McAfee, Inc.
Form 10-Q
December 21, 2007

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

Form 10-Q

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended September 30, 2007**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

Commission file number: 001-31216

McAfee, Inc.
(Exact name of registrant as specified in its charter)

Delaware (*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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

As of December 7, 2007, 159,908,615 shares of the registrant s common stock, $0.01 par value, were outstanding.

MCAFEE, INC.
FORM 10-Q

September 30, 2007

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements (Unaudited)***

MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2007	December 31, 2006
	(In thousands, except share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 500,339	$ 389,627
Short-term marketable securities	370,280	215,722
Accounts receivable, net of allowance for doubtful accounts of $3,197 and $2,015, respectively	156,570	170,855
Prepaid expenses and prepaid taxes	148,019	132,203
Deferred income taxes	234,105	236,310
Other current assets	16,512	31,915
Total current assets	1,425,825	1,176,632
Long-term marketable securities	673,259	634,820
Restricted cash	559	950
Property and equipment, net	91,849	91,999
Deferred income taxes	348,096	228,103
Intangible assets, net	89,781	113,574
Goodwill	535,693	530,477
Other assets	28,689	23,715
Total assets	$ 3,193,751	$ 2,800,270
LIABILITIES		
Current liabilities:		
Accounts payable	$ 37,371	$ 35,652
Accrued income taxes	53,462	118,589
Other accrued liabilities	206,117	171,331
Deferred revenue	737,419	704,807
Total current liabilities	1,034,369	1,030,379
Deferred revenue, less current portion	217,505	192,718
Accrued taxes and other long-term liabilities	66,521	149,924
Total liabilities	1,318,395	1,373,021

Commitments and contingencies (Notes 11 and 12)

STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none in 2007 and 2006		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; Issued: 172,512,046 shares at September 30, 2007 and December 31, 2006; Outstanding: 159,908,615 shares at September 30, 2007 and 159,915,439 shares at December 31, 2006	1,726	1,726
Treasury stock, at cost: 12,603,431 shares at September 30, 2007 and 12,596,607 shares at December 31, 2006	(303,270)	(303,074)
Additional paid-in capital	1,789,431	1,527,843
Accumulated other comprehensive income	35,579	31,472
Retained earnings	351,890	169,282
Total stockholders equity	1,875,356	1,427,249
Total liabilities and stockholders equity	$ 3,193,751	$ 2,800,270

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

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
	(In thousands, except per share data) (Unaudited)			
Net revenue:				
Service and support	$ 164,171	$ 160,388	$ 496,938	$ 466,298
Subscription	140,366	110,822	402,025	299,197
Product	17,449	15,853	52,731	74,422
Total net revenue	321,986	287,063	951,694	839,917
Cost of net revenue:				
Service and support	11,470	13,127	35,698	39,736
Subscription	44,089	29,624	121,090	76,077
Product	14,886	15,415	38,210	45,810
Amortization of purchased technology	7,420	5,987	24,304	16,180
Total cost of net revenue	77,865	64,153	219,302	177,803
Operating costs:				
Research and development	54,399	50,641	163,831	144,426
Marketing and sales	90,989	91,260	279,217	264,990
General and administrative	38,140	35,055	125,093	127,101
SEC and compliance costs	10,885	7,901	25,085	11,673
Amortization of intangibles	2,959	2,656	9,197	8,305
Restructuring charges (benefit)	109	(1,393)	3,158	(274)
In-process research and development				460
Total operating costs	197,481	186,120	605,581	556,681
Income from operations	46,640	36,790	126,811	105,433
Interest and other income	19,450	13,922	52,480	32,585
Gain on investments, net	371	154	631	68
Income before provision for income taxes	66,461	50,866	179,922	138,086
Provision for income taxes	3,060	16,776	25,127	33,491
Net income	$ 63,401	$ 34,090	$ 154,795	$ 104,595
Other comprehensive income:				
Unrealized gains on marketable securities, net of reclassification adjustment for gains recognized on marketable securities during the period and income tax	$ 1,156	$ 878	$ 1,059	$ 1,457
Foreign currency translation (loss) gain	(1,320)	1,791	3,049	(4,742)

