McAfee, Inc.
Form 10-Q
August 09, 2004

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

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

McAfee, Inc.

(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code:

(408) 988-3832

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

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

As of July 30, 2004, 156,219,258 shares of the registrant s common stock, $0.01 par value, were outstanding.

THIS DOCUMENT CONTAINS 71 PAGES.
THE EXHIBIT INDEX IS ON PAGE 69.

MCAFEE, INC.

FORM 10-Q

June 30, 2004

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2004	December 31, 2003
	(In thousands, except share and per share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 355,518	$ 333,651
Short-term marketable securities	183,105	174,499
Accounts receivable, net	115,985	170,218
Prepaid expenses, income taxes and other current assets	110,749	97,616
Deferred taxes	182,857	160,550
Assets held for sale		24,719
Total current assets	948,214	961,253
Long-term marketable securities	330,607	258,107
Restricted cash	20,749	20,547
Property and equipment, net	106,238	111,672
Deferred taxes	164,767	199,196
Intangible assets, net	92,205	105,952
Goodwill	441,352	443,593
Other assets	6,346	20,178
Total assets	$2,110,478	$2,120,498
LIABILITIES		
Current liabilities:		
Accounts payable	$ 22,072	$ 32,099
Accrued liabilities	126,415	147,281
Deferred revenue	434,488	342,795
Current portion of convertible debt	339,079	
Liabilities related to assets held for sale		23,310
Total current liabilities	922,054	545,485
Deferred revenue, less current portion	102,077	116,762
Convertible debt		347,397
Other long term liabilities	240,649	222,765
Total liabilities	1,264,780	1,232,409
Commitments and contingencies (Notes 11 and 12)		
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; Issued: 164,698,647 shares and 162,071,798 shares at June 30, 2004 and December 31, 2003, respectively;		
Outstanding: 155,685,447 shares and 161,721,798 shares at June 30, 2004 and December 31, 2003, respectively	1,647	1,621

Additional paid-in capital	1,125,479	1,087,625
Deferred stock-based compensation	(320)	(598)
Accumulated other comprehensive loss	30,573	34,027
Accumulated deficit	(161,709)	(229,879)
Treasury stock, at cost: 9,013,200 shares and 350,000 shares at June 30, 2004 and December 31, 2003, respectively	(149,972)	(4,707)
Total stockholders equity	845,698	888,089
Total liabilities and stockholders equity	$2,110,478	$2,120,498

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 OPERATIONS AND COMPREHENSIVE INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
		(In thousands, except per share data) (Unaudited)		
		(As Restated, See Note 13)		(As Restated, See Note 13)
Net revenue:				
Product	$ 80,007	$119,204	$163,738	$246,510
Services and support	145,671	97,821	281,018	189,829
Total net revenue	225,678	217,025	444,756	436,339
Cost of net revenue:				
Product	24,496	20,365	47,448	39,055
Services and support	9,792	13,002	20,639	26,232
Amortization of purchased technology	3,276	2,776	6,669	4,517
Total cost of net revenue	37,564	36,143	74,756	69,804
Operating costs and expenses:				
Research and development(1)	44,346	45,965	89,725	92,395
Marketing and sales(2)	96,114	87,045	189,072	175,986
General and administrative(3)	35,722	29,780	62,436	57,988
(Gain) loss on sale of assets and technology	274	(904)	(45,404)	(941)
Provision for (recovery from) doubtful accounts, net	149	(64)	674	(387)
Reimbursement related to litigation settlement	(5,890)		(24,991)	
Amortization of intangibles	3,516	3,721	7,089	8,732
Restructuring charge	682	6,826	2,872	22,607
In-process research and development		6,600		6,600
Total operating costs	174,913	178,969	281,473	362,980
Income from operations	13,201	1,913	88,527	3,555
Interest and other income	4,224	2,660	8,575	7,208
Interest and other expenses	(2,137)	(2,034)	(2,878)	(5,205)
Loss on repurchase of zero coupon convertible debentures		(136)		(2,727)
Gain (loss) on sale of marketable securities	(1,319)	500	(831)	1,548
Income before provision for income taxes and cumulative effect of change in accounting principle	13,969	2,903	93,393	4,379
Provision for income taxes	3,769	412	25,223	556
Income before cumulative effect of change in accounting principle	10,200	2,491	68,170	3,823
Cumulative effect of change in accounting principle, net of tax				11,142

Net income	$ 10,200	$ 2,491	$ 68,170	$ 14,965
Other comprehensive income:				
Unrealized loss on marketable securities, net	$ (2,373)	$ (77)	$ (2,123)	$ (766)
Foreign currency translation gain (loss)	(2,307)	8,026	(1,333)	10,485
Comprehensive income	$ 5,520	$ 10,440	$ 64,714	$ 24,684
Basic income per share:				
Income before cumulative effect of change in accounting principle	$ 0.06	$ 0.02	$ 0.42	$ 0.02
Cumulative effect of change in accounting principle, net of taxes				0.07
Net income per share basic	$ 0.06	$ 0.02	$ 0.42	$ 0.09
Shares used in per share calculation basic	160,313	160,341	161,800	159,954
Diluted income per share:				
Income before cumulative effect of change in accounting principle	$ 0.06	$ 0.02	$ 0.40	$ 0.02
Cumulative effect of change in accounting principle, net of taxes				0.07
Net income per share diluted	$ 0.06	$ 0.02	$ 0.40	$ 0.09
Shares used in per share calculation diluted	163,925	164,608	184,705	165,053

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

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

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

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

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

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

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

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

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

2. Summary of Significant Accounting Policies

Basis of Presentation

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

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

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

Proforma Stock Compensation Disclosure

As permitted by Statement of Financial Accounting Standard (SFAS) No. 123, *Accounting for Stock-Based Compensation,* (SFAS 123) and as amended by SFAS No. 148, *Accounting for Stock- Based Compensation Transition and Disclosure,* (SFAS 148), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employee,* (APB 25), and Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions Involving Stock-Based Compensation, an interpretation of APB Opinion No. 25* (FIN 44) and the related interpretations in accounting for its stock-based compensation plans. Stock-based compensation related to non-employees is based on the fair value of the related stock or options in accordance with SFAS 123 and its interpretations. Expense associated with stock-based compensation is amortized over the vesting period of each individual award.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

New Accounting Pronouncements

Accounting for Enhancements to One-Time Termination Benefits

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Accounting for Consolidation of Variable Interest Entities

