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

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/ A

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

For the quarterly period ended March 31, 2002 or

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

For the transition period from to

Commission file number: 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0316593**
(State 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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $0.01 Par Value

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

146,844,567 shares of the registrant s common stock, $0.01 par value, were outstanding as of March 31, 2002.

EXPLANATORY NOTE:

THIS 10-Q/ A IS BEING FILED FOR THE PURPOSE OF AMENDING AND RESTATING ITEMS 1, 2 AND 3 OF PART I OF FORM 10-Q TO REFLECT THE RESTATEMENT OF OUR CONDENSED CONSOLIDATED BALANCE SHEETS AS OF MARCH 31, 2002 AND DECEMBER 31, 2001. WE HAVE MADE NO FURTHER CHANGES TO THE PREVIOUSLY FILED 10-Q. ALL INFORMATION IN THE FORM 10-Q/ A IS AS OF MARCH 31, 2002 AND DOES NOT REFLECT ANY SUBSEQUENT INFORMATION OR EVENTS OTHER THAN THE RESTATEMENT.

THIS DOCUMENT CONTAINS 48 PAGES.

THE EXHIBIT INDEX IS ON PAGE 45.

NETWORKS ASSOCIATES, INC.

FORM 10-Q/ A, March 31, 2002

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2002	December 31, 2001
	(As Restated See Note 2)	(As Restated See Note 2)
	(In thousands, except share and per share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 688,580	$ 612,832
Short-term marketable securities	176,584	135,761
Accounts receivable, net	84,433	136,366
Prepaid expenses, income taxes and other current assets	49,320	54,959
Deferred taxes	118,958	142,869
Total current assets	1,117,875	1,082,787
Long-term marketable securities	213,038	194,357
Fixed assets, net	61,458	64,040
Land	4,414	4,414
Deferred taxes	101,584	84,399
Intangible assets, excluding goodwill, net	25,261	28,124
Goodwill, net	156,892	156,930
Other assets	19,271	18,853
Total assets	$ 1,699,793	$ 1,633,904
LIABILITIES		
Current liabilities:		
Accounts payable	$ 22,590	$ 26,368
Accrued liabilities	274,926	293,583
Deferred revenue	223,418	250,048
Current portion of convertible debt	236,611	
Total current liabilities	757,545	569,999
Deferred taxes	18,050	20,445
Deferred revenue, less current portion	36,292	24,312
Convertible debt, less current portion	345,000	578,850
Other long term debt and liabilities	524	393
Total liabilities	1,157,411	1,193,999
Contingencies (Notes 9)		
Minority interest	20,597	17,311
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none at March 31, 2002 and December 31, 2001.		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; Issued and Outstanding: 146,844,567 shares at March 31, 2002 and 140,699,222 shares at December 31, 2001.	1,468	1,406
Additional paid-in capital	829,391	742,315
Accumulated other comprehensive loss	(34,044)	(30,345)

Accumulated deficit	(275,030)	(290,782)
Total stockholders equity	521,785	422,594
Total liabilities, minority interest and stockholders equity	$1,699,793	$1,633,904

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

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three Months Ended March 31,	
	2002	**2001**
	(in thousands, except per share data) (Unaudited)	
Net revenue:		
Product	$139,250	$ 92,501
Services and support	81,462	63,391
Total net revenue	220,712	155,892
Cost of net revenue:		
Product	25,289	23,460
Services and support	15,347	13,523
Total cost of net revenue	40,636	36,983
Operating costs and expenses:		
Research and development(1)	34,605	39,973
Marketing and sales(2)	102,474	100,817
General and administrative(3)	25,416	31,408
Provision for doubtful accounts, net	730	(9,269)
Amortization of intangibles	2,852	15,845
Restructuring charge	1,116	
Total operating cost and expenses	167,193	178,774
Income (loss) from operations	12,883	(59,865)
Interest and other income	6,662	11,042
Interest expense	(7,690)	(4,680)
Gain on sale of assets and technology	6,717	
Write-down of strategic and other investments		(5,000)
Income (loss) before provision for income tax and minority interest	18,572	(58,503)
Provision for (benefit from) income taxes	1,403	(10,440)
Net income (loss) before minority interest	17,169	(48,063)
Minority interest in net loss (income) of consolidated subsidiaries	(1,417)	702
Net income (loss)	$ 15,752	$ (47,361)
Other comprehensive income (loss):		
Unrealized loss on investments, net	$ (2,527)	$ (8,013)
Foreign currency translation loss	(1,172)	(316)
Comprehensive income (loss)	$ 12,053	$ (55,690)

Net income (loss) per share basic	$ 0.11	$ (0.35)
Shares used in per share calculation basic	144,436	137,140
Net income (loss) per share diluted	$ 0.10	$ (0.35)
Shares used in per share calculation diluted	154,782	137,140

(1) Includes stock-based compensation charge of $118 and $91 for the three months ended March 31, 2002 and 2001, respectively.