Comprehensive income		$	63,237	$	36,759	$	158,903	$	101,310
Net income per share	Basic	$	0.40	$	0.21	$	0.97	$	0.65
Net income per share	Diluted	$	0.39	$	0.21	$	0.94	$	0.64
Shares used in per share calculation	Basic		159,808		159,728		159,802		161,343
Shares used in per share calculation	Diluted		164,513		161,485		163,871		163,132

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

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income	$ 154,795	$ 104,595
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	59,858	50,688
Provision for (recovery of) doubtful accounts, net	382	(197)
Non-cash restructuring charge (benefit)	1,375	(286)
Interest released from restricted cash		489
Acquired in-process research and development		460
Discount amortization on marketable securities	(4,377)	(5,438)
(Gain) loss on sale of assets and technology	(24)	207
Gain on sale of investments	(631)	(68)
Deferred income taxes	10,679	(22,224)
Increase in fair value of options accounted for as liabilities	1,689	
Non-cash stock-based compensation expense	41,218	37,988
Excess tax benefits from stock-based compensation	(12)	(4,811)
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	20,021	31,328
Prepaid expenses, prepaid taxes and other assets	(10,392)	(45,839)
Accounts payable	627	939
Accrued taxes and other liabilities	(934)	(9,281)
Deferred revenue	27,403	65,723
Net cash provided by operating activities	301,677	204,273
Cash flows from investing activities:		
Purchase of marketable securities	(714,007)	(1,034,796)
Proceeds from sales of marketable securities	360,238	471,990
Proceeds from maturities of marketable securities	167,545	246,694
Decrease in restricted cash	391	49,896
Purchase of patents	(9,300)	
Purchase of property, equipment and leasehold improvements	(25,704)	(30,707)
Proceeds from sale of assets and technology	4,105	
Acquisitions, net of cash acquired		(65,871)
Net cash used in investing activities	(216,732)	(362,794)
Cash flows from financing activities:		
Proceeds from issuance of common stock from option and stock purchase plans		32,007

Excess tax benefits from stock-based compensation		12		4,811
Repurchase of common stock		(196)		(234,679)
Net cash used in financing activities		(184)		(197,861)
Effect of exchange rate fluctuations on cash		25,951		9,752
Net increase (decrease) in cash and cash equivalents		110,712		(346,630)
Cash and cash equivalents at beginning of period		389,627		728,592
Cash and cash equivalents at end of period	$	500,339	$	381,962
Non-cash investing activities:				
Unrealized gain on marketable securities, net	$	1,059	$	1,457
Accrual for purchase of property, equipment and leasehold improvements	$	1,321	$	1,849
Fair value of assets acquired in business combinations, excluding cash acquired	$		$	75,158
Liabilities assumed in business combinations	$		$	9,289
Non-cash financing activities:				
Modification of stock options reclassification from equity to liability award	$	4,326	$	
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	22,998	$	50,844
Cash received from income tax refunds	$	11,838	$	2,972

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

McAfee, Inc. and our wholly-owned subsidiaries (we , us or our) are a worldwide security technology company that secures systems and networks from known and unknown threats around the world. Our security solutions are offered primarily to large enterprises, governments, small and medium-sized businesses and consumers through a network of qualified partners. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific, excluding Japan; and Latin America.

2. Summary of Significant Accounting Policies and Basis of Presentation

The accompanying condensed consolidated financial statements include our accounts as of September 30, 2007 and December 31, 2006 and for the three and nine months ended September 30, 2007 and September 30, 2006. All intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2006 consolidated balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, we believe that all disclosures are adequate to make the information presented not misleading. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in our annual report on Form 10-K for the year ended December 31, 2006.

