focus.

Following our IntruVert and Entercept acquisitions in the first half of 2003, we reorganized our products into our McAfee System Protection Solutions and McAfee Network Protection Solutions product groups. At the end of 2003, we agreed to dispose of our Magic Solutions business. These activities are intended to better leverage the McAfee brand and better position us as a provider of a complete set of system and network protection solutions differentiated by intrusion prevention technology. Risks related to these activities include:

- we may be unable to successfully expand our McAfee brand beyond our anti-virus products;
- our strategic positioning may result in our competing more directly with larger, more established competitors, such as Cisco Systems and Microsoft;
- many of our network and system protection products were recently acquired and the income potential for these products is unproven and the market for these products is volatile;
- our sales force requires additional specialized training to sell a number of our products;
- disposition activities may result in significant accounting charges, management distraction and undesired loss of personnel; and
- there may be customer confusion around our strategy.

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

Our success depends in large part on our ability to attract and retain, in addition to senior management personnel, technically qualified and highly-skilled sales, consulting, technical and marketing personnel. Competition for qualified individuals is intense. To attract and retain critical personnel, we believe that we must 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 increases. At our most recent annual meeting held in December 2003, our stockholders did not approve a proposed increase in options available for grant under our employee stock option plans. Additionally, the accounting industry continues to consider whether corporations must include a compensation expense in their statement of income relating to the issuance of employee stock options. If options are required to be expensed,we may decide to issue fewer stock options and may be impaired in our efforts to attract and retain necessary personnel. Conversely, issuing a comparable number of stock options could adversely impact our results of operations.

In recent periods, we have taken and may continue to take efforts to rationalize the size of our employee base, including after the sale of our Magic Solutions, PGP and TIS businesses. While our overall employee level at the end of 2003 decreased to approximately 3,700 from approximately 3,800 at the end of 2002, through our 2003 acquisitions, we hired a number of new employees. Reductions in personnel 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. For new employees, there also may be reduced levels of productivity as recent additions or hires are trained and otherwise assimilate and adapt to our organization and culture. In addition, we may face difficulties in recruiting, hiring and training qualified employees for our Bangalore facility, where we have increased our employee levels in connection with the relocation of a significant portion of our research and development operations.

Table of Contents

Other than executive management who have at will employment agreements, our employees are not typically subject to an employment agreement or non-competition agreement. We may be unsuccessful in retaining management or other critical personnel. It could be difficult, time consuming and expensive to replace any key management member or other critical personnel, particularly if the individual is highly skilled. Integrating new management and other key personnel also may be difficult and costly. The loss of 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.

We Face Risks Associated With Past and Future Acquisitions.

We may buy or make investments in complementary companies, products and technologies. In addition to our acquisition of the publicly traded shares of McAfee.com, in 2003 we completed strategic acquisitions of Entercept and IntruVert.

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.

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.

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.

Table of Contents

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, 2003 and 2002, we used approximately $217.3 million and $118.3 million of cash to make various acquisitions, including approximately $217.1 million in net cash used in 2003 to acquire IntruVert and Entercept and approximately $98.4 million used in 2002 to acquire the publicly traded shares of McAfee.com, our previously publicly traded subsidiary. 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.

We Have Recently Experienced Significant Additions to Our Senior Management and Changes in Our Sales Organization.

Several members of our senior management were only added in the last year, and we may add new members to senior management. In December 2003, we promoted Mike Dalton to President of our EMEA region. In July 2003, we reorganized our sales organization and, among other actions, we elevated Kevin Weiss to the newly created position of executive vice president of worldwide sales. Also, in September 2003, we named James Lewandowski executive vice president of North American sales and Donna Troy executive vice president of worldwide channels. Changes in management and our sales organization may be disruptive to our business and may result in the departure of existing employees and/or customers. It may take significant time to locate, retain and integrate qualified management personnel.

We Face Risks Related to Our International Operations.

For 2003, 2002 and 2001, net revenue in our international operating regions represented approximately 35%, 37% and 35% of our net revenue. 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 the reorganization of our international sales forces by regions;
- the ability to successfully localize software products for a significant number of international markets;
- uncertainties relative to regional economic circumstances, including the economic weakness throughout Asia and Latin America over the past several years and pricing pressures associated with weak economic conditions in these regions;
- our ability to adapt to sales practices and customer requirements in different cultures;
- compliance with more stringent consumer protection laws;
- currency fluctuations and risks related to hedging strategies;
- political instability in both established and emerging markets;
- tariffs, trade barriers and export restrictions; and
- a high incidence of software piracy in some countries.

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.

Table of Contents

We May Incur Significant Stock-Based Compensation Charges Related to Repriced Options, Assumed Mcafee.Com and IntruVert Options and Compensation Expenses Related to the Entercept 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, and (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. 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 credit) 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 credit) 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 credit) to earnings will be recorded over the remaining life of the options subject to variable accounting treatment.

For 2003 and 2002, stock-based compensation charges of approximately $3.4 million and $16.1 million, respectively, were recorded for McAfee.com Options. In 2002, credits of approximately $5.5 million were recorded for the Repriced Options. No stock based compensation charges were recorded for the Repriced Options in 2003.

During the remaining life of both the McAfee.com Options and Repriced Options, we may record additional stock-based compensation charges or credits. We estimate that a $1 increase in our stock price at December 31, 2003 would increase our future stock compensation charge by approximately $0.5 million.

For the cash paid to cancel the IntruVert Options that was placed in escrow, we will recognize compensation expense as the former IntruVert employees provide services to us. For the IntruVert Restricted Stock, we will recognize compensation expense monthly over the next three to four years as the former IntruVert employees provide services to us. For 2004, we expect the expense to be approximately $2.8 million with respect to the IntruVert Options and Restricted Stock.

We may also incur significant compensation payments under the Entercept Retention Plan (the Retention Plan Payments). For the Retention Plan Payments, we will recognize compensation expense as the required service periods for the retention payments expire over one year. The Retention Plan Payments were funded at the time of the Entercept acquisition, and amounts not paid to the Retention Plan participants will be paid to the former Entercept stockholders. For 2004, we expect the remaining expenses to be approximately $0.6 million.

We Depend on Revenue from Our Flagship Anti-Virus and Sniffer Products.

We have historically derived a majority of our net revenue from our flagship McAfee anti-virus software products and our Sniffer network fault identification and application performance management products. These products are expected to continue to account for a significant portion of our net revenues. Because of this revenue concentration, our business could be harmed by a decline in demand for, or in the prices of, these products as a result of, among other factors, any change in our pricing model, a maturation in the markets for these products or other risks described in this document. In recent periods, our Sniffer-based revenues have been adversely impacted by, among other things, customer budgetary constraints and a slowing in network infrastructure deployments.

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.

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. Our top ten distributors typically represent approximately 46% to 62% of our net sales in any quarter. Our two largest distributors, Ingram Micro and Tech Data, together accounted for approximately 33% in 2003 and 35% in 2002 of net revenue.

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.

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.

Sale of Competing Products

Our distributors may sell other vendors products that are complementary to, or compete with, our products. While we encourage our distributors to focus on our products through market and support programs, these distributors may give greater priority to products of other suppliers, including competitors.

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 $2.9 million at December 31, 2003, $6.6 million at December 31, 2002 and $8.4 million at December 31, 2001. 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. For the years ended December 31, 2003, 2002, and 2001, our amortization charge for purchased technology and other intangibles was approximately $27.0 million, $13.9 million and $12.9 million respectively. 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 2003. As a result of this review, 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 . In 2003, we have determined that we have no impairment of our property and equipment and amortizable intangibles.

We Face Risks Related to the Recent Reorganization of Our Expert Services Organization.

Historically, our professional service organization was organized by product group. In October 2002, we announced the formation of our Expert Services organization. This organization will be located in each of our geographical regions. The Expert Services organization combines the professional service teams from our network protection and system protection product groups to serve as our professional services and educational organization. Risks related to this reorganization include:

- the failure to identify and close upon significant consulting opportunities;
- the integration of our professional services teams may prove to be unsuccessful, might take more time than anticipated or might cost more than expected;
- the highly discretionary nature of consulting expenditures;
- integration of the professional services teams and related activities may divert management s attention; and
- integration of the professional services teams may be disruptive to pre-existing customer relationships.

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

Table of Contents

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;
- respond promptly to new customer requirements and industry standards; 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.

Our long-term success depends on our ability to keep our products current. For example, the proliferation of new and changing viruses makes it imperative to update anti-virus products frequently to avoid obsolescence. Accordingly, we must upgrade and update existing product offerings, modify and enhance acquired products and introduce new products that meet our customers needs. We believe that our ability to provide these upgrades and updates frequently and at low cost is key to our success.

We Face Risks Related to Our On-Line Subscription Services Strategy.

McAfee System Protection Solutions offers on-line subscription services to multiple user segments including large enterprises, small-medium businesses and consumers. Our McAfee.com website is dedicated to selling and delivering security services over the Internet for consumers and small businesses (primarily small office and home). Our ASaP web sites support our selling and delivery of subscription services to small-medium business and large enterprises. This web-based model is a relatively new concept and our on-line subscription services may fail to maintain or increase market acceptance. The growth and market acceptance and ultimate profitability of our on-line subscription services are highly uncertain and subject to a number of factors, including:

- our ability to successfully adapt existing products or develop new or enhanced products that operate in a fast, secure and reliable manner over the Internet;
- increased expenditures associated with the creation of a new business or delivery platform, such as product development, marketing, channel development and technical and administrative support;
- the uninterrupted operability of our websites delivering security services over the Internet;
- our ability to attract and retain professionals to manage the delivery of services;
- the introduction of new products by third-party competitors; and
- our ability to properly price our products and services to maximize profitable growth.

We also allow intermediaries such as Internet service providers to sell and host our subscription based services. The service offerings of these partners may compete directly with our own subscription service sales efforts. Our success in making our on-line services available through our partners depends on several factors, including:

- our ability to attract, train and maintain qualified and financially stable partners;
- our ability to develop and maintain mutually satisfactory revenue sharing arrangements with our partners; and
- our ability to maintain customer satisfaction.

Our Managed Service Provider Strategy Exposes Us to Risks in Addition to Those Generally Experienced with Our On-Line Subscription Services Strategy.

We also make our technology available to be integrated with partner offers to be delivered as outsourced security solutions or managed security solutions. Unlike our on-line subscription services, Managed Service Provider (MSP) solutions are customized, monitored and updated by networking professionals for a specific customer. To successfully offer MSP services we must:

effectively monitor and customize each customer s managed services;

attract and retain qualified networking professionals to manage customer accounts; and

effectively price our products and services to account for the higher costs associated with selling managed services.

We also allow intermediaries, such as Outsourcers, MSPs and Managed Security Service Providers to sell and host our products and services in a managed environment. This partner strategy exposes us to additional risks:

we must select, train and maintain qualified and financially stable partners;

it is more difficult for us to ensure customer satisfaction as we do not have direct customer contact and we rely on our partners to timely and properly customize and administer our products, services and support:

we must develop and maintain mutually satisfactory revenue sharing arrangements with our partners; and

our partners may compete with our own direct sales efforts.

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, 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 licensed software. 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.

Table of Contents

Obsolescence

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

We Rely on the Continued Prominence of Microsoft Technology.