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

The Meaning of Other-Than-Temporary Impairment

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

Accounting Change

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

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

3. Stock-Based Compensation

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Exchange of McAfee.com options. On September 13, 2002, the Company acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of Networks Associates, Inc. common stock plus $8.00 in cash, which will be paid to the option holder only upon exercise of the option, in exchange for each McAfee.com option. McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of the Company s common stock. The assumed options have been accounted for under the guidance in EITF Issue No. 00-23 *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25* and FIN 44. Accordingly, these options are subject to variable accounting treatment, which means that a compensation charge has been measured initially at the date of the closing of the merger and then remeasured at the end of each reporting period. The initial charge was based on the excess of the closing price of the Company s stock over the exercise price of the options plus the $8.00 per share payable in cash, which will be paid upon exercise of the option. This compensation charge will initially be remeasured using the same methodology and recorded as an expense using the accelerated method of amortization under FIN 28. To the extent that the options issued were fully vested at the date of the closing of the McAfee.com acquisition, the Company immediately recorded a compensation expense of approximately $10.5 million. Fully vested options will continue to be remeasured using the same method and compensation charges will be recorded until the earlier of the date of exercise, forfeiture or cancellation without replacement. Charges related to unvested options will be recorded in deferred stock-based compensation in stockholders equity. Depending upon movements in the market value of the Company s common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

During the three months ended June 30, 2004 and 2003 and during the six months ended June 30, 2004 and 2003, the Company recorded a charge of approximately $0.3 million, $0.3 million, $2.2 million and $1.1 million, respectively, related to exchanged options subject to variable accounting. This stock based compensation charge was based on the Company s closing share price of $18.13 and $12.68 on June 30, 2004 and 2003, respectively. As of June 30, 2004, the Company had approximately 0.6 million outstanding exchanged options subject to variable accounting.

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire the Company s common stock. These options are subject to variable accounting as discussed above. Upon the executives termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former McAfee.com executives were exercised within the first quarter of 2003. As a result, the Company recorded a final stock-based compensation charge of $1.1 million during the three months ended March 31, 2003.

Repriced options. On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price of $11.063, the then current fair market value of its common stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted. During the three and six months ended June 30, 2004 and 2003, the Company did not incur a charge related to these repriced options subject to variable plan accounting. For the three and six months ended June 30, 2004 and 2003, the Company s stock-based compensation charge calculation related to options subject to variable plan accounting was based on quarter-end per share price of the Company s stock of $18.13 and $12.68, respectively. The Company will incur stock-based compensation charges if the Company s stock price increases above $20.375 per share. As of June 30, 2004, the Company had options to purchase approximately 0.4 million shares, which were outstanding and subject to variable plan accounting.

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

4. Business Combinations and Divestitures

IntruVert Networks, Inc.

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

Entercept Security Technologies, Inc.

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

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The following unaudited pro forma financial information presents the combined results of the Company, IntruVert and Entercept as if the acquisitions had occurred at the beginning of 2003 (in thousands except per share amounts):

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

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

Magic Solutions

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Sniffer Technologies

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

5. Goodwill and Other Intangible Assets

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

Goodwill information is as follows (in thousands):

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

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

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

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

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

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

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

6. Restructuring

2004 Restructuring

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

2003 Restructuring

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

The Company s estimates of the excess facilities charge may vary significantly depending, in part, on factors which may be beyond the Company s control, such as the Company s success in negotiating with its lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if further consolidations are required or if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charge was allocated to North America.

7. Convertible Debt and Line of Credit

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

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

5.25% Convertible Subordinated Note Due 2006

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

Zero Coupon Convertible Debentures Due 2018

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

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

Line of Credit

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

8. Interest Rate Swap Transaction

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

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

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

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

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

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

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

9. Net Income Per Share

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

10. Business Segment Information

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

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

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Company offers web sites, which provide suites of on-line products and services personalized for the user based on the users PC configuration, attached peripherals and resident software. The Company also offers managed security and availability applications to corporations and governments on the Internet.

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

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

11. Litigation

General

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

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

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

Securities Case

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Other Matters

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

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

12. Contingencies and Guarantees

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

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

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

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

13. Restatement

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

14. Subsequent Events

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

Assets:	
Prepaid expenses	$ 2,391

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

Forward-Looking Statements; Trademarks

Some of the statements contained in this Report on Form 10-Q are forward-looking statements that involve risks and uncertainties. The statements contained in the Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expects, plans, anticipates, believes, estimates, pr targets, goals, projects, continue, or variations of such words, similar expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors beginning on page 42 in this document. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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

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

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

Overview and Executive Summary

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

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

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

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

Sales by product and customer category:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

McAfee System Protection Solutions

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

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

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

McAfee Network Protection Solutions

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

Expert Services and Technical Support

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

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

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

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

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

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

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

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

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

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

McAfee Research

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

Strategic Alliances

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

Product Licensing Model

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

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

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

On-Line Subscription Services and Managed Applications

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

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

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

Critical Accounting Policies

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

Results of Operations

Three and Six Months Ended June 30, 2004 and 2003

Net Revenue

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

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

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

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

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

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

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Net Revenue by Geography

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Cost of Net Revenue; Gross Margin

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

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

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

As a percentage of total cost of

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

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

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

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

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

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

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

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

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

	Operating Expenses				Percentage of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Research and development	$ 44,346	$ 45,965	$ 89,725	$ 92,395	20%	21%	20%	21%
Marketing and sales	96,114	87,045	189,072	175,986	43	40	43	40
General and administrative	35,722	29,780	62,436	57,988	16	14	14	13
Gain (loss) on sale of assets and technology	274	(904)	(45,404)	(941)			(10)	
Provision for (recovery from) doubtful accounts, net	149	(64)	674	(387)				
Reimbursement related to litigation settlement	(5,890)		(24,991)		(3)		(6)	
Amortization of intangibles	3,516	3,721	7,089	8,732	2	1	1	2
Restructuring charge	682	6,826	2,872	22,607		3	1	5
In-process research and development		6,600		6,600		3		2
Total operating costs, including the effects of stock-based compensation	$174,913	$178,969	$281,473	$362,980	78%	82%	63%	83%

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

	Operating Expenses				Percentage of Net Revenue			
	Three Months Ended June 30,		Six Months Ended June 30,		Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003	2004	2003	2004	2003
	(In thousands, except percentages)							
Research and development(1)	$ 44,088	$ 45,389	$ 88,153	$ 91,077	19%	21%	20%	21%
Marketing and sales(2)	96,063	86,887	188,385	175,572	43	40	43	40
General and administrative(3)	35,591	29,555	62,029	56,794	17	14	14	13
Gain on sale of assets and technology	274	(904)	(45,404)	(941)			(10)	
Provision for (recovery from) doubtful accounts, net	149	(64)	674	(387)				
Reimbursement related to litigation settlement	(5,890)		(24,991)		(3)		(6)	
Amortization of intangibles	3,516	3,721	7,089	8,732	2	1	1	2
Restructuring charge	682	6,826	2,872	22,607		3	1	5
In-process research and development		6,600		6,600		3		2
Total operating costs, excluding the effects of stock-based compensation	174,473	178,010	278,807	360,054	78%	82%	63%	83%
Stock-based compensation	440	959	2,666	2,926				
Total operating costs, including the effects of stock-based compensation	$174,913	$178,969	$281,473	$362,980	78%	82%	63%	83%

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

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

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

We are currently engaged in a comprehensive cost reduction and productivity plan to significantly enhance our operating margins by mid-2005, which we expect will cause operating margins to fluctuate. In addition, our ability to improve operating margins in the near-term may be impacted by our obligations to provide post-closing services to Network General.