In the opinion of our management, all adjustments (which consist of normal recurring adjustments, except as disclosed herein) necessary to fairly present our financial position, results of operations and cash flows for the interim periods presented have been included. The results of operations for the three and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year or for any future periods.

Significant Accounting Policies

On January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109,* (FIN 48) as discussed more fully below. Other than this change, we have had no significant changes in our accounting policies during the nine months ended September 30, 2007 as compared to the significant accounting policies described in our annual report on Form 10-K for the year ended December 31, 2006.

Income Taxes

We adopted the provisions of FIN 48 effective January 1, 2007. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

FIN 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to estimate and measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement. It is inherently difficult and subjective to estimate such amounts, as this requires determination of the probability of various possible outcomes. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Such a

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision in the period. See Note 9 for further discussion of the impact of adoption of FIN 48.

Inventory

Inventory, which consists primarily of finished goods owned at fulfillment partner locations and inventory sold into our channel which has not been sold through to the end-user, is stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first in, first out basis. Inventory balances are included in other current assets in our condensed consolidated balance sheets, and are $2.9 million as of September 30, 2007 and $2.7 million as of December 31, 2006.

Deferred Costs of Revenue

Deferred costs of revenue, which consist primarily of costs related to revenue-sharing and royalty arrangements, are included in prepaid expenses and prepaid taxes and other assets on our condensed consolidated balance sheets. We only defer direct and incremental costs related to revenue-sharing arrangements and recognize such deferred costs proportionate to the related revenue recognized. Our deferred costs as of September 30, 2007 are $94.1 million, and $70.2 million as of December 31, 2006.

SEC and Compliance Costs

SEC and compliance costs include expenses associated with independent consultants engaged to examine and recommend improvements to our internal controls to ensure compliance with federal securities laws as required by our settlement with the SEC, which was finalized in 2006, and expenses related to the investigation into our stock option granting practices.

Recent Accounting Pronouncements

Noncontrolling Interests

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51* (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for us beginning January 1, 2009. We do not expect the adoption of SFAS 160 to have a material impact on our consolidated financial position, results of operations or cash flows.

Business Combinations

In December 2007, the FASB revised SFAS No. 141, *Business Combinations* (SFAS 141(R)), to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141(R) establishes principles and requirements for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed, and any noncontrolling interest in an acquisition, at their fair value as of the acquisition date. SFAS 141(R) is effective for us beginning

January 1, 2009. We are currently assessing how the adoption of SFAS 141(R) will impact our consolidated financial position, results of operations and cash flows.

Fair Value Option

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 1* (SFAS 159). SFAS 159 permits entities to choose to measure certain financial instruments and other items at fair value that are not currently required to be measured at fair value, with unrealized gains and losses related to these financial instruments reported in earnings at

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

each subsequent reporting date. SFAS 159 is effective for us beginning January 1, 2008. We do not expect the adoption of SFAS 159 to have a material impact on our consolidated financial position, results of operations or cash flows.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements regarding fair value measurement. Where applicable, SFAS 157 simplifies and codifies fair value related guidance previously issued within generally accepted accounting principles. Although, SFAS 157 does not require any new fair value measurements, its application may, for some entities, change current practice. SFAS 157 is effective for us beginning January 1, 2008. We do not expect the adoption of SFAS 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement

In March 2006, the FASB s Emerging Issues Task Force released Issue 06-3, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF 06-3). A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amount of taxes if reflected on a gross basis in the income statement. EITF 06-3 was effective for us beginning January 1, 2007. We present revenue net of sales taxes in our condensed consolidated statements of income and comprehensive income and did not change our policy as a result of EITF 06-3.

3. Employee Stock Benefit Plans

We record compensation expense for stock-based awards issued to employees and directors in exchange for services provided based on the estimated fair value of the awards on their grant dates. Compensation expense is recognized over the required service period of the awards. Our stock-based awards include stock options, restricted stock awards, restricted stock units and our Employee Stock Purchase Plan (ESPP).