Although we intend to support other operating systems, we seek to be the leading supplier of network security and management products for Windows/ Intel based networks. Sales of our products would be materially and adversely affected by market developments that are adverse to the Windows operating environments, including the failure of users and application developers to accept Windows. In addition, our ability to develop products using the Windows operating environments is dependent on our ability to gain timely access to, and to develop expertise in, current and future developments by Microsoft. We may be unable in the future to gain the necessary access from Microsoft to its product development activities, particularly in light of Microsoft s recent acquisition of GeCAD Software, an anti-virus software provider.

We May Fail to Support Operating Systems Which Successfully Compete with Microsoft s Technology, Including Competing Versions of the Unix Operating System.

We are expanding our product support to include the Unix operating system and the Linux operating system. Sales of our products could be materially and adversely impacted by our failure to support those operating systems or competing operating systems that receive broad market acceptance. The Unix system encompasses many separate operating systems of which we only support a few. In recent periods, the Linux operating system has gained broader market acceptance at the expense of Unix operating systems. As a result, we placed our anti-virus products for Sun Microsystems Solaris Unix operating system into a maintenance only mode. If we fail to adequately support the Linux operating system or if the Unix versions supported by us are disproportionately affected by the success of Linux, our product sales may be adversely impacted.

We Face Risks Related to Customer Outsourcing to System Integrators.

Some of our customer s have outsourced the management of their information technology departments to large system integrators. If this trend continues, we face the risk that our established customer relationships could be disrupted and our products displaced by alternative system and network protection solutions offered by system integrators. Significant product displacements as a result of information technology department outsourcing 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 Security and Management 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 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. In 2000, a putative securities class action was filed against us, our directors and our former officers. In 2003, we entered into a memorandum agreement of settlement resolving the litigation for $70.0 million, with the settlement approved by the court in February 2004.

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

During the 12-month period ended December 31, 2003, our stock price was highly volatile ranging from a per share high of $20.28 to a low of $10.75. On January 30, 2004, our stock s closing price per share price was $17.35. 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.

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 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 software 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 recently 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 diskette duplication by distributors or our independent agents, diskettes 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 may at times in the future falsely detect viruses 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 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 New Risks Related to Our Anti-Spam Software Products.

Our anti-spam products may falsely identify e-mails as unwanted spam, reducing the adoption of these products, or alternatively fail to properly identify unwanted e-mails, particularly as spam e-mails are often designed to circumvent anti-spam products. Parties whose e-mails are blocked by our products may also seek redress against us for labeling them as spammers or for interfering with their business.

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

We are implementing a new customer relationship management information system. Implementation 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 system and the ongoing operations and support of the new system 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. For example, many parts of the United States and Canada experienced a widespread power blackout in August 2003, adversely impacting business in those areas. 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.

Table of Contents

The U.S. Military Global Presence and Potential Terrorist Attacks 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.

We Face Risks Associated With Governmental Contracting.

Our customers include the U.S. government and a significant number of other U.S. state and local governments or agencies. We are also currently engaged in several research and development contracts with U.S. government agencies.

Procurement

Contracting with public sector customers is highly competitive and can be expensive and time-consuming, often requiring that we incur significant upfront time and expense without any assurance that we will win a contract. Public sector customers may also change the way they procure new contracts and may adopt new rules or regulations governing contract procurement, including required competitive bidding or use of open source products, where available.

Fee Awards

Minimum fee awards for companies entering into U.S. government contracts are generally between 3% and 7% of the costs incurred by them in performing their duties under the related contract. However, these fees may be as low as 1% of contract costs.

Budgetary Constraints and Cycles

Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products and services.

Modification or Cancellation of Contracts

Public sector customers often have contractual or other legal rights to terminate current contracts for convenience or due to a default. If a contract is cancelled for convenience, which can occur if the customer s product needs change, we may only be able to collect for products and services delivered prior to termination. If a contract is cancelled because of default, we may only be able to collect for products and services delivered, and we may be forced to pay any costs incurred by the customer for procuring alternative products and services. The U.S. government may also terminate contracts with us if we come under foreign government control or influence, require that we disclose our pricing data during the course of negotiations, ban us from doing business with any government entity and require us to prevent access to classified data.

Governmental Audits

U.S. government and other state and local agencies routinely investigate and audit government contractors administrative processes. They may audit our performance and pricing and review our compliance with applicable rules and regulations. If they find that we have improperly allocated costs, they may require us to refund those costs or may refuse to pay us for outstanding balances related to the improper allocation. An

unfavorable audit could result in a reduction of revenue, and may result in civil or criminal liability if the audit uncovers improper or illegal activities.

Security Clearances

Some agencies within the U.S. government require some or all of our personnel to obtain proper security clearance. If our key personnel are unable to obtain or retain this clearance, we may be unable to bid for or retain some government contracts.

We May Not Realize the Anticipated Benefits from Our Strategic Investments.

We have made a number of venture and minority investments in private companies with complementary products, services and technologies. During 2002 and 2001, we recorded impairment charges of $0.2 million and $20.6 million, respectively, in connection with these investments. We recorded no impairment charges in 2003 as all of our investments have no carrying value. We may make additional strategic investments. These investments are speculative in value, and we may lose all or part of the money invested.

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.

Future Sales of Our Common Stock in the Public Market or Option Exercises and Sales Could Lower Our Stock Price.

A substantial number of the shares of our common stock are subject to stock options and our outstanding convertible notes may be converted into shares of common stock. We cannot predict the effect, if any, that future sales of shares of common stock, or the availability of shares of common stock for future sale, will have on the market price of our common stock. Sales of substantial amounts of common stock, including shares issued upon the exercise of stock options or the conversion of our outstanding convertible notes, or the perception that such sales could occur, may adversely affect prevailing market prices for our common stock.

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 2004 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

Table of Contents

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 2. ***Properties***

Our headquarters currently occupy approximately 135,000 square feet in facilities located in Santa Clara, California under leases expiring in 2013. Worldwide, we lease facilities with approximately 808,000 total square feet, with leases that expire at various times. Our primary international facilities are located in, Germany, India, Japan, the Netherlands and the United Kingdom. Other significant domestic sites include California, Maryland, Oregon and Texas. We believe that our existing facilities are adequate for the present and that additional space will be available as needed.

We own our regional office located in Plano, Texas. The 170,000 square feet facility, opened in January 2003 and is located on 15.6 acres of owned land. This facility supports approximately 1,000 employees working in our customer support, engineering, accounting and finance, information technology, internal audit, legal and telesales groups.

Item 3. ***Legal Proceedings***

Information with respect to this item is incorporated by reference to note 20 to the notes to consolidated financial statements included in this Form 10-K.

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

1. The election of Messrs. Leslie Denend and George Samenuk as Class II directors, each for a three year term:

Leslie Denend:	
Shares in Favor	135,459,809
Shares Withheld	2,415,052
George Samenuk:	
Shares in Favor	134,877,105
Shares Withheld	2,997,756

2. The approval of an amendment to the Company s 1997 Stock Incentive Plan to increase the number of shares of the Company s common stock reserved for issuance thereunder by 2,000,000 shares:

Shares in Favor	38,585,715
Shares Against	73,307,748
Shares Abstained	362,092

3. The approval of an amendment to the Company s Stock Option Plan for Outside Directors to increase the initial stock option grant and subsequent annual grant to non-employee directors by 5,000 shares to 50,000 and 25,000 shares of common stock, respectively:

Shares in Favor	62,830,924
Shares Against	49,038,448
Shares Abstained	386,183

Table of Contents

4. The approval of an amendment to the Company s 2002 Employee Stock Purchase Plan to increase the number of shares of the Company s common stock reserved for issuance thereunder by 2,000,000 shares:

Shares in Favor	106,275,748
Shares Against	5,611,758
Shares Abstained	368,049

5. The ratification of the appointment of PricewaterhouseCoopers LLP as the independent accountants of the Company for the fiscal year ending December 31, 2003:

Shares in Favor	131,790,293
Shares Against	5,727,546
Shares Abstained	357,022

Table of Contents

PART II

Item 5. ***Market for the Registrant s Common Equity and Related Stockholder Matters***

Price Range of Common Stock

From our initial public offering on October 6, 1992 to February 11, 2002, our common stock traded on the NASDAQ National Market. After the combination with Network General Corporation on December 1, 1997, our common stock traded under the symbol NETA. Prior thereto, our common stock traded under the symbol MCAF. Effective February 12, 2002, our common stock commenced trading on the New York Stock Exchange (NYSE) under the symbol NET.

The following table sets forth, for the period indicated the high and low closing sales prices for our common stock for the last eight quarters, all as reported by NYSE or NASDAQ, as applicable. The prices appearing in the table below do not reflect retail mark-up, mark-down or commission and, for the periods prior to February 12, 2002, when the stock was listed on the NYSE, reflect over the counter market quotations and may not necessarily represent actual transactions.

	High	Low
Year Ended December 31, 2003		
First Quarter	$20.28	$13.72
Second Quarter	14.40	10.80
Third Quarter	15.50	10.75
Fourth Quarter	15.59	12.95
Year Ended December 31, 2002		
First Quarter	$29.99	$22.23
Second Quarter	25.81	16.29
Third Quarter	19.60	10.10
Fourth Quarter	18.83	8.45

Dividend Policy

We have not paid any cash dividends since our reorganization into a corporate form in October 1992. We intend to retain future earnings for use in our business and do not anticipate paying cash dividends in the foreseeable future.

Holders of Common Stock

As of January 31, 2004, there were approximately 915 record owners of our common stock.

Public Filings

Our Internet address is www.networkassociates.com. We make available free of charge through our Internet website current and archived press releases and presentations, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Sections 13(a) or 15(d) of the Securities and Exchange Act, as amended, as soon as reasonably practicable after we electronically file such material with the SEC. We also make available through our Internet website our Corporate Governance Guidelines, the charter for the committees of our board of directors and our Code of Business Conduct and Ethics.

The public may read and copy any materials we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Members of the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0300. Information can also be downloaded from the SEC s web-site at www.sec.gov.

Table of Contents

Item 6. ***Selected Financial Data***

You should read the following selected financial data with the consolidated financial statements and related notes and Management s Discussion and Analysis of Financial Conditions and Results of Operations appearing elsewhere in this Form 10-K. In addition, for a description of events in connection with the restatement of our 2001, 2000 and 1999 operating results, you should read our 2002 10-K and Amendment No. 2 to our 2000 10-K, including in each case note 3 to the consolidated financial statements contained therein, each of which were filed with the SEC on October 31, 2003.