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 $0.3 million and $0.6 million in the three months ended June 30, 2004 and 2003, respectively, research and development expenses decreased 3% or $1.3 million to $44.1 million. Excluding the effects of stock-based compensation of $1.6 million and $1.3 million in the six months ended June 30, 2004 and 2003, respectively, research and

development expenses decreased 3% or $2.9 million to $88.2 million. The decrease in research and development can be attributed to (i) additional headcount being added to our Bangalore research facility whose employees have significantly lower salaries; (ii) a decrease in research and development due to our divestiture of Magic in January 2004; (iii) decreased spending in

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research and development related to Sniffer as we prepared for its sale in July 2004; offset slightly by increased IntruVert related research and development expenditures following its acquisition in the second quarter of 2003.

We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to remain relatively flat in future periods and continue to fluctuate as a 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 $0.1 million and $0.2 million in the three months ended June 30, 2004 and 2003, respectively, marketing and sales expenses increased 11% or $9.2 million to $96.1 million in 2004. Excluding the effects of stock-based compensation of $0.7 million and $0.4 million in the six months ended June 30, 2004 and 2003, respectively, marketing and sales expenses increased 7% or $12.8 million to $188.4 million in 2004. The increase in both periods can be primarily attributed to higher sales commissions related to higher bookings in 2004 as compared to 2003 and increased spending in worldwide marketing expenditures.

We anticipate that marketing and sales expenses will decrease in absolute dollars due to our sale of the Sniffer product line, and will continue to fluctuate as a percentage of net revenue.

General and Administrative. General and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. Excluding the effects of stock-based compensation of $0.1 million and $0.2 million for the three months ended June 30, 2004 and 2003, respectively, general and administrative expenses increased 20% or $6.0 million to $35.6 million in 2004. Excluding the effects of stock-based compensation of $0.4 million and $1.2 million for the six months ended June 30, 2004 and 2003, respectively, general and administrative expenses increased 9% or $5.2 million to $62.0 million in 2004. The increase in both periods can be attributable to costs related to the implementation of Sarbanes-Oxley, fees incurred in the divestiture of Sniffer, costs related to outside consultants assisting with our cost reduction strategy, and increased legal fees due to our SEC investigation.

We expect our general and administrative expenses to decrease as we continue to implement cost control measures, but increase as a percentage of net revenue. For the quarter ended September 30, 2004, we expect approximately $10 million in pre-closing Sniffer related revenue. Consequently, we expect these expenses to increase as a percentage of net revenue as we will not be able to reduce operating expenses as quickly as revenue is reduced.

Gain on Sale of Assets and Technology. In December 2003, we announced the sale of our Magic assets to BMC Software. We completed the transaction in January 2004, and as a result, recognized a gain of approximately $46.5 million. We received net cash proceeds of approximately $47.6 million related to the sale. The assets and liabilities of Magic were located primarily in our North American and EMEA reporting units. This gain was offset by a write off of equipment of approximately $1.1 million.

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 provision for doubtful accounts was a net charge of approximately $0.1 million for the three months ended June 30, 2004 from a net recovery of $0.1 million for the three months ended June 30, 2003. The provision for doubtful accounts was a net charge of approximately $0.7 million for the six months ended June 30, 2004 from a net recovery of $0.4 million for the six months ended June 30, 2003.

Reimbursement Related to Litigation Settlement During the first quarter of 2004, we received insurance reimbursements of approximately $19.1 million from our insurance carriers. During the second quarter of 2004, we received a final payment of approximately $5.9 million from our insurance carriers. The reimbursements were a result of our insurance coverage related to the class action lawsuit we settled in October 2003 for $70.0 million. The $70.0 million was expensed in 2002.

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Amortization of Intangibles. We recorded $3.5 million and $3.7 million of amortization related to intangibles for the three months ending June 30, 2004 and 2003, respectively. We recorded $7.1 million and $8.7 million of amortization related to intangibles for the six months ending June 30, 2004 and 2003, respectively. The decrease in amortization of intangibles in both periods is as a result of several intangibles becoming fully amortized at the end of 2003.

Restructuring Charge

2004 Restructuring

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

In the second quarter of 2004, we recorded a restructuring charge of approximately $1.6 million related to the severance of approximately 80 employees in the our sales, technical support and general and administrative functions. Approximately $0.6 million of the restructuring charge was related to our EMEA operating segment and the remaining $1.0 million was related to our North American operating segment. These reductions are part of the previously announced cost-savings measures being implemented by us. Approximately 60 employees remained employed at the end of June 30, 2004, but their employment will end within 60 days.

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

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

2003 Restructuring

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

As part of the consolidation of activities into the Plano facility, we relocated employees from our Santa Clara, California headquarters site. 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 the permanently vacated facilities in Santa Clara, California. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. The total restructuring charge and related cash outlay are based on our management s current estimates. As of June 30, 2004, $1.3 million of the accrued lease termination costs have been classified as current accrued liabilities, while the remaining balance of $11.5 million has been classified as other long term liabilities.

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During the second and third quarter of 2003, we recorded restructuring charges of $6.8 million and $0.6 million, respectively, which consisted of $6.7 million related to a headcount reduction of 210 employees and $0.7 million related to other expenses such as legal expenses incurred in international locations in conjunction with the headcount reduction. The restructuring charge related to headcount reductions was $0.9 million and $5.8 million in our North American and EMEA operating segments, respectively. The employees were located in 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.

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

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

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

Our 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 reporting segments.

In-Process Research and Development. During the second quarter of 2003, we expensed $5.7 million of in process research and development related to IntruVert. The ongoing project at IntruVert at the time of the purchase 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 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

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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.

During the second quarter of 2003, we expensed $0.9 million of in process research and development related to Entercept. The ongoing projects at Entercept at the time of the purchase comprised a Linux version of their current product. At the date we acquired Entercept, 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 product is expected to release in the fourth quarter of 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 increased $1.5 million to $4.2 million from $2.7 million for the three months ended June 30, 2004 when compared to 2003. The increase is due to higher average cash and investment balances in the second quarter of 2004 as compared to the second quarter of 2003 due to the use of cash to purchase IntruVert and Entercept in the second quarter of 2003. Interest and other income increased $1.4 million to $8.6 million from $7.2 million for the six months ended June 30, 2004 and 2003, respectively. The increase is due to higher average cash and investment balances in the first six months of 2004 as compared to the first six months of 2003. In the first quarter of 2003, the payments we made to redeem zero coupon convertible debentures were made late in the quarter, therefore, increasing the average cash and investment balances over the entire quarter.