The following table summarizes stock-based compensation expense in accordance with the provisions of SFAS No. 123(R) *Share Based Payment* (SFAS 123(R)) (in thousands):

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Amortization of fair value of options issued to employees	$ 4,808	$ 6,955	$ 14,080	$ 24,677
Former employees extension of post-termination exercise period	128		11,206	
Cash settlement of options	(76)	2,668	2,114	2,668

Restricted stock awards and units	5,785	4,984	15,932	11,447
Employee Stock Purchase Plan		257		1,864
Total stock-based compensation expense	$ 10,645	$ 14,864	$ 43,332	$ 40,656

Amortization of fair value of options issued to employees. We recognize the fair value of stock options issued to employees as stock-based compensation expense over the vesting period of the awards. As we adopted SFAS 123(R) using the modified prospective method, these charges include compensation expense for stock options granted prior to January 1, 2006 but not yet vested as of January 1, 2006, based on the grant date fair value

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for stock options granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).

Former employees extension of post-termination exercise period. From July 2006, when we announced that we might have to restate our historical financial statements as a result of our ongoing stock option investigation, through the date we become current on our reporting obligations under the Securities Exchange Act of 1934, as amended, (blackout period), we have not been able to issue any shares, including those pursuant to stock option exercises. In January 2007, we extended the post-termination exercise period for vested options held by certain former employees and outside directors who terminated and whose stock options would have expired during the blackout period. We recognized $0.1 million and $11.2 million of stock-based compensation expense in the three and nine months ended September 30, 2007, respectively, based on the fair value of the modified options. The stock-based compensation expense in the three months ended September 30, 2007 was based on modified options held by former employees that vested during the three months ended September 30, 2007. The stock-based compensation expense in the nine months ended September 30, 2007 was based on modified options held by former employees that terminated from January 1, 2007 through September 30, 2007, and which were vested as of the modification date and through September 30, 2007. The expense was calculated in accordance with the guidance in SFAS 123(R). The options were deemed to have no value prior to the extension of the life beyond the blackout period.

Based on the guidance in SFAS 123(R) and related FASB Staff Positions, after the January 2007 modification, stock options held by former employees and outside directors that terminated prior to such modification became subject to the provisions of EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock*, (EITF 00-19). As a result, in January 2007, these options were reclassified as liability awards within current liabilities. Accordingly, at the end of each reporting period, we determine the fair value of these options utilizing the Black-Scholes valuation model and recognize any change in fair value of the options in our condensed consolidated statements of income and comprehensive income in the period of change until the options are exercised, expire or are otherwise settled. We recognized a benefit of $0.2 million and expense of $1.7 million related to the change in fair value of these options in the three and nine months ended September 30, 2007, respectively. Such amounts are included in general and administrative expense in our condensed consolidated statements of income and comprehensive income, and are not reflected as stock-based compensation expense in the table above. We will record expense or benefit in future periods based on the closing price of our common stock.

In November 2007, due to a delay in our becoming current in our reporting obligations, we extended the post-termination exercise period for options held by former employees and outside directors who terminated subsequent to the January 2007 modification and those previously modified in January 2007 as discussed above, until the earlier of (i) the ninetieth calendar day after we become current in our reporting obligations under the Securities Exchange Act of 1934, as amended, (ii) the expiration of the contractual terms of the options, or (iii) December 31, 2008. Based on the guidance in SFAS 123(R) and related FASB Staff Positions, after the November 2007 modification, stock options held by the former employees and outside directors that terminated subsequent to the January 2007 modification and prior to November 2007 became subject to the provisions of EITF 00-19. As a result, in November 2007, these options will be reclassified as liability awards within current liabilities. Accordingly, at the end of each reporting period, we will determine the fair value of these options utilizing the Black-Scholes valuation model and recognize any change in fair value of the options in our consolidated statements of income in the period of change until the options are exercised, expire or are otherwise settled. Such amounts will be included in general and administrative expense in our condensed consolidated statements of income and comprehensive income, and will not be reflected as stock-based compensation expense. We will record expense or benefit in future periods based on the closing price of our common stock.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash settlement of options. Certain stock options held by terminated employees expired during the blackout period as they could not be exercised during the 90 day period subsequent to termination. The cash payment to settle these options will be based upon an average closing price of our common stock subsequent to us becoming current on our reporting obligations under the Securities Exchange Act of 1934, as amended. We have recorded a liability based on the intrinsic value of these options as of September 30, 2007. We will continue to adjust this amount in future reporting periods based on the closing price of our common stock.