	Years Ended December 31,				
	2003	2002	2001	2000	1999
	(In thousands, except for per share amounts)				
Statement of Operations Data					
Total net revenue	$936,336	$1,043,044	$1,071,660	$ 709,372	$ 660,337
Income (loss) from operations	65,653	114,727	153,483	(127,541)	(136,725)
Income (loss) before provision for (benefit from) income taxes, minority interest and cumulative effect of change in accounting principle	73,125	129,933	148,136	(70,924)	(127,776)
Income (loss) before cumulative effect of change in accounting principle	59,905	128,312	83,253	(108,014)	(151,964)
Cumulative effect of change in accounting principle, net of taxes	10,337				
Net income (loss)	70,242	128,312	83,253	(108,014)	(151,964)
Income (loss) per share, before cumulative effect of change in accounting principle, basic	$ 0.37	$ 0.86	$ 0.60	$ (0.78)	$ (1.10)
Income (loss) per share, before cumulative effect of change in accounting principle, diluted	$ 0.36	$ 0.80	$ 0.53	$ (0.78)	$ (1.10)
Cumulative effect of change in accounting principle, basic	$ 0.07	$	$	$	$
Cumulative effect of change in accounting principle, diluted	$ 0.07	$	$	$	$
Net income (loss) per share, basic	$ 0.44	$ 0.86	$ 0.60	$ (0.78)	$ (1.10)
Net income (loss) per share, diluted	$ 0.43	$ 0.80	$ 0.53	$ (0.78)	$ (1.10)
Shares used in per share calculation basic	160,338	149,441	137,847	138,072	138,695
Shares used in per share calculation diluted	164,489	176,249	164,363	138,072	138,695

	Years Ended December 31,				
	2003	2002	2001	2000	1999
	(In thousands)				
Balance Sheet Data					
Cash and cash equivalents	$ 333,651	$ 674,226	$ 612,832	$ 275,539	$ 329,732
Working capital	415,768	475,418	443,035	79,591	64,560
Total assets	2,120,498	2,045,487	1,658,093	1,465,622	1,510,387
Deferred revenue and taxes	459,557	329,195	404,826	531,555	446,778
Long term debt and other long-term liabilities	570,162	519,150	579,243	400,456	382,517
Total equity	888,089	770,168	341,493	222,923	355,938

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operation***

Forward-Looking Statements and Factors That May Affect Future Results

This Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others things, those risk factors set forth in this section and elsewhere in this report. We identify forward-looking statements by words such as may, will, should, could, expects, plans, anticipates, believes, estimates potential or continue or similar terms that refer to the future. We cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview and Executive Summary

We are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. We offer two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. Our computer security solutions are offered primarily to large enterprises, governments, small and medium sized business and consumer users.

We derive our revenue and generate cash from customers from primarily two sources (i) product revenue, which includes software license, hardware and royalty revenue, and (ii) services and support revenue, which includes software license maintenance, training, consulting and on-line subscription arrangements revenue. For 2003 and 2002, our net revenue was $936.3 million and $1,043.0 million, and our net income was $70.2 million and $128.3 million. Our net revenue is impacted by corporate, government and consumer spending levels. During the past three years, we have experienced softness in corporate level spending, with many of our customers delaying or permanently postponing technology solution implementations. 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 and Latin America. In 2003, 35% of our net revenue was generated outside of North America, with North America and EMEA collectively accounting for 90% of our total net revenue. Our 2003 sales in EMEA totaling $240.6 million were favorably impacted by the strengthening of the Euro and the British Pound during the year. North America and EMEA have experienced many of the same economic trends.

Table of Contents

Sales by product and customer category:

McAfee. Our McAfee products include enterprise, small and medium sized businesses and consumer products, with enterprise including our Entercept host-based intrusion protection products that were acquired in connection with the Entercept acquisition in 2003. While sales to enterprises and small and medium sized businesses have been down, we have experienced significant growth in the consumer market. From 2002 to 2003, we experienced 8% growth in our consumer anti-virus business and our on-line subscription arrangements revenue grew 39%. In 2003, we added 1.9 million net new subscribers to our McAfee.com on-line subscription service and at year-end had a total subscriber base of approximately 3.7 million customers. Our McAfee ASaP on-line service is targeted at small and medium sized businesses and has approximately 2.0 million subscribers at the end of 2003. Drivers of this subscriber growth include numerous virus outbreaks in 2003, including Slammer and Lovesan (Blaster) and strategic relationships with OEMs and others, such as AOL, Dell and MSN.

IntruShield. Our IntruShield network protection products, acquired by us in the second quarter of 2003, are sold primarily to enterprises and small and medium sized businesses. During 2003, we saw sales grow to approximately $9.0 million in the fourth quarter of 2003, with approximately 100 new customers added to our IntruShield customer base in the quarter.

Sniffer Technologies. Our Sniffer business has been impacted by the softness in corporate spending in 2002 and into 2003. We saw our Sniffer revenues decrease 21% from 2002 to 2003; however, we did begin to see a rebound in the fourth quarter of 2003, with Sniffer revenues up 33% over the prior quarter. We saw our newest Sniffer products performing very well in the quarter with approximately 22% of Sniffer sales being derived from products less than one year old.

Magic. We recently 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 $48.0 million, subject to final purchase price adjustments. During 2003, 2002 and 2001, net revenue from the sale of Magic Solutions products totaled approximately $63.2 million, $68.4 million and $60.7 million respectively. The loss of future Magic revenues may increase our operating expenses as a percentage of net revenue.

Deferred revenue balances. Our deferred revenue balance at December 31, 2003 was $481.6 million, of which approximately $22.0 million relates to our Magic business. We believe that the deferred revenue balance improves predictability of future revenues. In the middle of 2003, we introduced our perpetual plus licensing program in EMEA and are introducing this program in the United States in the first quarter of 2004. Under the perpetual plus licensing program more revenue is allocated to service and support, therefore increasing the deferred revenue balance.

Cash, cash equivalents and investment balances. Cash, cash equivalents and investment balances at December 31, 2003 and 2002 totaled $766.3 million and $1.0 billion. During 2003, we generated approximately $156.3 million in cash from operations, used $374.5 million of cash for investing activities and used $146.6 million of cash for financing activities. Our primary utilization of cash in 2003 was to retire zero coupon debentures, make acquisitions and provide for settlement of a securities class action lawsuit commenced against us in 2000.

In 2004, 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) continuing to take the steps to make Sniffer more profitable and cash flow positive; (iv) implementing cost controls and business streamlining measures required to improve operating margins; and (v) continuing to grow our intrusion prevention business.

Table of Contents

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 on 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 differ, and could be material, from these estimates under different assumptions or conditions.

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

Our critical accounting policies are as follows:

- revenue recognition;
- estimating valuation allowances and accrued liabilities, specifically sales returns and other allowances, the allowance for doubtful accounts, our facility restructuring accrual; and the assessment of the probability of the outcome of litigation against us;
- accounting for income taxes; and
- valuation of goodwill, 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 bifurcate the fee and we do not apply separate accounting guidance to the hardware and software elements. For hardware transactions where no software is involved, we apply the provisions of Staff Accounting Bulletin 104 *Revenue Recognition* (SAB 104). In addition, we apply the provisions of Emerging Issues Task Force Issue No. 00-03 *Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity s Hardware* to our on-line software subscription services.

We license our software products on a one and two-year subscription basis or on a perpetual basis. Our two-year subscription licenses include the first year of maintenance and support. Our on-line subscription arrangements require customers to pay a fixed fee and receive service over a period of time, generally one or two years. Customers do not pay 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 the license key which is delivered primarily through e-mail. 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. We assess collection based on a number of factors, including past transaction history and credit-worthiness of direct customers. We do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash. For indirect customers, we monitor the financial condition and ability to pay for goods sold. If we do not identify potential collection problems with our indirect customers on a timely basis, we could incur a charge for bad debt that could be material to our consolidated financial statements.

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

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

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

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

of income and affect our net accounts receivable line item on our consolidated balance sheet. These estimates affect all of our operating geographies.

If our sales returns experience were to increase by an additional 1% of license revenues, our allowance for sales returns at December 31, 2003 would increase and net revenue for 2003 would decrease by approximately $3.4 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.

	December 31, 2003	December 31, 2002
	(In millions)	
Allowance for sales return	$ 9.1	$ 6.7
Allowance for sales incentives	30.5	25.6
Total allowance for sales return and incentives	39.6	32.3
Allowance for doubtful accounts	3.1	6.7
Total allowance	$42.7	$39.0

At December 31, 2003, our accounts receivable balance, excluding Magic accounts receivable, was $170.2 million, net of allowance for doubtful accounts of $2.9 million. Our total allowance for doubtful accounts, including allowance related to Magic accounts receivable, amounts to $3.1 million and our total allowance for sales return and incentives amounts to $39.6 million. Our accounts receivable balance was $160.2 million, net of allowance for doubtful accounts of $6.6 million and provision for sales returns and other allowances of $32.3 million as of December 31, 2002. If an additional 1% of our gross accounts receivable were deemed to be uncollectible at December 31, 2003, our allowance for doubtful accounts and provision for bad debt expense would increase by approximately $2.4 million.

Restructuring Accrual. 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 the first quarter of 2003. We recorded this facility restructuring charge 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 charge and corresponding liability, 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 Santa Clara as well as current market interest rates. The assumptions used are our management s best estimate at the time of the accrual, and adjustments are made on a periodic basis if better information is obtained. If, at December 31, 2003, our estimated sublease income were to decrease 10%, the restructuring reserve and related expense would have increased by approximately $0.5 million.

The estimates regarding our restructuring accrual affect our current liabilities and other long term liabilities line items in our consolidated balance sheet, since this liability will be settled each year through 2013. The estimate affects our statement of income in the restructuring line item. At December 31, 2003, our North American operating geography was the only geography affected by this estimate.

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

33

Table of Contents

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

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

The net deferred tax asset as of December 31, 2003 is $359.7 million, net of a valuation allowance of $88.3 million due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire. The valuation allowance is based on our historical 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 gains or losses could occur in future years from resolution of outstanding matters. We continue to assess our potential tax liability included in accrued taxes in the consolidated financial statements, and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position.

Valuation of Goodwill, Intangibles, and Long-lived Assets

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

We are required to make estimates regarding the fair value of our reporting units when testing for potential impairment. We estimate the fair value of our reporting units using a combination of the income approach and the market approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. Under the market approach, we estimate the fair value based on market multiples of revenues or earnings for comparable companies. We estimate cash flows for these purposes using internal budgets based on recent and historical trends. We base these estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. We also make certain judgments about the selection of comparable companies used in the market approach in valuing our reporting units, as well as certain assumptions to allocate shared assets and liabilities to calculate the carrying

value for each of our reporting units. If an impairment were present, these estimates would affect an impairment line item on our consolidated statement of income and would affect the goodwill and/or intangible line items in our consolidated balance sheet. As goodwill is allocated to all of our reporting units, any impairment could potentially affect each operating geography.

Based on our current impairment test, there would have to be a significant change in assumptions used in such calculation in order for an impairment to occur as of December 31, 2003.

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 $443.6 million, excluding $9.8 million related to Magic, and $273.9 million as of December 31, 2003 and 2002, respectively. We did not hold any indefinite-lived intangibles as of December 31, 2003 or 2002. Net finite-lived intangible assets and long-lived assets amounted to $217.6 million and $182.8 million as of December 31, 2003 and 2002, respectively.

Previous Restatement of Consolidated Financial Statements

This Management s Discussion and Analysis of Financial Condition and Results of Operations gives effect to the restatement of our consolidated financial statements for 1998 through 2001 and should be read in conjunction with the consolidated financial statements contained in our 2002 Form 10-K (2000 through 2002) and Amendment No. 2 to our 2000 Form 10-K/ A (1998 through 2000), including in each case, the related notes and, in particular, note 3 describing the restatement. Among others, the more significant categories of restatement adjustments were recorded:

- to properly reflect sales to our distributors and resellers on the sell-through basis for 1998 through 2000, which is how we have accounted for these sales since 2001; and
- to correct certain errors previously made in the application of the revenue recognition principles under SOP 97-2 to multi-element revenue transactions in 1998 through 2000.

We have determined that, excluding the effect of currency-related adjustments, the aggregate amount of net revenue was not reduced as a result of our change to the sell-through revenue recognition method for years prior to 2001 or adjustments related to multi-element licensing arrangements in 1998 through 2000. These adjustments had the effect of deferring revenue from earlier periods to be recognized in later periods, with amounts deferred in connection with our multi-element licensing arrangements generally being recognized in later periods as service and support revenue. In the aggregate, for 2003, 2002 and 2001, the restatement adjustments had the effect of increasing net revenues by $5.7 million, $101.2 million and $259.2 million, respectively, and decreasing expenses by $13.6 million in 2003, and increasing expenses in 2002 and 2001 by

$63.1 million and $75.3 million, respectively. In addition, net revenue in 2004 is expected to be increased by approximately $0.3 million as a result of the restatement.