Interest Expense. Interest expense increased $0.1 million to $2.1 million from $2.0 million for the three months ended June 30, 2004 and 2003, respectively. The increase in interest expense of approximately $0.1 million was primarily due to the decrease in capitalized interest related to construction in progress. Many of our information technology projects, including our customer relationship management system, have been placed in service, therefore reducing the amount of interest that can be capitalized. Interest expense decreased $2.3 million to $2.9 million from $5.2 million for the six months ended June 30, 2004 and 2003, respectively. The decrease in interest expense for this period is due to (i) a decrease of approximately $1.0 million following the redemption of our zero coupon convertible debentures in the first and second quarters of 2003, (ii) an increase in the fair market value of our interest-rate swap of approximately $0.9 million which results in a decrease of related expenses and (iii) a decrease on interest related to the swap of $0.4 million.

Loss on Redemption of Zero Coupon Convertible Debentures. In the three and six months ended June 30, 2003, we recognized a $0.1 million and $2.7 million loss respectively, on the redemption of substantially all of the remaining zero coupon convertible subordinated debentures. We redeemed debentures which had an aggregate face amount at maturity of $358.0 million for approximately $177.1 million. The aggregate accreted value of the debentures on the date of redemption was $174.5 million.

Provision for Income Taxes. Our consolidated provision for income taxes for the three months ended June 30, 2004 and 2003 was $3.8 million and $0.4 million (including the tax effect on the cumulative effect of change in accounting principle), respectively, reflecting an effective tax rate of 27% and 14%, respectively. Our consolidated provision for income taxes for the six months ended June 30, 2004 and 2003 was $25.2 million and $3.4 million (including the tax effect on the cumulative effect of change in accounting principle),

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respectively, reflecting an effective tax rate of 27% and 18%, respectively. The effective tax rate differs from the statutory rate primarily due to the impact of research and development tax credits, utilization of foreign tax credits, and lower effective rates in some overseas jurisdictions. Our future effective tax rates could be adversely affected if earnings are lower than anticipated in countries where we have lower statutory rates or by unfavorable changes in tax laws and regulations.

Cumulative Effect of Change in Accounting Principle. In the six months ended June 30, 2003, we had a one-time credit of $11.1 million, net of income taxes, in connection with a change in the way we account for sales commission to sales personnel. Prior to January 1, 2003, we expensed sales commissions as incurred. Commission expense now directly related to sales transactions and is deferred and recognized ratably over the same period as the related revenue is recognized and recorded.

Stock-Based Compensation

We recorded stock-based compensation charges of $0.4 million and $1.0 million in the three months ended June 30, 2004 and 2003, respectively. We recorded stock-based compensation charges of $2.7 million and $2.9 million in the six months ended June 30, 2004 and 2003, respectively. These charges are comprised of the following (in thousands):

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

Exchange of McAfee.com options. For the three months ended June 30, 2004 and 2003, we recorded a charge of approximately $0.3 million and $0.3 million, respectively, related to exchanged options subject to variable accounting. For the six months ended June 30, 2004 and 2003, we recorded a charge of approximately $2.2 million and $1.1 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 $18.13 and $12.68 on June 30, 2004 and 2003, respectively. As of June 30, 2004, we had outstanding exchanged options to acquire approximately 0.6 million shares subject to this variable accounting.

Existing executive. On January 15, 2002, our board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. During the three months ended June 30, 2004 and 2003, the Company recorded approximately $0.1 million in both periods, and for the six months ended June 30, 2004 and 2003, the Company recorded approximately $0.2 million in both periods related to stock-based compensation associated with Mr. Samenuk s 2002 restricted stock grant.

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

In October 2002, we terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire our common stock. These options are subject to variable accounting as discussed above. Upon the executives termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former McAfee.com executives were exercised during the quarter ended March 31, 2003. As a result, we recorded a final stock-based compensation charge of $1.1 million during the three months ended March 31, 2003.

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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 of $11.063, the then current fair market value of our common stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted. During the three and six months ended June 30, 2004 and 2003, we did not incur a charge related to these repriced options subject to variable plan accounting. For the three and six months ended June 30, 2004, our stock-based compensation charges related to options subject to variable plan accounting were based on quarter-end per share price of our stock of $18.13. For the three and six months ended June 30, 2003, stock-based compensation charges related to options subject to variable plan accounting were based on quarter end per share price of our stock of $12.68. As of June 30, 2004, we had options to purchase approximately 0.4 million shares, which were outstanding and subject to variable plan accounting.

Extended life of vested options held by terminated employees. During a significant portion of 2003, we suspended exercises of stock options until our required public company reports were filed with the SEC. The period during which stock options were suspended is known as the blackout period. Due to the blackout period, we 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 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. In the first quarter of 2004, we recorded a stock-based compensation charge of approximately $0.1 million. During the three and six months ended June 30, 2003 and the six months ended June 30, 2004, we recorded a stock-based compensation charge of $0.5 million and $0.1 million, respectively.

Recent Accounting Pronouncements

See Note 2 to the condensed consolidated financial statements.

Liquidity and Capital Resources

	Six Months Ended June 30,	
	2004	2003
	(In thousands)	
Net cash provided by operating activities	$ 193,527	$ 89,864
Net cash used in investing activities	$ (55,747)	$(298,910)
Net cash used in financing activities	$(108,310)	$(156,810)

Overview

At June 30, 2004, we had cash, cash equivalents and marketable securities totaling $869.2 million, as compared to $713.6 million at June 30, 2003. In the six months ended June 30, 2004, we received cash proceeds of approximately $25.0 million of insurance reimbursements from our insurance carriers related to the settling of our class action lawsuit. We also received approximately $47.6 million from the sale of Magic, as well as approximately $37.0 million related to our employee stock purchase plan and stock option exercises. Uses of cash during the six months ended June 30, 2004, included the repurchase of approximately 8.6 million shares of our common stock for approximately $145.3 million, the purchase of approximately $16.0 million of property and equipment, and net purchase of marketable securities of approximately $87.0 million, as well as the payment of our routine operating expenses. A more detailed discussion of changes in our liquidity follows.

Operating Activities

Net cash provided by operating activities for the six months ended June 30, 2004 and 2003 was the result of our net income of $68.2 million and $15.0 million, respectively, which is adjusted for non-cash items such as depreciation and amortization, non-cash restructuring charges, gain on the sale of assets and technology, non-cash interest, non-cash loss on repurchase of convertible debentures, stock-based compensation and changes in various assets and liabilities such as accounts payable, accounts receivable and deferred revenue.

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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 46 days and 48 days at June 30, 2004 and 2003, respectively. We calculate accounts receivable DSO on a net basis by dividing the accounts receivable balance at the end of the quarter by the amount of revenue recognized for the quarter multiplied by 90 days. We expect DSO s to vary from period to period because of changes in quarterly revenue and the effectiveness of our collection efforts. During 2004 and 2003, 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 $30.9 million from December 31, 2003 to June 30, 2004. Our operating cash flows, including changes in accounts payable and accrued liabilities, is impacted by the timing of payments to our vendors for accounts payable. We typically pay our vendors and service providers in accordance with invoice terms and conditions, and take advantage of invoice discounts when available. The timing of future cash payments in future periods will be impacted by the nature of accounts payable arrangements. In the six months ended June 30, 2004 and 2003, we did not make any significant changes to our payment timing to our vendors.