Restricted stock awards and units. We recognize stock-based compensation expense for the fair value of restricted stock awards and restricted stock units. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock awards and units. The fair value of these awards is recognized to expense over the requisite service period of the awards.

Employee Stock Purchase Plan. We recognize stock-based compensation expense for the fair value of employee stock purchase rights issued pursuant to our ESPP. The estimated fair value of employee stock purchase rights is based on the Black-Scholes pricing model. Expense is recognized ratably based on contributions and the total fair value of the employee stock purchase rights estimated to be issued. We had no stock-based compensation expense related to our employee stock purchase plan during the nine months ended September 30, 2007 due to suspension of this plan in July 2006.

The following table summarizes the stock-based compensation expense by income statement line item that we recorded in accordance with the provisions of SFAS 123(R) (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Cost of net revenue service and support	$ 276	$ 546	$ 1,231	$ 1,503
Cost of net revenue subscription	189	180	732	485
Cost of net revenue product	145	190	602	576
Stock-based compensation expense included in cost of net revenue	610	916	2,565	2,564
Research and development	2,752	4,299	11,017	11,637
Marketing and sales	3,486	6,158	16,811	16,257
General and administrative	3,797	3,491	12,939	10,198
Stock-based compensation expense included in operating expenses	10,035	13,948	40,767	38,092
Total stock-based compensation expense related to stock-based equity awards	10,645	14,864	43,332	40,656
Deferred tax benefit	(2,914)	(2,966)	(12,602)	(10,014)

Total stock-based compensation expense related to stock-based equity awards, net of tax	$ 7,731	$ 11,898	$ 30,730	$ 30,642

At September 30, 2007, the estimated fair value of all unvested stock options, restricted stock units, and restricted stock awards that have not yet been recognized as compensation expense was $63.5 million, net of expected forfeitures. We expect to recognize this amount over a weighted-average period of 2.4 years.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under SFAS 123(R), we used the Black-Scholes model to estimate the fair value of our option awards and employee stock purchase rights issued under the ESPP. The key assumptions used in the model during the three and nine months ended September 30, 2007 and 2006, respectively, are provided below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Stock option grants:				
Risk free interest rate	4.7%	4.9%	4.7%	4.8%
Weighted average expected lives (years)	5.7	5.9	6.1	5.6
Volatility	38.0%	34.0%	32.0%	38.4%
Dividend yield				
ESPP:				
Risk free interest rate				4.6%
Weighted average expected lives (years)				0.5
Volatility				38.0%
Dividend yield				

During the three and nine months ended September 30, 2007, and the three months ended September 30, 2006, we did not have any ESPP grants.

We derive the expected term of our options through the use of a lattice model that factors in historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Since January 1, 2006, we have used the implied volatility of options traded on our stock with a term of six months or more to calculate the expected volatility of our option grants. We have not declared any dividends on our stock in the past and do not expect to do so in the foreseeable future.

Internal Revenue Code Section 409A

Adverse tax consequences will result from our revision of accounting measurement dates for stock options that vest subsequent to December 31, 2004 (409A affected options). These adverse tax consequences include a penalty tax payable by the option holder under Internal Revenue Code (IRC) Section 409A (and, as applicable, similar penalty taxes under state tax laws). As virtually all holders of options with revised measurement dates were not involved in or aware of their incorrect option exercise prices, we took certain actions to deal with the adverse tax consequences that may be incurred by the holders of such options.