Results of Operations

Years Ended December 31, 2003, 2002, and 2001

Net Revenue

The following table sets forth for the periods indicated our product revenue and services and support revenue as a percent of net revenue (in thousands, except percentages):

	For the Year Ended December 31,			Percentage of Net Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Net revenue:						
Product	$513,610	$ 631,550	$ 611,030	55%	61%	57%
Services and support	422,726	411,494	460,630	45	39	43
Total net revenue	$936,336	$1,043,044	$1,071,660	100%	100%	100%

Net revenue decreased 10% or $106.7 million from 2002 to 2003 and decreased 3% or $28.6 million in 2002 from 2001. The overall decline in each period is due primarily from weaknesses in the United States and other economies and continued reductions in corporate spending. Many of our customers and potential customers have: (i) delayed initiating the purchase process; (ii) increased the evaluation time to complete a purchase or postponed, sometimes indefinitely, full IT deployments; and/or (iii) reduced their capital expenditure budgets, thereby restricting their software/services purchases to those believed by them to be necessary to satisfy an immediate need. Net revenue for 2003 includes approximately $63.2 million of Magic revenue. We sold our Magic business in January 2004.

In the first quarter of 2004, we will expand our perpetual plus licensing arrangements to the United States. Under these arrangements, introduced in Europe and Asia earlier in 2003, we provide a perpetual license coupled with additional support, with a higher percentage of the contract value allocated to support revenues. As a result of these arrangements, we expect (i) an increase in the amount of services and support revenue relative to product revenue as a result of higher renewal rates and (ii) because support revenues are deferred and recognized over the life of the arrangement, an increased amount of revenue being deferred to future periods. Deferred revenue increased 21% to $481.6 million which includes $22.0 million of deferred revenue related to Magic, at December 31, 2003 from $397.2 million at September 30, 2003 and has increased $152.4 million from December 31, 2002.

Net Revenue by Geography

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

	For the Year Ended December 31,			Percentage of Net Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Net revenue:						

North America	$606,685	$ 653,532	$ 696,136	65%	63%	65%
EMEA	240,616	298,659	292,663	26	28	26
Japan	40,519	39,369	28,919	4	4	3
Asia-Pacific	29,014	33,595	37,606	3	3	4
Latin America	19,502	17,889	16,336	2	2	2
Total net revenue	$936,336	$1,043,044	$1,071,660	100%	100%	100%

Net revenue outside of North America (United States and Canada) accounted for approximately 35%, 37% and 35% of net revenue for 2003, 2002 and 2001. In the previous three years, net revenue from North America and EMEA has comprised approximately 90% of our business. In 2003, we saw a weakening of the U.S. dollar against many currencies, but most dramatically against the Euro and Great Britain Pound. As a result of the weakening U.S. dollar, we experienced positive impacts on our net revenue in EMEA region.

In 2003, total net revenue in North America decreased 7% or $46.8 million as compared to 2002 and decreased 6% or $42.6 million from 2001 to 2002. The decrease in revenue is due to the overall economic downturn that has been experienced in the past three years in the United States as well as a softness in corporate spending.

In EMEA, total net revenue decreased 19% or $58.0 million from 2003 to 2002. In 2002, EMEA net revenue remained relatively flat, increasing 2% or $6.0 million from 2001. As in North America, the European economies have been subject to a prolonged economic downturn resulting in companies temporarily or permanently delaying technology expenditures. Also, in the middle of 2003, we introduced our new perpetual plus licensing model in Europe with a larger portion of total contract values being deferred into later years.

Our Japan, Latin America and Asia-Pacific operations combined have historically been approximately 9% of our total business, and we expect this trend to continue.

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

Product Revenue

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

	For the Year Ended December 31,			Percentage of Product Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Term subscription licenses	$113,696	$181,825	$197,044	23%	29%	32%
Perpetual licenses	227,492	277,882	183,309	44%	44%	30%
Hardware	99,502	93,359	87,932	19%	15%	14%
Retail	45,993	63,236	127,453	9%	10%	21%
Other	26,927	15,248	15,292	5%	2%	3%
Total product revenue	$513,610	$631,550	$611,030	100%	100%	100%

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. The $117.9 million, or 19%, decrease in product revenue from 2002 to 2003 is due to (i) the introduction of our perpetual plus licensing arrangements in EMEA and Asia-Pacific resulting in reduced product revenues and increased services and support revenues, (ii) continued softness in corporate spending over the past three years and (iii) the shift of our focus on the retail boxed product to our on-line subscription model for consumers and small and medium sized businesses. Product revenue from 2001 to 2002 remained relatively flat.

Retail revenue in 2001 and 2002 includes approximately $72 million and $20 million of revenue deferred from prior years as part of our financial restatement. During 1998 through 2000 we did not properly establish VSOE on the sales of certain retail products. We generally expect a decline in our retail boxed products revenue as we continue to shift our focus to our on-line subscription services (with the related revenues categorized in services and support revenue below).

Our customers license our software on a perpetual or term subscription basis depending on their preference. We expect perpetual licenses to become a larger percentage of product revenue in the future as we

implement our perpetual plus licensing model. We expect the remaining mix of product revenue to remain relatively consistent as a percentage of revenue.

Services and Support Revenue

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

	For the Year Ended December 31,			Percentage of Services and Support Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Support and maintenance	$313,731	$310,473	$359,403	74%	75%	78%
Consulting	27,421	36,740	41,276	7%	9%	9%
Training	9,486	12,527	19,161	2%	3%	4%
On-line subscription arrangements	72,088	51,754	40,790	17%	13%	9%
Total services and support revenue	$422,726	$411,494	$460,630	100%	100%	100%

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

In 2001, $100.4 million more of service and support revenue was recognized as compared to 2002 due to our restatement and the deferral of services and support revenue from 1998 through 2000 with respect to multi-element revenue contracts. Excluding this difference, service and support revenue increased by $51.5 million, reflecting growth of our installed customer base, an overall increase in maintenance pricing year over year and an $11.0 million increase in on-line subscription revenue generated primarily by our McAfee.com consumer site.

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

Cost of Net Revenue; Gross Margin

	For the Year Ended December 31,			Percentage of Cost of Net Revenue		
	2003	**2002**	**2001**	**2003**	**2002**	**2001**
	(In thousands, except percentages)					
Cost of net revenue:						
Product	$ 86,646	$104,039	$114,917	58%	63%	65%
Services and support	51,611	57,519	56,536	34	35	32
Amortization of purchased technology	11,369	3,153	5,039	8	2	3
Total cost of net revenue	$149,626	$164,711	$176,492	100%	100%	100%
Gross margin	$786,710	$878,333	$895,168			
Gross margin percentage	84%	84%	84%			

Our total cost of net revenue decreased $15.1 million, or 9% due primarily to our 10% decrease in net revenue from 2002 to 2003. The decrease of $11.8 million, or 7% from 2001 to 2002 was also as a result of lower revenues in the same period.

Cost of Product Revenue. Our cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels; royalties; and, with respect to hardware-based anti-virus products and network fault and performance products, computer platforms and other hardware components. The decrease from 63% to 58% in the cost of product revenue as a percentage of total cost of net revenue from 2002 to 2003 is due to lower costs of computer platforms and other hardware components as at the end of 2002 we began using a more competitive contract manufacturer which also utilized a greater number of standardized computer platforms and hardware components. We also benefited from the favorable impact of cost control measures. Cost of product revenue as a percentage of total cost of net revenue remained relatively flat between 2002 and 2001. We anticipate that cost of product revenue will continue to fluctuate as a percent of cost of net revenue.

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. Services and support as a percentage of cost of net revenue remained relatively flat at 34% to 35% in 2003 and 2002, and increased to 35% from 32% in 2001. The increase from 2001 to 2002 was due almost exclusively to additional technical support and customer service personnel hired during 2001 to meet our customers technical support needs. We anticipate that cost of service revenue will continue to fluctuate as a percent of cost of net revenue.

Amortization of Purchased Technology. Amortization of purchased technology increased, $8.2 million or 261%, from 2002 to 2003. The increase is due to our acquisitions of Entercept and IntruVert, in respect of which we recorded purchased technology of $21.7 million and $18.2 million, respectively. The purchased technology is being amortized over its estimated useful life of seven years. Amortization of purchased technology is expected to be $12.5 million in 2004.

Gross Margins. Our gross margins were stable at 84% from 2001 to 2003. The increase of amortization of purchased technology in 2003 as a percentage of cost of net revenue to 8% offset the improvement we experienced in our cost of product revenues from 2003 to 2002.

Operating Costs

Set forth below for the indicated periods are our operating costs, including and excluding stock-based compensation. Our management believes that a presentation of operating costs excluding stock-based compensation provides investors a meaningful basis of evaluating our underlying cost and expense levels. The size and amount of our stock based compensation charges has varied, and in the future will vary, from period

Table of Contents

to period based on movements in our stock price, making period to period comparisons difficult and, in some cases, not meaningful. See Stock-Based Compensation below.

Including Stock-Based Compensation:

	For the Year Ended December 31,			Percentage of Net Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Research and development	$184,606	$148,801	$146,701	20%	14%	14%
Marketing and sales	363,306	397,747	421,583	39	38	39
General and administrative	129,920	119,393	111,106	14	11	10
Provision for (recovery from) doubtful accounts	(1,216)	(219)	7,449			1
Litigation settlement		70,000			7	
Amortization of intangibles	15,637	10,742	51,025	2	1	5
Acquisition related costs not subject to capitalization		16,026			2	
Restructuring charges	22,204	1,116	3,821	2		
In-process research and development	6,600					
Total operating costs, including the effects of stock-based compensation	$721,057	$763,606	$741,685	77%	73%	69%

Excluding Stock-Based Compensation:

	For the Year Ended December 31,			Percentage of Net Revenue		
	2003	2002	2001	2003	2002	2001
	(In thousands, except percentages)					
Research and development(1)	$179,449	$144,838	$142,097	19%	14%	13%
Marketing and sales(2)	358,241	395,767	411,229	39	38	39
General and administrative(3)	127,635	102,932	101,712	14	9	9
Provision for (recovery from) doubtful accounts	(1,216)	(219)	7,449			1
Litigation settlement		70,000			7	
Amortization of intangibles	15,637	10,742	51,025	2	1	5
Acquisition related costs not subject to capitalization		16,026			2	
Restructuring charges(4)	22,204	1,116	3,302	2		
In-process research and development	6,600					
Total operating costs, including the effects of stock-based compensation	$708,550	$741,202	$716,814	76%	71%	67%

(1) Excludes stock-based compensation charge of $5,157, $3,963 and $4,604 for 2003, 2002 and 2001, respectively.

(2) Excludes stock-based compensation charge of $5,065, $1,980 and $10,354 for 2003, 2002 and 2001, respectively.

Table of Contents

(3) Excludes stock-based compensation charge of $2,285, $16,461 and $9,394 for 2003, 2002 and 2001, respectively.