Our cash balances are held in numerous locations throughout the world, including substantial amounts held outside the United States. As of June 30, 2004 and 2003, approximately $364.6 million and $266.2 million, respectively, were 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 United States liquidity needs would be met 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 $26.2 million and $415.8 million at June 30, 2004 and December 31, 2003, respectively. The decrease in working capital of $389.6 million from December 31, 2003 to June 30, 2004 is due to an increase of cash and short-term marketable securities balances, offset by lower accounts receivable due to customer payments, offset by final sale of Magic assets and liabilities held for sale of $24.7 million and $23.3 million, respectively and the classification of our convertible debt of $339.1 million and related issuance costs of $8.9 million as current at June 30, 2004 due to our intent to redeem the convertible debt earlier than its maturity. Current liabilities increased $376.6 million due to a $91.7 million increase in current deferred revenue and reclassification of our convertible debt to current liabilities offset by lower accrued liabilities and accounts payable of $30.9 million. Our perpetual plus licensing model, now introduced worldwide, results in less revenue recognition up-front, therefore causing increases in our deferred revenue.

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

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

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Investing Activities

A summary of our investing activities at June 30, 2004 and 2003 is as follows (in thousands). The detail of these line items can be seen in our condensed consolidated statement of cash flows.

	Six Months Ended June 30,	
	2004	**2003**
Net purchases of marketable securities	$(87,130)	$ (41,424)
Cash payments for acquisitions		(215,998)
Cash payments for property and equipment	(15,952)	(41,124)
Proceeds from sale of Magic, net	47,565	
Cash payments for restricted cash	(202)	(186)
Other	(28)	(178)
Net cash used in investing activities	$(55,747)	$(298,910)

Investments

We made net purchases of our marketable securities of $87.1 million and $41.4 million for the six months ended June 30, 2004 and 2003, respectively. We have classified our investment portfolio as available for sale, and our investments are made with a policy of capital preservation and liquidity as the primary objectives. We generally hold investments in money market, fixed income and U.S. government agency securities. We may sell an investment at any time if the quality rating of the investment declines, the yield on the investment is no longer attractive or we are in need of cash. Because we invest only in investment securities that are highly liquid with a ready market, we believe that the purchase, maturity and sale of our investments has no material impact on our overall liquidity.

Acquisitions

In the second quarter of 2003, we paid a total of approximately $216.0 million in cash for IntruVert Networks, Inc. (IntruVert) and Entercept Security Technologies, Inc. (Entercept). We acquired IntruVert and Entercept to enhance our network protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in our current product offering, and sell IntruVert and Entercept products to our existing customer base.

Property and equipment

We purchased $16.0 million of equipment during the first two quarters of 2004 to update hardware for our employees and enhance various back office systems and purchases of equipment for our Bangalore research and development facility. In the first two quarters of 2003, we added $41.1 million of property and equipment, related to new computer equipment for employees moving from California to Texas, the completion of our regional office in Plano, Texas and continued investments in updating hardware and enhancing various back office systems. Our property and equipment additions have historically been funded from operations.

The decrease in purchases of property and equipment from 2003 to 2004 can be attributed to our cost saving measures that have been implemented as well as many large projects that were under development and construction such as our regional office in Plano, Texas and our customer relationship management project have been completed. 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.

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Proceeds from Sale of Assets and Technology

We completed the sale of our Magic product line to BMC Software in January 2004, and as a result, recognized a gain of approximately $46.5 million. We received net cash proceeds of approximately $47.6 million related to the sale. We received an additional $0.9 million final purchase price payment related to the sale of Magic in April 2004.

Restricted Cash

At June 30, 2004 and 2003, we had on deposit approximately $20.2 million and $20.9 million, respectively, 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 summary of our financing activities at June 30, 2004 and 2003 is as follows (in thousands). The detail of these line items can be seen in our condensed consolidated statement of cash flows.

	Six Months Ended June 30,	
	2004	**2003**
Proceeds from issuance of stock from option and stock purchase plans	$ 36,955	$ 20,479
Redemption of zero coupon convertible debentures		(177,289)
Repurchase of common stock	(145,265)	
Net cash used in financing activities	$(108,310)	$(156,810)

Stock Option and Stock Purchase Plans

Cash flows from financing activities in the six months ended June 30, 2004 and 2003 included the receipt of $37.0 million and $20.5 million, respectively, of cash related to exercises of stock options and stock purchases from the employee stock purchase plan. Historically, our recurring cash flows provided by financing activities have been from the receipt of cash from the issuance of common stock under these plans. For example, we received total cash proceeds from these plans in the amount of $35.4 million and $109.9 million in 2003 and 2002, 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. 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. This suspension is the primary reason for the decrease in option and stock purchase plan activity in 2003.

Redemption of Zero Coupon Convertible Debentures

In February 2003, outstanding Debentures, with an aggregate face amount at maturity of $358.5 million, became redeemable for cash at the option of the holders thereof, at which time we repurchased Debentures which had an aggregate face amount at maturity of $358.0 million for a

net price of $177.1 million. Additionally, in June 2003, we redeemed the remaining Debentures with an aggregate face amount at

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maturity of $0.5 million for a net price of $0.2 million. We recognized a loss of $2.7 million on the redemption of Debentures during 2003.

Repurchase of Common Stock

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. During the second quarter of 2004, we purchased approximately 8.7 million shares for approximately $145.3 million, and in the fourth quarter of 2003, we repurchased 0.4 million shares for approximately $4.7 million.

Convertible Debt and Line of Credit

In August 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). We plan to use approximately $350 million of our cash on August 20, 2004 to redeem the notes. Prior to redemption, the notes may be converted into shares of our common stock at an effective conversion price of approximately $18.31 per share. Interest is payable semi-annually in cash in arrears on February 15 and August 15 of each year. 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. Because we intended to redeem the notes, the notes are classified as current liabilities in our condensed consolidated balance sheet at June 30, 2004.

We plan to keep our interest rate swap intact after the notes are called. The swap will become a speculative investment with gains and losses being recorded in our statement of income.

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 repurchase 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.

In April 2004, we renewed and expanded our $16.5 million credit facility with a bank. The credit facility was increased $2.0 million and is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between us and bank at the time of each specific transaction. The credit facility is intended to be used for short term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time. None is outstanding at June 30, 2004.

Off-Balance Sheet Arrangements

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

Item 3. ***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 2 of this form 10-Q. Our market risks at June 30, 2004, have not changed significantly from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2003 filed with the Securities and Exchange Commission.

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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 historical operating results include revenues and expenses related to our Magic and our Sniffer product lines for periods prior to their disposition in January 2004 and July 2004, respectively. For 2003, Magic and Sniffer accounted for $63.2 million and $210.2 million, or 7% and 22%, of our total revenues. Our expenses are based in part on our expectations regarding future revenues and our post-Sniffer support obligations, making expenses in the short term relatively fixed. We may be unable to adjust our expenses in time to compensate for any unexpected revenue shortfall.