Section 16(a) Officers and Directors

In December 2006, our board of directors approved the amendment of 409A affected options for those who were Section 16(a) officers upon the receipt of 409A affected options to increase the exercise price to the fair market value of our common stock on the revised measurement date. These amended options would not be subject to taxation under

IRC Section 409A. Under Internal Revenue Service (IRS) regulations, these option amendments had to be completed by December 31, 2006 for anyone subject to Section 16(a) requirements upon receipt of the 409A affected options. There were no costs associated with this action, as the modifications increased the exercise price, which results in no incremental expense.

IRS Announcement 2007-18 Compliance

In February 2007, our board of directors approved our participation in a voluntary program under Internal Revenue Service Announcement 2007-18 and a similar state of California Announcement, whereby we will pay

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

additional 409A taxes on behalf of certain former United States employees who have already exercised 409A affected options for the additional taxes they incur under IRC Section 409A (and, as applicable, similar state of California tax law). Current and former Section 16(a) officers and directors are specifically excluded from the program. Through September 30, 2007, we recorded $1.3 million of costs associated with this program for Section 409A affected options exercised during this period.

Certain Former Employees Future Exercises of 409A Affected Options

In May 2007, our board of directors approved cash payments as necessary to certain former employees who exercised 409A affected options during 2006 that may exercise 409A affected options in the future. In the three months ended September 30, 2007, we recorded no costs associated with former employees exercises of certain 409A affected options. In the nine months ended September 30, 2007, we recorded $0.9 million of costs associated with former employees exercises of certain 409A affected options. We may incur additional costs in future periods associated with former employees expected exercises of certain 409A affected options but we do not expect the costs to be material.

In November 2007, our board of directors approved the unilateral amendment of 409A affected options held by certain former employees who did not exercise 409A affected options during 2006 to increase the exercise price to the fair market value of our common stock on the revised measurement date, and to make cash payments as compensation for the increase in the exercise prices of amended options. These amended options would not be subject to taxation under IRC Section 409A. We expect to incur additional costs of $0.5 million associated with former employees future exercises of certain 409A affected options once we become current on our reporting obligations under the Security Exchange Act of 1934, as amended.

The following table summarizes, for the periods indicated, costs associated with actions taken by us with respect to IRC Section 409A (in thousands):

	Nine Months Ended September 30, 2007	
Cost of net revenue	$	
Research and development		874
Marketing and sales		589
General and administrative		788
Costs associated with IRC Section 409A	$	2,251

We are also considering offering active employees who are option holders the opportunity to amend or exchange their options to avoid the adverse consequences of 409A.

4. Business Combinations and Divestitures

Citadel Security Software

In December 2006, we acquired substantially all of the assets of Citadel Security Software Inc. (Citadel) a security software provider focused on solutions in security policy compliance and vulnerability remediation, for $56.1 million in cash, plus $3.9 million in working capital reimbursements and $1.2 million in direct acquisition costs, totaling $61.2 million. We have incorporated Citadel s technology into our existing consumer products.

Our management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques. We recorded $41.7 million of goodwill. We recorded no in-process research and development related to this acquisition.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The intangible assets, other than goodwill, are being amortized over their useful lives of 2.0 to 5.0 years or a weighted-average period of 4.0 years. As part of the acquisition, we did not assume any outstanding stock options or warrants. A performance and retention plan, which provides for payment of up to $0.6 million through 2008, was established at the close of the acquisition. At September 30, 2007, $0.5 million had been expensed and $0.2 million had been paid related to this performance plan.