(4) Excludes stock-based compensation charge of $0, $0 and $519 for 2003, 2002 and 2001, 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. Excluding the effects of stock-based compensation of $5.2 million and $4.0 million in 2003 and 2002, respectively, research and development expenses increased $34.6 million to $179.4 million. Of this increase: $9.7 million and $3.2 million, respectively, relates to our acquisitions IntruVert and Entercept, and our acquisitions Deersoft and Traxess; $4.6 million relate to the 2003 opening of our research and development facility in Bangalore, India and $9.0 million relates to increased McAfee research and development expenditures; and $8.0 million relates to higher headcount. We plan to increase our research and development expenditures in Bangalore, India. Excluding the effects of stock-based compensation of $4.0 million and $4.6 million in 2002 and 2001, respectively, research and development expenses remained relatively flat at $144.8 million in 2002 versus $142.1 million in 2001.

We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to increase in future periods. We anticipate that research and development expenses will continue to increase in absolute dollars, but will continue to fluctuate as a percent 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. Excluding the effects of stock-based compensation of $5.1 million and $2.0 million in 2003 and 2002, respectively, marketing and sales expenses decreased $37.5 million, or 9% from 2002 to 2003 primarily due to a corresponding 10% decrease in net revenue from 2003 to 2002. We also experienced lower sales and marketing expense in 2003 of approximately (i) $10.6 million due to a reduction of salary, benefit and commission expenses following a decrease in headcount of approximately 100 sales personnel, (ii) $5.7 million from our reduced use of outside services and other cost saving measures and (iii) $2.1 million related to travel expense cost savings measures. As a result of the change in the way we account for sales commissions, we had lower sales and marketing expense of approximately $5.0 million. Excluding the effects of stock-based compensation of $2.0 million and $10.4 million in 2002 and 2001, respectively, marketing and sales expenses decreased 4% to $395.8 million in 2002 from $411.2 million in 2001 primarily due to a decrease in commissions.

We anticipate that marketing and sales expenses will increase in absolute dollars, but 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. Excluding the effects of stock-based compensation of $2.3 million and $16.5 million for 2003 and 2002, respectively, general and administrative expenses increased $24.7 million, or 24%, to $127.6 million in 2003. The increase is due to costs incurred in connection with our restatement of $8.8 million and acquisition related bonuses of $4.0 million. The acquisition related bonuses are being expensed monthly as the former IntruVert and Entercept employees provide services to us. We expect these future acquisition related bonuses to be approximately $3.4 million in 2004 with an additional $2.3 million being recognized in total through 2007.

In 2003, our legal expenses increased approximately $4.6 million in 2003 from 2002 due to an increase in outside legal services due to our on-going SEC and DOJ investigations. Our information technology department expenses increased approximately $6.2 million due to increases in headcount and depreciation and equipment expense. We also had a full year of internal audit and four-months of Sarbanes-Oxley expenses in 2003, resulting in an increase of approximately $0.8 million and $1.4 million, respectively, as compared to 2002.

Excluding the effects of stock-based compensation of $16.5 million and $9.4 million for 2002 and 2001, respectively, general and administrative expenses remained relatively flat at $102.9 million and $101.7 million for 2002 and 2001.

We expect our general and administrative expenses to remain generally flat as we implement cost control measures.

Provision for (Recovery from) Doubtful Accounts, Net. Provision for doubtful accounts consists of our estimates for the uncollectibility of receivables, net of recoveries of amounts previously written off. The recovery for doubtful accounts was $1.2 million and $0.2 million in 2003 and 2002, respectively. The provision for doubtful accounts was $7.4 million in 2001.

Litigation Settlement. We agreed to settle a securities class action litigation in September 2003. The $70.0 million litigation charge was recorded in 2002 because our agreement to settle, which established the liability to be probable and estimable, occurred prior to the publication of our 2002 consolidated financial statements in October 2003. We paid the $70.0 million settlement in October 2003.

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

Amortization of Intangibles. We expensed $15.6 million, $10.7 million, and $51.0 million of amortization related to intangibles in 2003, 2002, and 2001, respectively. Intangibles consist of purchased goodwill, purchased technology and other identifiable intangible assets. The increase in amortization of $4.9 million in 2003 is the result of the acquisition of IntruVert and Entercept in 2003.

The decrease in amortization in 2002 was largely a result of the implementation of SFAS 142 which requires us to cease amortizing goodwill and, therefore, we realized a decrease in the annual amortization of $51.2 million.

*Restructuring Costs 2003*In January 2003, as part of a restructuring effort to gain operational efficiencies, we consolidated operations formerly housed in three leased facilities in the Dallas, Texas area into our newly constructed 170,000 square-foot regional headquarters facility in Plano, Texas. The new facility houses approximately 1,000 employees working in finance, legal, information technology, and the customer support and telesales groups servicing the McAfee System Protection Solutions and McAfee Network Protection Solutions businesses. We also relocated approximately 170 employees from our Santa Clara, California headquarters.

As a result of this consolidation, in March 2003, we recorded a restructuring charge of $15.8 million which consisted of a non-cash charge of $2.1 million related to asset disposals and discontinued use of certain leasehold improvements, furniture and equipment; non-cash write off of $(1.9) million deferred rent liability; and a $15.6 million accrual for estimated lease related costs associated with permanently vacated facility in Santa Clara, California. The remaining costs associated with vacating the Santa Clara facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facility and will generally be paid over the remaining lease term ending in 2013.

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

Table of Contents

The following table summarizes our restructuring accrual established in 2003 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2003	$	$	$	$
Restructuring accrual	15,734	6,692	739	23,165
Cash payments	(1,707)	(6,259)	(167)	(8,133)
Adjustment to liability	(273)	(116)	(572)	(961)
Accretion	463			463
Balance, December 31, 2003	$ 14,217	$ 317	$	$ 14,534

Our management s estimates of the excess facilities charge may vary significantly depending, in part, on factors which may be beyond our control, such as our success in negotiating with our lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if further consolidations are required or if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charge was not allocated to our reporting segments. However, the restructuring charge related to headcount reductions was $0.9 million in North America and $5.8 million in EMEA.

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

The following table sets forth our restructuring accrual established in February 2002 and the activity against the accrual during 2002 (in thousands):

	Other Costs	Severance and Benefits	Total
Balance, February 2002	$ 190	$ 926	$ 1,116
Cash payments	(190)	(926)	(1,116)
Balance, December 31, 2002	$	$	$

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

43

Table of Contents

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

Interest and Other Income. Interest and other income was $15.5 million in 2003, $27.3 million in 2002 and $28.0 million in 2001. Interest and other income decreased from 2003 to 2002 primarily due to a decrease of cash and investments of $247.5 million from 2002 to 2003 and an overall decrease in average yields on our marketable securities. In 2003, we used cash of approximately $217.1 million to purchase Entercept and IntruVert and $177.3 million to redeem the remaining portion of our outstanding zero coupon debentures. Interest and other income increased slightly from 2001 to 2002 primarily due to an increased cash and investment balances of approximately $70.8 million, offset by an overall decrease in average yields.

Interest and Other Expenses. Interest and other expense decreased to $7.5 million in 2003 from $25.1 million in 2002. Interest and other expense decreased by $8.8 million due to a reduction in interest and expense due to the repurchase in 2003 of the remaining zero coupon debentures during 2003. Additionally, in 2003, we realized a full year of effect of the interest rate swap we entered into in July 2002 resulting in interest and expense savings of $9.2 million compared to 2002. We also recorded $0.3 million of capitalized interest in 2003. The reduction in our interest expense due to positive effects from our swap is dependent on interest rates. As interest rates remain low, we will continue to receive positive impact from our swap, however, if interest rates begin to rise, the positive effects of the swap will begin to diminish.

Interest and other expense increased slightly to $25.1 million in 2002 from $24.7 million in 2001. Interest and other expense during 2002 increased $12.7 million due to the recognition of a full twelve months of interest and expense on the 5.25% convertible subordinated notes issued in August 2001. This was offset by a $7.3 million reduction in interest and expense due to the partial repurchase of $140.0 million face value of zero coupon debentures during 2002. Additionally, we entered into an interest rate swap in July 2002 related to the 5.25% convertible subordinated notes resulting in interest and expense savings during 2002 of $4.2 million over the stated rate. In addition, we recorded $0.8 million of capitalized interest in 2002 related to the construction of the Plano, Texas office facility.

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

Gain (loss) on repurchase of zero coupon convertible debentures. We recognized a loss of $2.7 million on the repurchase of zero coupon debentures in 2003, and recognized gains on the repurchase of zero coupon debentures of approximately $26,000 and $1.7 million in 2002 and 2001, respectively. The zero coupon debentures have been fully repurchased, therefore no future gains or losses are expected.

Gain on Investments, Net. In 2003 and 2002, we recognized a $3.1 million and $3.8 million gain on the sale of equity and debt securities, respectively. In 2001, we recognized a $10.2 million gain on the sale of equity and debt securities. Our investments are classified as available for sale and we may sell securities from time to time to move funds into investments with more lucrative investment yields, thus resulting in gains and losses on sale.

Table of Contents

Impairment of Strategic and Other Investments. For the years ended December 31, 2002 and 2001, we recorded impairment charges of $0.2 million and $20.6 million, respectively, related to an other than temporary decline in the value of our venture and strategic investments. No such impairment charges were incurred in 2003 as all of our investments have no carrying value.

Provision for (benefit from) Income Taxes. The provision for (benefit from) income taxes was $16.8 million (including $3.6 million included in the cumulative effect of change in accounting principle), $(0.3) million and $66.0 million in 2003, 2002 and 2001, respectively. Tax expense was 19.3% and 0% of earnings before income taxes and minority interest for 2003 and 2002, respectively. Tax expense for 2001 was 45%. The increase in the effective tax rate from 2002 to 2003 was primarily attributable to the generation of fewer tax credits along with less income being derived in lower tax jurisdictions. The decrease in the effective tax rate from 2001 to 2002 was primarily due to foreign tax credit benefits in 2002, the elimination of the goodwill write-off, increased benefit from foreign earnings taxed at a lower rate, and a reduction of non-deductible and other costs. Each year, our tax expense is mainly influenced by the mix of income between geographic jurisdictions, including taxable income in certain foreign countries.

Stock-Based Compensation

We recognized stock-based compensation expense of $12.5 million, $22.4 million and $24.9 million in 2003, 2002 and 2001, respectively. Our stock-based compensation charges comprised of the following for the years presented (in thousands):

	Years Ended December 31,		
	2003	2002	2001
Exchange of McAfee.com options	$ 3,369	$ 16,101	$
Former employees	1,125	10,118	2,668
New and existing executives	424	1,478	3,230
Extended life of vested options of terminated employees	3,720		
Extended vesting term of options		193	
Extended period of Employee Stock Purchase Plan	3,869		
Shares purchased outside Employee Stock Purchase Plan and other		62	9
Repriced options		(5,548)	17,396
Warrants to outside consultants			1,049
PGP restructuring			519
Total stock-based compensation	$ 12,507	$ 22,404	$ 24,871

Described below are the events giving rise to the more significant stock-based compensation charges in 2003. These and the other stock-based compensation charges are described in greater detail in note 16 to our consolidated financial statements. We expect significant future stock-based compensation charges related to the exchange of McAfee.com options and repriced employee stock options, with the amount of these charges being impacted by fluctuations in our stock price. The stock-based compensation charges in 2002 and 2001 with respect to (i) former employees, relate primarily to charges taken in connection with the former executive officers of McAfee.com, the minority shares of which we acquired in 2002, and our former executive officers which left the company in late 2002 or early 2001 and (ii) new and existing executives, relate primarily to charges taken in connection our retention of new executive officers in 2001.