Operational Factors

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

volume, size, timing and contractual terms of new licenses and renewals of existing licenses;

our perpetual plus licensing program, in the near term;

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;

system and personnel limitations may adversely impact our ability to process the large number of orders that typically occur near the end of a fiscal quarter;

costs or charges related to our acquisitions or dispositions, including our acquisitions of Entercept Security Technologies and IntruVert Networks in 2003, the dispositions of our Magic and Sniffer product lines;

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;

costs related to certain events, including our recently announced cost reduction and profitability plan, 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.

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

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.

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

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

As a result of information obtained in connection with the ongoing SEC and DOJ investigations, we concluded in March 2003, that we would restate our consolidated financial statements to, among other things, reflect revenue on sales to our distributors for 1998 through 2000 on a sell-through basis (which is how we reported sales to distributors since the beginning of 2001). Although we filed these restated consolidated financial statements on October 31, 2003, the SEC and DOJ inquiries have resulted in, 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 in October 2003 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, involve the imposition of fines or penalties or other remedies by the SEC 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 October 2003 restatement.

Our Recent Business Transformation, including Our Intrusion Prevention Focus, Dispositions and Cost Reduction Plan, Expose Us to Significant Risks.

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. In January 2004 and July 2004, respectively. we disposed of our Magic Solutions and Sniffer Technologies product lines. In April 2004, we began our ongoing cost reduction and profitability plan with an objective of significantly improving our operating margins by mid-2005. In July 2004 we changed our name to McAfee, Inc. These activities are intended to, among other things, streamline our business, better leverage the McAfee brand, better position us as a provider of a complete set of system and network protection solutions differentiated by intrusion prevention technology, and help accelerate profit and growth. Risks related to these activities include:

- our growth and/or profitability may not increase in the near-term or at all and we may fail to achieve desired savings or performance targets on a timely basis or at all;
- revenues for our products may be adversely impacted as a number of the members of the sales force transferred to Sniffer also sold non-Sniffer products;
- our obligations to provide the Sniffer business post-closing IT, facilities and other support may adversely impact our timing for implementing various cost-saving efforts, such as facilities consolidations, and could result in financial liability for us;

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our business, including our sales force and internal finance and IT operations, may be disrupted or otherwise strained due to, among other things, our cost saving measures and our Sniffer post-closing support obligations;

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

we may be unable to successfully expand our McAfee brand significantly beyond our anti-virus products and we will likely lose any brand equity built around our Network Associates name;

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; and

there may be customer confusion around our strategy.

The Implementation of New, or the Evaluation and Testing of Existing, Disclosure Control Procedures Could Have Adverse Consequences, including Possible Additional Restatements of Our Financial Results, and Could Require Other Remedial Measures.

In the first quarter of 2004, we restated previously reported quarters of 2003; and in the second quarter of 2004, we restated the previously reported first quarter of 2004. These matters were identified by us and reported to our auditors. In conjunction with these restatements, our former auditors and our current auditors, respectively, reported that the underlying control issues giving rise to the respective restatement should be considered a material weakness under standards established by the Public Company Accounting Oversight Board. We regularly evaluate and test our disclosure controls and procedures, including our internal control over financial reporting. In the process, we may identify additional material weaknesses or significant deficiencies in the design or operation of our internal controls, which in turn could require our implementing additional controls and procedures, hiring of additional personnel or outside consultants or additional restatements of prior period results. These actions may be expensive and, in particular, further restatements, may reduce prior period operating results, undermine investor confidence and the value of our stock and subject us to possible litigation.

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. Following its GeCAD Software acquisition, Microsoft has from time to time indicated that it may enter the consumer anti-virus market; and

in the market for our other intrusion detection and protection products, Cisco Systems, Computer Associates, Enterasys Internet Security Systems, Netscreen (which was 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

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their products. For example, Juniper Networks recently acquired 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 GeCAD acquisition, 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.

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 maintain an open and collaborative work environment. In certain cases, personnel may feel constrained in raising HR or other operational issues, notwithstanding our policies encouraging personnel to raise these issues. We also believe we need to provide a competitive compensation package, including stock options. Increases in shares available for issuance under our stock option plans require stockholder approval. Institutional stockholders, or our other stockholders generally, may not approve future requests for option increases. For example, at our 2003 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, it is likely that the accounting industry will require corporations to 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, in conjunction with the July Sniffer disposition, we continue to take efforts to rationalize the size of our employee base. On July 16, 2004 (post-Sniffer close), we had approximately 2,950 employees, down from approximately 3,800 and 3,700 at the end of 2002 and 2003, respectively. Included in these totals are a significant number of new employees following our 2003 acquisitions and increased hiring activities in India. Reductions in personnel, including as a result of the Sniffer sale, may harm our business, employee retention or our ability to attract new personnel by, among other things, reducing overall employee morale, requiring remaining personnel to perform a greater amount of, or new and different, responsibilities or result in the loss of personnel otherwise critical to our business. 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.

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.

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We Face Risks Associated with Past and Future Acquisitions.

We may buy or make investments in complementary companies, products and technologies. 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.

Internal Controls, Policies and Procedures

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

Open Source Software

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

open source license terms may be ambiguous and may result in unanticipated obligations regarding our products;

competitors will have improved access to information that may help them develop competitive products;

open source software cannot be protected under trade secret law;

it may be difficult for us to accurately determine the developers of the open source code and whether the acquired software infringes third party intellectual property rights; and

open source software potentially increases customer support costs because licensees can modify the software and potentially introduce errors

Use of Cash and Securities

Our available cash and securities may be used to acquire or invest in companies or products, possibly resulting in significant acquisition-related charges to earnings and dilution to our stockholders. For example, in

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2003 we used approximately $217.3 million of cash to make various acquisitions, including approximately $217.1 million in net cash to acquire IntruVert and Entercept. 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 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. In July 2004, we hired David Roberts as our new senior vice president of North American Channel Operations. In June 2004, we promoted Christopher Bolin to the position of executive vice president and chief technology officer. 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 the six months ended June 30, 2004 and the year ended December 31, 2003, net revenue in our international operating regions represented approximately 36% and 35%, respectively, 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 our business strategy and the reorganization of our international sales forces by regions;

the ability to successfully localize software products for a significant number of international markets;

our ability to effectively provide service and support for our hardware based products from the U.S.;

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 and privacy laws;

currency fluctuations and risks related to hedging strategies;

political instability in both established and emerging markets;

tariffs, trade barriers and export restrictions

a high incidence of software piracy in some countries; and

international labor laws and our relationship with our employees and regional work council.

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.

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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 and the Sniffer Bonus Plan.

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 the six months ended June 30, 2004 and the year ended December 31, 2003, stock-based compensation charges of approximately $2.2 million and $3.4 million, respectively, were recorded for McAfee.com Options. No stock based compensation charges were recorded for the Repriced Options in the first or second quarters of 2004 or the year ended 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 June 30, 2004 would increase our future stock compensation charge by approximately $0.4 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, the final expense was approximately $0.6 million.