Onigma

In October 2006, we acquired 100% of the capital shares of Onigma Ltd. (Onigma) a provider of data protection solutions that monitor, report and prevent confidential data from leaving an enterprise, for $18.9 million in cash and $0.2 million in direct acquisition costs, totaling $19.1 million. We have incorporated Onigma s technology into our existing corporate security products.

Our management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques. There was no goodwill associated with this acquisition. We recorded no in-process research and development related to this acquisition.

The intangible assets are being amortized over their useful lives of 2.0 to 4.0 years or a weighted-average period of 3.9 years. As part of the acquisition, we did not assume any outstanding stock options or warrants. A performance and retention plan, which provides for payment of up to $0.9 million through 2007, was established at the close of the acquisition. At September 30, 2007, $0.5 million had been expensed and $0.3 million had been paid related to this performance plan.

Preventsys

In June 2006, we acquired 100% of the outstanding capital shares of Preventsys, Inc. (Preventsys), a creator of security risk management and automated security compliance reporting, for $4.4 million in cash and $0.4 million in direct acquisition costs, totaling $4.8 million. We have added Preventsys products to our existing portfolio of corporate security offerings.

Our management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques. We recorded $0.2 million of goodwill (none of which was deductible for tax purposes).

We recorded $0.5 million for in-process research and development, which was fully expensed upon purchase because technological feasibility had not been achieved, and there was no alternative use for the projects under development. The in-process research and development included the development of a new version of the security risk management system that will include increased functionality and new features. We introduced this version during the fourth quarter of 2006. At the date of acquisition, we estimated that 40% of the development effort had been completed and that the remaining 60% of development would take approximately two months to complete. As of December 31, 2006, all development was complete, and costs were $0.5 million. The intangible assets, other than goodwill, are being amortized over their useful lives of 3.0 to 5.0 years or a weighted-average period of 3.2 years. As part of the acquisition, we did not assume any outstanding stock options or warrants. A performance and retention plan, which provides for payment of up to $0.8 million through 2007, was established at the close of the acquisition. At September 30, 2007, $0.8 million had been expensed and paid related to this performance plan.

SiteAdvisor

In April 2006, we acquired 100% of the outstanding capital shares of SiteAdvisor, Inc. (SiteAdvisor), a web safety consumer software company that tests and rates internet sites on an ongoing basis, for $60.8 million in cash and $0.2 million in direct acquisition costs, totaling $61.0 million. We have bundled the SiteAdvisor technology with our existing consumer product offerings.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques. We recorded $50.6 million of goodwill (none of which was deductible for tax purposes). We recorded no in-process research and development related to this acquisition.

The intangible assets, other than goodwill, are being amortized over their useful lives of 2.0 to 4.0 years or a weighted-average period of 3.0 years. As part of the acquisition, we did not assume any outstanding stock options or warrants. A performance and retention plan, which provides for payment of up to $9.1 million through 2008, was established at the close of the acquisition. At September 30, 2007, $8.6 million had been expensed and $8.5 had been paid related to this performance plan.

The following is a summary of the assets acquired and liabilities assumed in the acquisition of Citadel, Onigma, Preventsys and SiteAdvisor as adjusted for the resolution of ongoing purchase price valuation procedures (in thousands):

	SiteAdvisor	Preventsys	Onigma	Citadel	Total
Technology	$ 15,450	$ 3,540	$ 23,139	$ 15,900	$ 58,029
Other intangibles	420	890	1,889	6,500	9,699
Goodwill	50,397	269		42,041	92,707
Cash	29	23	125		177
Other assets	485	661	281	1,117	2,544
Deferred tax assets	587	1,978	530		3,095
Total assets acquired	67,368	7,361	25,964	65,558	166,251
Accrued liabilities	37	1,024	372	426	1,859
Deferred revenue		203		3,937	4,140
Deferred tax liabilities	6,269	1,750	6,429		14,448
Total liabilities assumed	6,306	2,977	6,801	4,363	20,447
Net assets acquired	61,062	4,384	19,163	61,195	145,804
In-process research and development expensed		460			460