Exchange of McAfee.com Options. On September 13, 2002, we acquired the minority interest in McAfee.com. In exchange for each McAfee.com option, holders received options for 0.675 of a share of our common stock plus $8.00 in cash, which will be paid to the option holder only 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 our common stock. Because McAfee.com was our consolidated subsidiary and these options were repriced in conjunction with the acquisition of the minority interest, these options were

Table of Contents

accounted for under the variable method of accounting which requires that a compensation charge be remeasured at the end of every reporting period using fair market value.

During 2003 and 2002, we recorded a charge of approximately $3.4 million and $16.1 million, respectively, related to exchanged options subject to variable accounting. Our stock-based compensation charge related to exchanged options subject to variable accounting was based on our closing share price of $15.04 and $16.09 on December 31, 2003 and 2002, respectively. As of December 31, 2003, we had outstanding exchanged options to acquire approximately 0.8 million of our shares subject to this variable accounting.

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 option exercises were suspended is known as the black-out period. Due to the blackout period, we have extended the exercisability of any options that would otherwise terminate during the blackout period for a period of time equal to a specified period after termination of the blackout period. Accordingly, we have recorded 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 2003, we recorded a stock-based compensation charge of approximately $3.7 million for the extension of life of vested options held by terminated employees.

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

Repriced Options. On April 22, 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 10.3 million shares were cancelled and the same number of new options were granted. These new options vest at the same rate that they would have vested under previous option plans and are subject to variable accounting. Accordingly, we have 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 on July 1, 2000. At December 31, 2002, these options were substantially fully vested. Depending upon movements in the market value of our common stock, this accounting treatment may result in additional stock-based compensation charges in future periods.

During 2002 and 2001, we incurred charges (credits) to earnings of approximately ($6.5) million and $15.6 million, respectively, related to options subject to variable plan accounting. As of December 31, 2003, options to purchase 0.7 million shares of the company were outstanding and subject to variable accounting.

We also incurred an initial stock-based compensation charge in connection with the initial issuance of the repriced options. Approximately $1.0 million and $1.8 million was expensed during 2002 and 2001, respectively.

Acquisitions

IntruVert Networks, Inc.

On May 14, 2003, we 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 $103.3 million in cash. We acquired IntruVert to enhance our intrusion detection product line. The results of operations of IntruVert have been included in our consolidated financial statements since the date of acquisition.

Under the transaction, we recorded approximately $18.2 million for developed technology, $1.9 million for acquired product rights, including revenue related order backlog and contracts, $71.8 million for goodwill

(none of which is deductible for tax purposes), $11.0 million in cash, $7.4 million for net deferred tax liabilities and $2.2 million for tangible assets, net of liabilities. We also recorded approximately $5.7 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to five years or a weighted average period of 4.5 years. We also accrued approximately $0.3 million in duplicative site costs for lease space no longer being utilized and permanently vacated related to the IntruVert acquisition of which less than $0.1 million remains as an accrual as of December 31, 2003.

Entercept Security Technologies, Inc.

On April 30, 2003, We 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 $125.8 million in cash. We acquired Entercept to enhance our intrusion detection product line. The results of operations of Entercept have been included in our consolidated financial statements since the date of acquisition.

Under the transaction, we recorded approximately $21.7 million for developed technology, $2.8 million for acquired product rights, including revenue related order backlog and contracts, $99.7 million for goodwill (none of which is deductible for tax purposes), $9.6 million for net deferred tax liabilities, $10.6 million of deferred tax assets, $1.0 million in cash and $1.5 million in liabilities, net of tangible assets. We also recorded approximately $0.9 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to six years or a weighted average period of 5.6 years.

As a result of the acquisition, we accrued $2.8 million in duplicative sites costs for permanently vacated facilities at the acquisition date. The accrual will be fully utilized by 2006, the end of the original lease term. In the fourth quarter of 2003, we entered into a sublease for the vacated facility, and therefore, adjusted the accrual by the value of the sublease. The following is a summary of activity in the restructuring accrual related to Entercept in 2003 (in thousands):

Original accrual	$ 2,837
Cash payments	(684)
Adjustments	(1,137)
Balance, December 31, 2003	$ 1,016

Liquidity and Capital Resources

	2003	2002	2001
		(In thousands)	
Cash, cash equivalents and investments	$ 766,257	$ 1,013,709	$ 942,950
Net cash provided by operating activities	$ 156,304	$ 195,093	$ 145,989
Net cash (used in) provided by investing activities	$ (374,480)	$ (183,646)	$ 20,775
Net cash provided by (used in) financing activities	$ (146,579)	$ 43,736	$ 158,599

Overview

We ended 2003 with cash, cash equivalents and investments totaling $766.3 million, as compared to $1,013.7 million at the end of 2002. The decrease was due primarily to our purchase of Entercept and IntruVert in 2003 for $217.1 million; our payment of $70.0 million to settle a pending securities class action lawsuit; and our use of $177.3 million of cash to repurchase the remaining balance of zero coupon convertible debentures. The uses of cash were offset by the receipt of approximately $35.4 million in proceeds from stock

issued under employee stock purchase plans and options, as well as cash collections from our customers and the timing of payment of our liabilities. A more detailed discussion of changes in our liquidity follows.

Operating Activities.

Net cash provided by operating activities in 2003, 2002 and 2001 was primarily the result of our net income of $70.2 million, $128.3 million and $83.3 million, respectively, which is adjusted for non-cash items such as depreciation and amortization, non-cash restructuring charges, acquired in-process research and development, stock-based compensation and changes in various assets and liabilities such as accounts payable, accounts receivable and other current assets.

Our historical and primary source of operating cash flow is the collection of accounts receivable from our customers and the timing of payments to our vendors and service providers. One measure of the effectiveness of our collection efforts is average accounts receivable days sales outstanding (DSO). DSOs were 92 days, 69 days, and 68 days at December 31, 2003, 2002 and 2001. We calculate accounts receivable DSO on a gross 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 2003, 2002 and 2001, we have not made any significant changes to our payment terms for our customers, which are generally net 30.

Our balances in accounts payable and accrued liabilities decreased $78.5 million causing a use of cash in operating activities. A primary cause of the decrease in accrued liabilities from 2002 to 2003 was our cash payment of $70.0 million related to our class action litigation settlement. We are pursuing the collection of insurance proceeds of up to $25.0 million from our insurance carriers in regards to this litigation settlement. We will record the proceeds when received. Our operating cash flows will be impacted in the future based on the timing of payments to our vendors for accounts payable. We typically pay our vendors and service providers in accordance with invoice terms and conditions, and take advantage of invoice discounts when available. The timing of future cash payments in future periods will be impacted by the nature of accounts payable arrangements and management s assessment of our cash inflows. In 2003, 2002 and 2001, we have not made any significant changes to our payment timing to our vendors.

Our cash balances are held in numerous locations throughout the world, including substantial amounts held outside the United States. As of December 31, 2003, approximately $271 million was held outside the United States. Most amounts held outside the United States could be repatriated to the United States, but, under current law, would be subject to United States federal income taxes, less applicable foreign tax credits. Repatriation of some foreign balances is restricted by local laws. We have provided for United States federal tax liability on these amounts for consolidated financial statement purposes except for foreign earnings that are considered indefinitely reinvested outside the United States. Repatriation could result in additional United States federal income tax payments in future years. Where local restrictions prevent an efficient intercompany transfer of funds, our intent is that cash balances would remain in the foreign country and we would meet United States liquidity needs through ongoing cash flows. 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.

Our working capital, defined as current assets minus current liabilities, was $415.8 million and $475.4 million at December 31, 2003 and December 31, 2002, respectively. The cause of the decrease in working capital of approximately $59.6 million is the use of cash discussed above in the Overview section, offset in part by the decrease in current liabilities of $173.8 million from 2002 to 2003. Current liabilities decreased due to the repurchase of the remaining balance of our zero coupon convertible debentures in 2003, offset by an increase of $50.5 million in the current portion of deferred revenue. Our new perpetual plus licensing model, results in less revenue recognition up-front, therefore causing increases in our deferred revenue.

We are currently under an SEC and DOJ investigation. As a result of these investigations, we may be exposed to penalties that may be material to our consolidated financial statements.

Table of Contents

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

Investing Activities.

A summary of our investing activities at December 31, 2003, 2002 and 2001 is as follows (in thousands). The detail of these line items can be seen in our consolidated statement of cash flows.

Activity	2003	2002	2001
Cash payments for acquisitions	$ (217,256)	$ (118,308)	$ (23,821)
Cash payments for property and equipment	(60,027)	(59,427)	(31,493)
Net proceeds (purchases) of investments in marketable securities	(97,861)	8,668	76,089
Cash payments for restricted cash	664	(21,734)	0
Sales of common stock investments	0	7,155	0
Net cash used in (provided by) investing activities	$ (374,480)	$ (183,646)	$ 20,775

Acquisitions

In 2003, we paid cash for our acquisitions of Entercept and IntruVert in the amount of $124.8 million and $92.3 million, respectively. We purchased IntruVert and Entercept to enhance our network intrusion prevention products. In September 2002, to among other things, reduce customer and brand confusion, we acquired the outstanding minority interest in McAfee.com for a combination of shares our common stock and $98.4 million total cash payments. In 2002, we also purchased several smaller entities for cash in the amount of $19.1 million in order to enhance our products and improve distribution in Latin America. In 2001, we repurchased the shares of Networks Associate Japan for $10.7 million due to a change in our business strategy and paid $12.3 million for acquired technology.

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

We have also made divestures previously. For example, in January 2004, we completed the sale of our Magic service desk business as part of our continued focus on security and security related products. In 2004, we received cash proceeds of approximately $48.0 million, subject to final purchase price adjustments.

Property and Equipment

We added $60.0 million of equipment during 2003 to update hardware for our employees and enhance various back office systems, including our new customer relationship management system which we are deploying in early 2004. In 2002, we added $59.4 million of property and equipment, including approximately $17.0 million related to the construction of our regional office in Plano, Texas. We added $31.5 million of property and equipment in 2001. Our property and equipment additions have been funded from operations.

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

Table of Contents

Investments

We received net proceeds from (and made net purchases of) and sales/maturities of our marketable securities of $(97.9 million), $8.7 million, and $76.1 million in 2003, 2002 and 2001. We have classified our investment portfolio as available for sale, and our investments are made with a policy of capital preservation and liquidity as the primary objectives. We generally hold investments in corporate bonds and U. S. government agency securities to maturity; however, we may sell an investment at any time if the quality rating of the investment declines, the yield on the investment is no longer attractive or we are in need of cash. Because we invest only in investment securities that are highly liquid with a ready market, we believe that the purchase, maturity of sale of our investments has no material impact on our overall liquidity.

Restricted Cash

At December 31, 2003, we had on deposit approximately $20.2 million as collateral for our interest rate swap arrangements we entered into related to our $345.0 million of 5.25% subordinated convertible debt. The arrangements require we keep a minimum amount of $20.0 million on deposit with the swap counterparties, subject to increase based on the fair value of the swap.

Financing Activities. A primary use of financing activities in 2003 was the use of $177.3 million of cash to repurchase the remaining balance of our zero coupon convertible debt. As a result of this redemption, we recorded a total loss on repurchase of approximately $2.7 million. In 2002 and 2001, we also repurchased portions of this debt using $66.2 million and $173.7 million of cash.