In connection with the Sniffer disposition, we implemented the Sniffer Bonus Plan primarily to encourage Sniffer s management to assist us in the sales process and remain with the business through the sale. Subject to reduction in certain cases, we expect total related cash payments of approximately $7.5 million payable approximately $5.0 million in third quarter of 2004 with the balance payable in the first quarter of 2006.

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

We have historically derived a majority of our net revenue from our flagship McAfee anti-virus software products and, prior to the Sniffer disposition, our Sniffer network fault identification and application performance management products. As a result of the disposition of the Sniffer product line, our McAfee anti-virus software products will account for a substantial majority 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, our McAfee anti-

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virus software 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.

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 34% for the six months ended June 30, 2004 and 33% for the year ended December 31, 2003 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 $2.3 million at June 30, 2004 and $3.1 million at December 31, 2003. 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 six months ended June 30, 2004 and the year ended December 31, 2003, our amortization charge for purchased technology and other intangibles was approximately $13.8 million and $27.0 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. Additionally, as required by SFAS 142, we also performed an additional goodwill impairment test due to the sale of Sniffer

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during the second quarter of 2004. As a result of these reviews, goodwill was determined not to be impaired. If during subsequent testing, we determine that goodwill is impaired, we will be required to take a non-cash charge to earnings.

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

We Face Risks Related to Our Strategic Alliances.

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

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

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

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.

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

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

offer a broad range of network and system protection products;

enhance existing products and expand product offerings;

extend security technologies to additional digital devices;

respond promptly to new customer requirements and industry standards; 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.

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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. Through our websites we sell and deliver security services over the Internet for consumers and small businesses (primarily small office and home) and subscription services to small-medium business and large enterprises. Our on-line subscription services may fail to maintain or increase market acceptance. Continued growth of our on-line subscription services is 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 this 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.

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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.

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

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unable in the future to gain the necessary access from Microsoft to its product development activities, particularly in light of Microsoft s acquisition of GeCAD Software, an anti-virus software provider.

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.

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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.

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

During the 12-month period ended June 30, 2004, our stock price was highly volatile ranging from a per share high of $19.75 to a low of $10.75. On July 30, 2004, our stock s closing price per share price was $17.98. Announcements, business developments, such as a material acquisition or disposition, litigation developments and our ability to meet the expectations of investors with respect to our operating and financial results, may contribute to current and future stock price volatility. Certain types of investors may choose not to invest in stocks with this level of stock price volatility. Further, we may not discover, or be able to confirm, revenue or earnings shortfalls until the end of a quarter. This could result in an immediate drop in our stock price.

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

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

Product Liability and Related Claims May Be Asserted Against Us.

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

Computer Hackers May Damage Our Products, Services and Systems.

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

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

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

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.

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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 in the past and may make additional strategic investments in the future. 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

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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 2005 annual meeting, must meet the qualifications and follow the procedures specified under both the Exchange Act of 1934 and our bylaws.

Our Rights Plan

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

Item 4. ***Controls and Procedures***

Our management evaluated, with the participation of our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report on Form 10-Q. Based on this evaluation, our CEO and CFO have concluded that 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. Except as described below, there has been no change in our internal control over financial reporting that occurred during the quarter ended June 30, 2004, 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-Q made as a result of events discovered subsequent to the quarter ended June 30, 2004.

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As more fully described in (i) our 2003 Annual Report on Form 10-K, we restated our quarterly operating results for certain quarters in 2003, and in (ii) our Amended Quarterly Report on Form 10-Q/ A for the quarter ended March 31, 2004, we restated our financial results for the quarter ended March 31, 2004. The circumstances giving rise to these restatements were identified by McAfee and reported to our auditors.

Our former auditors, PricewaterhouseCoopers LLP, reported that the underlying control issues giving rise to the restatement of the 2003 quarterly operating results should be considered a material weakness under standards established by the Public Company Accounting Oversight Board. In conjunction with making the required corrections to address matters arising out of the restatement of our 2003 operating results, during the quarter ended March 31, 2004, we bolstered internal controls around the recognition of international revenues as part of our quarterly financial closing process and the manual journal entry process. At the end of the quarter ended March 31, 2004 we also instituted additional review procedures to verify that the internal controls were effective. We have also hired additional personnel, and are continuing to determine 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. Furthermore, we have implemented a software patch related to our international deferred revenue and are in the process of testing this patch and reviewing results.

In conjunction with the restatement of our operating results for the quarter ended March 31, 2004, our current auditors, Deloitte & Touche LLP, reported that the underlying issues giving rise to the restatement of our operating results for the quarter ended March 31, 2004 is a material weakness under standards established by the Public Company Accounting Oversight Board. In connection with the restatement of our operating results for the quarter ended March 31, 2004, we reviewed the circumstances giving rise to the restatement, and determined that the actions we have implemented or are in the process of implementing as part of our internal controls assessment for the internal controls reporting required under Sarbanes-Oxley Act of 2002, will correct the underlying circumstances giving rise to the restatement. The current actions management has or is implementing include the hiring of additional personnel in revenue accounting, establishing additional controls including increased review procedures, increased testing of internal controls to ensure internal controls are operating as designed, modifying our revenue accounting software and performing review and corrections of system data affecting our revenue accounting.

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PART II: OTHER INFORMATION

Item 1. ***Legal Proceedings:***

Information with respect to this item is incorporated by reference to note 11 of the notes to the condensed consolidated financial statements included herein on page 20 of this Report on Form 10-Q.

Item 2. ***Changes in Securities, Use of Proceeds, and Issuer Purchases of Equity Securities:***

Stock Repurchases

The table below sets forth all repurchases by us of our common stock during the six months ended June 30, 2004 whether or not pursuant to a publicly announced plan or program (in thousands, except price per share):

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Repurchase Program(1)	Approximate Dollar Value of Shares That May Yet Be Purchased Under Our Stock Repurchase Program(1)
January 2004		$		$145,293
February 2004				$145,293
March 2004				$145,293
April 2004	450	15.86	450	$138,154
May 2004	8,213	16.82	8,213	$ 28
June 2004				$ 28
Total	8,663	$16.77	8,663(2)	

(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 8.7 million shares during the second quarter of 2004 for approximately $145.3 million and 0.4 million shares for a total of $4.7 million in 2003.

(2) 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 s in respect of their stock options assumed in our acquisition of the company. These shares have historically been included in our total outstanding share balance since issuance. In June 2004, the trust returned and we retired 1.5 million of these shares. These shares are not included in the 8.7 million share total.

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

None

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

The Company s annual meeting of stockholders was held on May 27, 2004.

1. The following nominees were elected as directors, each to hold office until his or her successor is elected and qualified, by the vote set forth below:

Nominee	For	Withheld
Robert Dutkowsky	136,374,179	6,361,439
Denis O Leary	137,086,066	5,649,552
Robert Pangia	132,271,764	10,463,854

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2. The approval of an amendment to the Company s 1997 Stock Incentive Plan.