Historically, our recurring cash flows provided by financing activities have been from the receipt of cash from the issuance of common stock under stock option and employee stock purchase plans. We received cash proceeds from these plans in the amount of $35.4 million, $109.9 million and $51.1 million in 2003, 2002 and 2001, 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. The decrease in cash proceeds from the exercise of stock options and employee stock purchase plans from 2002 to 2003 was primarily the result of the blackout period in most of 2003 due to our restatement. From March 2003 through November 2003, all purchases under our stock option plans and employee stock purchase plan were suspended pending the filing with the SEC of our public company reports, including our restated financial results. Following the October 31, 2003 filing of these reports, activity under our plans was resumed.

In 2001, we received net proceeds from the issuance of our 5.25% convertible subordinated notes in the amount of $335.1 million. We used the proceeds from this offering for working capital purposes.

Contractual Obligations

A summary of our contractual obligations at December 31, 2003 is as follows (in thousands):

	Payments Due by Period				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**
Long-term debt(1)	$392,496	$18,113	$374,383	$	$
Operating leases(2)	107,277	18,535	29,601	19,141	40,000
Purchase obligations(3)	1,846	1,846			
Total	$501,619	$38,494	$403,984	$19,141	$40,000

Table of Contents

(1) Under the terms of the 5.25% convertible subordinated notes in a total principal amount of $345.0 million, in 2004, 2005 and 2006, we will make interest payments of $18.1 million to the note holders. Pursuant to a related interest rate swap, the swap counter parties are obligated to make regular payments to us with respect to these interest obligations based on the 5.25% interest rate and, subject to quarterly resets, we are required to make regular payments to the counter parties based on a floating rate of LIBOR plus 1.66%.

(2) Operating leases are primarily for leased office space and for leased office equipment.

(3) We generally issue purchase orders to our contract manufacturers with delivery dates from four to six weeks from the purchase order date. In addition, we regularly provide such contract manufacturers with rolling six-month forecasts of product requirements for planning and long-lead time parts procurement purposes only. We are committed to accept delivery of materials pursuant to our purchase orders subject to various contract provisions which allow us to delay receipt of such order or allow us to cancel orders beyond certain agreed lead times. Such cancellations may or may not include cancellation costs payable by us. If we are unable to adequately manage our contract manufacturers and adjust such commitments for changes in demand, we may incur additional inventory expenses related to excess and obsolete inventory.

Off-Balance Sheet Arrangements

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

Convertible Debt

On August 17, 2001, we issued 5.25% convertible subordinated notes due 2006 with an aggregate principal amount of $345.0 million. The issuance generated net proceeds to us of approximately $335.1 million (after deducting fees and expenses). The notes mature on August 15, 2006, unless earlier redeemed by us at our option or converted at the holder s option. Interest is payable semi-annually in cash in arrears on February 15 and August 15 of each year, commencing February 15, 2002. At the option of the holder, the notes may be converted into our common stock at any time, unless previously redeemed, at a conversion price of $18.07 per share. At any time between August 20, 2004 and August 14, 2005, we may redeem all or a portion of the notes for cash at a repurchase price of 101.3125% of the principal amount. After August 14, 2005, the repurchase price is 100.0% of the principal amount. The notes are unsecured and are subordinated to all of our existing and future Senior Indebtedness (as defined in the related Indenture). We have no financial covenants related to these convertible subordinated notes.

In February 1998, we issued zero coupon convertible subordinated debentures due 2018 with an aggregate face amount at maturity of $885.5 million and generating net proceeds to us of approximately $337.6 million. Prior to December 31, 2002, we repurchased zero coupon debentures with an aggregate face amount of approximately $527.0 million, at a total price of $239.9 million. On February 13, 2003, we paid approximately $177.1 million in cash to redeem approximately $358.0 million in face amount of the zero coupon debentures. On June 9, 2003, we redeemed the remaining zero coupon debentures with an aggregate face amount at maturity of $0.5 million for a net price of $0.2 million.

Stock Repurchases

The table below sets forth all repurchases by us of our common stock during the quarter ended December 31, 2003 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)
October 2003		$		NA
November 2003				$ 150,000
December 2003	350	$ 13.45	350	145,293
Total	350	$ 13.45	350	

(1) In November 2003, our board of directors authorized the repurchase of up to $150.0 million of our common stock in the open market from time to time over the next two years, depending upon market conditions, share price and other factors. We purchased 350,000 shares for a total of $4.7 million in 2003.

In conjunction with a previous stock repurchase program, prior to 2001, we sold European style put options for 3.0 million shares of our common stock as part of our stock repurchase plan. In February 2001, we settled the remaining put options, which resulted in the purchase of 2.0 million shares of our stock for approximately $53.8 million.

In 1998, we deposited approximately 1.6 million shares of our common stock with a trustee for the benefit of the employees of Dr. Solomon in respect of their stock options assumed in our acquisition of the company. These shares are included in our total outstanding share balance. We believe our obligations with respect to these assumed stock options have been terminated or satisfied, and we are attempting to obtain the return of these shares.

Financial Risk Management

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

Foreign Currency Risk

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

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

52

Table of Contents

market at the end of each reporting period with any unrealized gain or loss being recognized in the consolidated statements of income. Net realized gains and losses arising from settlement of our forward foreign exchange contracts were not significant in 2003, 2002, and 2001.

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

	2003		2002	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Euro	$490	$490	$ 488	$ 488
British Pound Sterling	54	54	774	774
Singapore Dollar	(16)	(16)	15	15
Australian Dollar	75	75	155	155
Canadian Dollar	255	255	354	354
	$858	$858	$1,786	$1,786

Interest Rate Risk

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

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

The Transactions terminate on August 15, 2006 (Termination Date), subject to certain early termination provisions if on or after August 20, 2004 and prior to August 15, 2006 the twenty-day average closing price of our common stock equals or exceeds $22.59.

The Transactions qualified and were designated as a fair value hedge under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* to hedge against movements in the fair value of the Notes due to changes in the benchmark interest rate. Under the fair value hedge model, the derivative is recognized at fair value on the consolidated balance sheet with an offsetting entry to the consolidated income statement. In addition, changes in fair value of the Notes due to changes in the benchmark interest rate are recognized as a basis adjustment to the carrying amount of the Notes with an offsetting entry to the consolidated income statement. The gain or loss from the change in fair value of the Transaction and the offsetting change in the fair value of the Notes are recognized as interest and other expense. The net gain recorded as of December 31, 2003 and 2002 was approximately $5.6 million and $1.4 million, respectively.

To test effectiveness of the hedges, regression analysis is performed at least quarterly comparing the change in fair value of the Transactions and the Notes. The fair values of the Transactions and the Notes are calculated at least quarterly as the present value of the contractual cash flows to the expected maturity date, where the expected maturity date is based on probability-weighted analysis of interest rates relating to the five-year LIBOR curve and our stock prices. For the year ended December 31, 2003, the hedge was highly effective and therefore, the ineffective portion did not have a material impact on earnings.

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

The following table presents the hypothetical changes in fair values of the interest rate swaps held at December 31, 2003 assuming the following shifts in the yield curve at December 31, 2003. Beginning fair values represent the fair value of the swaps at December 31, 2003 (in millions).

	Valuation of Interest Rate Swap Given an Interest Rate Decrease of X Basis Points			No Change in Interest Rate	Valuation of Interest Rate Swap Given an Interest Rate Increase of X Basis Points		
Issuer	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
JP Morgan	$11.27	$ 9.77	$ 8.37	$ 7.00	$ 5.57	$4.27	$2.97
Lehman Brothers	13.03	11.30	9.68	8.10	6.44	4.94	3.43
Total	$24.30	$21.07	$18.05	$15.10	$12.01	$9.21	$6.40

The following table presents the hypothetical changes in the value of our 5.25% Convertible debt as of December 31, 2003 assuming the following shifts in the yield curve at December 31, 2003 and does not take into consideration the embedded equity conversion option of the bond. The beginning value represents the value of the debt at December 31, 2003 (in millions).

	Valuation of 5.25% Debt Given an Interest Rate Decrease of X Basis Points			No Change in Interest Rate	Valuation of 5.25% Debt Given an Interest Rate Increase of X Basis Points		
	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
5.25% Convertible Subordinated Notes due 2006	$379.68	$378.81	$377.89	$373.14	$374.63	$372.58	$374.75

Cash Management Risk

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

We also maintain a minority investment in a publicly traded company and historically have had investments in private companies. These investments are reviewed for other than temporary declines in value on a quarterly basis. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance or operating model and changes in market conditions. During 2002, we disposed of our shares in a majority of these investments. As of December 31, 2003, the minority investments we continue to hold totaled $0.4 million at estimated fair value. These investments were in a public company.

The following tables present the hypothetical changes in fair values in the securities held at December 31, 2003 that are sensitive to the changes in interest rates. The modeling technique used measures the change in fair values arising from hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS), 100 BPS and 150 BPS over six and twelve-month time horizons. Beginning fair values represent the market principal plus accrued interest and dividends at December 31, 2003. Ending fair values are the market principal plus accrued interest, dividends and reinvestment income at six and twelve month time horizons.

Table of Contents

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

Issuer	Valuation of Securities Given an Interest Rate Decrease of X Basis Points		No Change in Interest Rate	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	$243.7	$242.7	$241.7	$240.7	$239.7	$238.8
Corporate notes, bonds and preferreds	234.5	233.6	232.7	231.9	231.1	230.2
Total	$478.2	$476.3	$474.4	$472.6	$470.8	$469.0

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

Issuer	Valuation of Securities Given an Interest Rate Decrease of X Basis Points		No Change in Interest Rate	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	$245.9	$245.0	$244.1	$243.1	$242.4	$241.7
Corporate notes, bonds and preferreds	235.0	234.6	234.3	233.9	233.6	233.2
Total	$480.9	$479.6	$478.4	$477.0	$476.0	$474.9

Recent Accounting Pronouncements Update

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

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

Quantitative and qualitative disclosure about market risk is set forth at Management s Discussion and Analysis of Financial Condition and Results of Operations under Item 7.

Table of Contents

Item 8. ***Financial Statements and Supplementary Data***
Quarterly Operating Results (Unaudited)

	Three Months Ended							
	December 31, 2003	**September 30, 2003**	**June 30, 2003**	**March 31, 2003**	**December 31, 2002**	**September 30, 2002**	**June 30, 2002**	**March 31, 2002**
	(In thousands, except per share data)							
		(1)(As Restated)	(1)(As Restated)	(1)(As Restated)				
Statement of Operations and Other Data:								
Net revenues	$272,222	$227,775	$217,025	$219,314	$269,525	$254,430	$263,441	$255,648
Gross margin	230,335	189,840	180,882	185,653	229,437	214,133	221,869	212,894
Income (loss) from operations	52,946	10,093	1,009	1,605	(15,680)	26,863	55,675	47,869
Income (loss) before provision for income taxes, minority interest and cumulative effect of change in accounting principle	55,478	13,268	2,903	1,476	(11,163)	31,442	56,096	53,558
Income (loss) before cumulative effect of change in accounting principle	45,308	10,774	2,491	1,332	(11,197)	34,124	53,746	51,639
Cumulative effect of, change in accounting principle, net of taxes	(805)			11,142				
Net income (loss)	44,503	10,774	2,491	12,474	(11,197)	34,124	53,746	51,639
Cumulative effect of change in accounting principle, per share	$	$	$	$ 0.07	$	$	$	$
Basic income (loss) per share	$ 0.28	$ 0.07	$ 0.02	$ 0.08	$ (0.07)	$ 0.23	$ 0.37	$ 0.36
Diluted income (loss)per share	$ 0.26	$ 0.07	$ 0.02	$ 0.08	$ (0.07)	$ 0.21	$ 0.33	$ 0.31

(1) During analysis of our international subsidiaries 2003 deferred revenue balances we detected that our accounting system was recognizing deferred revenue using fluctuating foreign currency exchange rates (the current rate). The subsidiaries deferred revenue should be recognized using the exchange rate applied when the deferred revenue was initially recorded (the historical rate). As a result, we have (i) recorded adjustments to previously reported or announced 2003 quarterly revenue resulting in a cumulative $3.8 million or 0.4%, revenue increase to $936.3 million from the previously announced 2003 revenue of $932.5 million and (ii) increased previously announced 2003 earnings per share, or EPS, by $0.03 per share to $0.44 (basic) and $0.43 (diluted). Further, in adjusting 2003 quarterly interim revenue we also reclassified two previously recorded correcting adjustments in the third and fourth quarters to appropriately reflect these adjustments in the second and third quarters of 2003. These quarterly adjustments had no net impact on cumulative 2003 revenue. As a result of these adjustments, for the first, second, third and fourth quarters of 2003, previously reported or announced revenue of $218.4 million, $218.3 million, $226.9 million and $268.9 million is increased (decreased) by $0.9 million, $(1.3) million, $0.9 million and $3.3 million, respectively. Also, as a result of all adjustments for the first, second, third and fourth quarters of 2003, previously reported or announced net income of $11.6 million, $3.7 million, $9.9 million and $41.3 million is increased (decreased) by $0.9 million, $(1.2) million, $0.9 million and $3.2 million, respectively. Previously reported 2003 net income of $66.5 million was increased by $3.7 million to $70.2 million. EPS (basic and diluted) for the first and third quarters is increased by $0.01 each quarter from $0.07 to $0.08 per share, and $0.06 to $0.07 per share, respectively, with no adjustment to the second quarter EPS (basic or diluted). EPS for the fourth quarter increased $0.02 from $0.26 to $0.28 per share (basic) and from $0.24 to $0.26 per share (diluted). As a result of these adjustments, our previously announced deferred revenue and currency translation adjustment balance at December 31, 2003 is reduced (increased) by $4.5 million and $(0.7) million to $481.6 million and $33.3 million, respectively.

We believe that period-to-period comparisons of our financial results should not be relied upon as an indication of future performance.

Our revenues and results of operations have been subject to significant fluctuations, particularly on a quarterly basis, and our revenues and results of operations could fluctuate significantly quarter to quarter and year to year. Causes of such fluctuations may include the volume and timing of new orders and renewals, the sales cycle for our products, the introduction of new products, return rates, inventory levels, product upgrades or updates by us or our competitors, changes in product mix, changes in product prices and pricing models, the

portion of our licensing fees deferred and recognized as support and maintenance revenue, seasonality, trends in the computer industry, general economic conditions, extraordinary events such as acquisitions or litigation and the occurrence of unexpected events. For example, net income for the quarter ended December 31, 2002, reflects a $70.0 million charge related to our recently settled class action suit which. Significant quarterly fluctuations in revenues will cause significant fluctuations in our cash flows and the cash and cash equivalents, accounts receivable and deferred revenue accounts on our consolidated balance sheet. In addition, the operating results of many software companies reflect seasonal trends, and our business, financial condition and results of operations may be affected by such trends in the future. These trends may include higher net revenue in the fourth quarter as many customers complete annual budgetary cycles, and lower net revenue in the summer months when many businesses experience lower sales, particularly in the European market.

Our financial statements and supplementary data required by this item are set forth at the pages indicated at Item 15(a).

Item 9. ***Changes In and Disagreements With Accountants on Accounting and Financial Disclosure***

Nothing to report.

Item 9A. ***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) as of the end of the period covered by this annual report on Form 10-K. Based on this evaluation, our CEO and CFO have concluded that, except as described below, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. There has been no change in our internal control over financial reporting that occurred during the quarter ended December 31, 2003 which materially affected, or is reasonably likely to affect, our internal control over financial reporting. Described below are internal control over financial reporting changes made after the period covered by this Form 10-K made as a result of events discovered subsequent to, but impacting results for, the quarter and year ended December 31, 2003.

As more fully described in footnote (1) to Item 8, during our preparation and analysis of our 2003 consolidated financial statements, we identified and reported to our external auditors and audit committee required corrections to our previously reported or announced financial information relating to our booking of international deferred revenue and the making of manual journal entries. These corrections required restatement of previously reported first, second and third quarter 2003 quarterly information and adjustment of previously announced fourth quarter 2003 and full year 2003 information. In evaluating our corrections, our external auditor determined and reported to our audit committee in a letter that the underlying control issues should be considered a material weakness under standards established by the Public Company Accounting Oversight Board. In conjunction with making the required corrections, we have bolstered internal controls around the recognition of international revenues as part of our quarterly financial closing process and the manual journal entry process. We are also in the process of initiating additional internal control procedures to address the identified weaknesses, including the hiring of additional personnel, determining how to automate revenue recognition calculations so as to limit the number of manual adjustments, and engaging in additional testing of our control processes and procedures.

Table of Contents

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 27, 2004. We have adopted a code of ethics that applies to our Chief Executive Officer, Chief Financial Officer, Corporate Controller and other finance organization employees that establishes minimum standards of professional responsibility and ethical conduct. The finance code of ethics is publicly available on our website at www.networkassociates.com. If we make any substantive amendments to the finance code of ethics or grant any waiver, including any implicit waiver, from a provision of the code to our Chief Executive Officer, Chief Financial Officer or Corporate Controller, we will disclose the nature of such amendment or waiver on that website or in a report on Form 8-K.

Compliance with Section 16(a) of the Securities Exchange Act of 1934

Section 16(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act), requires the Company s officers and directors, and persons who own more than ten percent of a registered class of the Company s equity securities, to file certain reports of ownership with the SEC. Such officers, directors and stockholders are also required by SEC rules to furnish us with copies of all Section 16(a) forms they file. All reports required to be filed during fiscal year 2003 pursuant to Section 16(a) of the exchange act by directors, executive officers and 10% beneficial owners were filed on timely basis, except as follows: Mr. Leslie Denend s option grant of 20,000 shares in May 2003 was not reported in a timely manner to the SEC, Mr. Robert Dutkowsky s option grant of 20,000 shares in April 2003 was not reported to the SEC in a timely manner, Mr. Robert Pangia s option grant of 20,000 shares in April 2003 was not reported to the SEC in a timely manner and Ms. Liane Wilson s option grant of 20,000 shares in April 2003 was not reported to the SEC in a timely manner.

10b5-1 Trading Plans

Our Insider Trading Policy allows directors, officers and other employees covered under the policy to establish, under limited circumstances contemplated by Rule 10b5-1 under the Securities Exchange Act of 1934, written programs that permit automatic trading of our stock or trading of our stock by an independent person (such as an investment bank) who is not aware of material inside information at the time of the trade. As of the filing date of this report, a number of our executive officers, including George Samenuk, our Chairman and Chief Executive Officer, Stephen C. Richards, our Chief Operating Officer and Chief Financial Officer, Vernon Gene Hodges, our President, Kent H. Roberts, our Executive Vice President and General Counsel, each a Section 16 officer, have adopted or intend to adopt a Rule 10b5-1 trading plan. In addition, Amanda Hodges, the wife of our President, intends to adopt a 10b5-1 trading plan. We believe that additional directors, officers and employees have established or may establish such programs. As a result of our March 2003 announced restatement of certain prior period financial statements and the delay in the filing of our 2002 Form 10-K, all trades in our stock by our Section 16 officers, including trades pursuant to Rule 10b5-1 trading plans, were suspended from March 2003 until November 2003. All trades in our common stock made during the fourth quarter and following the termination of such suspension by officers who have adopted Rule 10b5-1 trading plans were made pursuant to the terms of such plans.

Item 11. ***Executive Compensation***

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 27, 2004.

Table of Contents

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 27, 2004.

Item 13. ***Certain Relationships and Related Transactions***

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 27, 2004.

Item 14. ***Principal Accountant Fees and Services***

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 27, 2004.

Table of Contents

PART IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) *Financial Statements:*

	Page Number
Report of Independent Auditors	61
Consolidated Balance Sheets:	
December 31, 2003 and 2002	62
Consolidated Statements of Income and Comprehensive Income:	
Years ended December 31, 2003, 2002 and 2001	63
Consolidated Statements of Stockholders Equity:	
Years ended December 31, 2003, 2002 and 2001	65
Consolidated Statements of Cash Flows:	
Years ended December 31, 2003, 2002, and 2001	67
Notes to Consolidated Financial Statements	69

(a)(2) *Financial Statement Schedule*

The following financial statement schedule of Networks Associates, Inc. for the years ended December 31, 2003, 2002, and 2001 is filed as part of this Form 10-K and should be read in conjunction with Networks Associates, Inc. s Consolidated Financial Statements.

Schedule II Valuation and Qualifying Accounts on Page 123

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

(a)(3) *Exhibits:* See Index to Exhibits on Page 124. The Exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as part of this report.

(b) Reports on Form 8-K:

On October 23, 2003, we furnished a report on Form 8-K to announce our third quarter 2003 financial results.

On November 1, 2003, we filed a report on Form 8-K in connection with the completion of our financial statement restatement and the filing of our Form 2002 10-K, Amendment No. 2 to our 2000 Form 10-K and our Q1 and Q2 2003 Form 10-Qs.

On November 13, 2003, we filed a Form 8-K filing and furnished certain financial information.

On November 21, 2003, we filed a Form 8-K filing and furnished certain financial information.

On November 24, 2003, we filed a Form 8-K in connection with our program to repurchase up to $150 million of our common stock.

On December 1, 2003, we filed a Form 8-K to file certain information in respect of historical segment data and to furnish certain Regulation FD disclosure in connection with our anticipated operating results for 2004.

On December 15, 2003, we filed a Form 8-K announcing the signing of an agreement to sell our Magic Solutions assets to BMC Software, Inc.

Table of Contents

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders

of Networks Associates, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Networks Associates, Inc. and its subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company s management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Notes 2 and 9 to the consolidated financial statements, the Company changed its method of accounting for exit and disposal activities effective January 1, 2003.

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

As discussed in Notes 2 and 10 to the consolidated financial statements, the Company changed its method of accounting for goodwill effective January 1, 2002.

PRICEWATERHOUSECOOPERS LLP

Dallas, Texas

February 26, 2004

Table of Contents

NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2003	2002
	(In thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 333,651	$ 674,226
Short-term marketable securities	174,499	133,577
Accounts receivable, net of allowance for doubtful accounts of $2,863 and $6,638, respectively	170,218	160,159
Prepaid expenses, income taxes and other current assets	97,616	52,238
Deferred taxes	160,550	174,469
Assets held for sale	24,719	
Total current assets	961,253	1,194,669
Long-term marketable securities	258,107	205,906
Restricted cash	20,547	21,211
Property and equipment, net	111,672	89,277
Deferred taxes	199,196	139,091
Intangible assets, excluding goodwill, net	105,952	93,551
Goodwill	443,593	273,934
Other assets	20,178	27,848
Total assets	$2,120,498	$2,045,487
LIABILITIES		
Current liabilities:		
Accounts payable	$ 32,099	$ 29,948
Accrued liabilities	147,281	220,766
Deferred revenue	342,795	292,277
Current portion of convertible debt		176,260
Liabilities related to assets held for sale	23,310	
Total current liabilities	545,485	719,251
Deferred revenue, less current portion	116,762	36,918
Conver		