Shares in Favor	115,475,222
Shares Against	27,145,941
Shares Abstained	114,455

3. The ratification of the appointment of Deloitte & Touche LLP as the independent public accountants for the year ending December 31, 2004.

Shares in Favor	140,390,077
Shares Against	2,263,683
Shares Abstained	81,858

Item 5. ***Other Information:***

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, Stephen C. Richards, our Chief Operating Officer and Chief Financial Officer, Vernon Gene Hodges, our President, Kevin Weiss, our Executive Vice President of Worldwide Sales, and Kent H. Roberts, our Executive Vice President and General Counsel, each a Section 16 officer, have adopted a Rule 10b5-1 trading plan. In addition, Amanda Hodges, the wife of our President, has adopted a 10b5-1 trading plan. We believe that additional directors, officers and employees may establish such programs. All trades in our common stock made during the second quarter of 2004 by officers who have adopted Rule 10b5-1 trading plans were made pursuant to the terms of such plans.

Item 6. ***Exhibits and Reports on Form 8-K:***

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

(b) *Form 8-K.*

On April 23, 2004, we furnished a report on Form 8-K announcing business, productivity and branding changes including the sale of our Sniffer product line and renaming of our company to McAfee.

On April 27, 2004, we furnished a report on Form 8-K to announce our first quarter 2004 results.

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SIGNATURES

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

MCAFEE, INC.

/s/ STEPHEN C. RICHARDS

Name: Stephen C. Richards
Title: *Chief Operating Officer and Chief Financial Officer*

Date: August 9, 2004

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INDEX TO EXHIBITS

Exhibit Number	Description
2.1	Agreement and Plan of Reorganization, dated October 13, 1997, among McAfee Associates, Inc., Mystery Acquisition Corp. and Network General Corporation, as amended by the First Amendment dated as of October 22, 1997.(1)
2.2	Asset Purchase Agreement (the APA) made and entered into as of April 22, 2004, by and among,(1) Network General Corporation (formerly Named Starburst Technology Holdings, Inc.), on the one hand; and (ii) McAfee, Inc. (formerly named Networks Associates, Inc.), Network Associates Technology, Inc., Network Associates International BV, Network Associates (India) Private Limited, McAfee Japan Co., Ltd. (formerly named Network Associates Japan Co., Ltd.), on the other hand, as amended by Amendment No. 1 thereto dated as of July 15, 2004(2)
3.1	Second Restated Certificate of Incorporation of the Registrant, as amended on December 1, 1997.(3)
3.2	Amended and Restated Bylaws of the Registrant.(4)
3.3	Certificate of Designation of Series A Preferred Stock of the Registrant.(5)
3.4	Certificate of Designation of Series B Participating Preferred Stock of the Registrant.(6)
4.3	Indenture dated as of August 17, 2001 between the Registrant and State Street Bank and Trust Company of California.(7)
10.1	Lease Assignment dated November 17, 1997 for facility at 3965 Freedom Circle, Santa Clara, California by and between Informix Corporation and McAfee Associates, Inc.(8)
10.2	Consent to Assignment Agreement dated December 19, 1997 by and among Birk S. McCandless, LLC, Guaranty Federal Bank, F.S.B., Informix Corporation and the Registrant.(8)
10.3	Subordination, Nondisturbance and Attornment Agreement dated December 18, 1997, between Guaranty Federal Bank, F.S.B., the Registrant and Birk S. McCandless, LLC.(8)
10.4	Lease dated November 22, 1996 by and between Birk S. McCandless, LLC and Informix Corporation for facility at 3965 Freedom Circle, Santa Clara, California.(8)
10.5*	2002 Employee Stock Purchase Plan.(9)
10.6*	1997 Stock Incentive Plan, as Amended.(9)
10.7*	Amended and Restated 1993 Stock Option Plan for Outside Directors.(4)
10.8*	2000 Nonstatutory Stock Option Plan.(10)
10.9*	Amended and Restated Employment Agreement between George Samenuk and the Registrant, dated October 9, 2001.(11)
10.10*	Employment agreement between Stephen C. Richards and the Registrant, dated April 3, 2001.(12)
10.11	1st Amendment to Lease dated March 20, 1998 between Birk S. McCandless, LLC and the Registrant.(13)
10.12	Confirmation, Amendment and Notice of Security Agreement dated March 20, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
10.13	Second Amendment to Lease dated September 1, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(13)
10.14	Subordination, Nondisturbance and Attornment Agreement dated June 21, 2000, among Column Financial, Inc., Informix Corporation, Birk S. McCandless, LLC, and the Registrant.(13)
10.15	Lease Agreement dated November 14, 1996 between Blue Lake Partners and McAfee Associates, Inc.(13)
10.16	Lease Amendment dated November 24, 1997 between Blue Lake Partners and McAfee Software, Inc.(13)
10.17	Lease Amendment dated March 17, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.18	Lease Amendment dated March 27, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)

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Exhibit Number	Description
10.19	Lease Amendment dated June 4, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.20	Lease Amendment dated July 21, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.21	Lease Amendment dated November 20, 1998 between Blue Lake Partners and McAfee Software, Inc.(13)
10.22	Lease Amendment dated March 18, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.23	Lease Amendment dated June 3, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.24	Lease Amendment dated October 7, 1999 between Blue Lake Partners and McAfee Software, Inc.(13)
10.25	Lease Amendment dated March 25, 2000 between Daltex Centre LP and the Registrant.(13)
10.26	Lease Amendment dated July 31, 2000 between Daltex Centre LP and the Registrant.(13)
10.27	Lease Amendment dated January 24, 2001 between Daltex Centre LP and the Registrant.(13)
10.28	Lease Amendment dated May 31, 2001 between Daltex Centre LP and the Registrant.(13)
10.29	Employment Agreement between Kent H. Roberts and the Registrant, dated October 9, 2001.(14)
10.30	Employment Agreement between Vernon Gene Hodges and the Registrant, dated December 3, 2001.(14)
10.31	Employment Agreement between Raymond J. Smets and the Registrant, dated October 7, 2002.(14)
10.32	Employment Agreement between Kevin M. Weiss and the Registrant Dated October 15, 2002.(17)
10.33	Form of Indemnification Agreement between the Registrant and its Executive Officers.(14)
10.34	Summary of Pay for Performance Plan.(4)
10.35	Network Associates, Inc. Tax Deferred Savings Plan.(16)
10.36	Umbrella Credit Facility of Registrant dated April 15, 2004.(18)
10.37	Fifth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(18)
10.38	Amendment to Employment Agreement of George Samenuk effective as of January 20, 2004.(18)
10.39	Amendment to Employment Agreement of Stephen C. Richards effective as of January 20, 2004.(18)
10.40	Sniffer Bonus Plan.(18)
10.41	Form of Sniffer Bonus Plan Participation Agreement (Ray Smets).(18)
10.42	Addendum to Raymond J. Smets Employment Agreement.
10.43	Sixth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.
31.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference from the Registrant s Registration Statement on Form S-4 filed with the Commission on October 31, 1997.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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