(2) Includes stock-based compensation charge of $175 and $144 for the three months ended March 31, 2002 and 2001, respectively.

(3) Includes stock-based compensation charge of $421 and $1,421 for the three months ended March 31, 2002 and 2001, respectively.

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

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
	(Unaudited) (in thousands)	
Cash flows from operating activities:		
Net income (loss)	$ 15,752	$ (47,361)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	12,700	23,962
Provision for (benefit from) doubtful accounts	730	(9,269)
Non cash interest expense on convertible notes	3,288	4,687
Gain on sale of assets and technology	(6,717)	
Realized gain (loss) on investments		(3,876)
Impairment of strategic investments		5,000
Minority interest	1,417	(702)
Deferred taxes	4,250	(17,249)
Stock compensation charges	714	1,656
Change in fair value of derivative	164	
Changes in assets and liabilities:		
Accounts receivable	48,467	54,018
Prepaid expenses, taxes and other	4,459	974
Accounts payable and accrued liabilities	(22,698)	(21,307)
Deferred revenue	(8,474)	16,411
Net cash provided by operating activities	54,052	6,944
Cash flows from investing activities:		
Purchase of marketable securities	(175,086)	(107,164)
Proceeds from sale of marketable securities	116,411	183,277
Purchase of fixed assets	(7,391)	(8,752)
Net cash provided by (used in) investing activities	(66,066)	67,361
Cash flows from financing activities:		
Proceeds from issuance of stocks from option plan and stock purchase plans	88,293	4,682
Repurchase of common stock		(53,800)
Other		(548)
Net cash provided by (used in) financing activities	88,293	(49,666)
Effect of exchange rate fluctuations	(531)	(1,824)
Net increase in cash and cash equivalents	75,748	22,815
Cash and cash equivalents at beginning of period	612,832	275,539
Cash and cash equivalents at end of period	$ 688,580	$ 298,354

Non cash investing activities:		
Unrealized loss on marketable investments	$ (2,527)	$ (8,013)

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

1. Basis of Presentation

These condensed consolidated financial statements have been prepared by Networks Associates, Inc. (the Company) without audit in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X. The unaudited, condensed consolidated financial statements include the accounts of the Company and its majority owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

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

Certain reclassifications have been made to the 2001 unaudited condensed financial statements and related notes to conform to the 2002 presentation.

2. Restatement and Adoption of New Accounting Pronouncements:

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

The Audit Committee s investigation determined that inaccurate accounting entries were made in 2000, 1999 and 1998, which required restatement. In 2000, these entries (a) recorded payments to a distributor in a balance sheet tax liability account instead of reducing Net revenue, (b) reclassified amounts from a tax liability account to the general and administrative and marketing and sales liability accounts, understanding general and administrative and marketing and sales expenses, (c) recorded additions to sales return reserves as tax expense rather than as a reduction of Net revenue, (d) increased a tax liability account by reducing Net revenue and (e) adjusted the foreign currency accounts resulting in an overstatement of Net revenue and an understatement of Interest and other income. Additional entries had the effect of overstating Net revenue, overstating Operating costs and expenses, and understating Interest and other income. In the aggregate for 2000, the adjustments for these entries and related tax effects increased previously reported net loss by $21.2 million from $102.7 million to $123.9 million, and increased previously reported basic and diluted net loss by $0.16 per share.

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

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

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

The following are reconciliations of the Company s financial position from balance sheets previously filed to these restated balance sheets (in thousands, except per share data):

Balance Sheet as of March 31, 2002

	As Previously Reported	Cumulative Effect of Prior Year Changes	As Restated
Cash and cash equivalents	$ 688,580	$	$ 688,580
Short-term marketable securities	176,584		176,584
Accounts receivable, net	84,433		84,433
Prepaid expenses, income taxes and other current assets	49,320		49,320
Deferred taxes	118,958		118,958
Total current assets	1,117,875		1,117,875
Long-term marketable securities	213,038		213,038
Fixed assets, net	61,458		61,458
Land	4,414		4,414
Deferred taxes	94,812	6,772	101,584
Intangible assets, excluding goodwill, net	25,261		25,261
Goodwill, net	156,892		156,892
Other assets	19,271		19,271
Total assets	$1,693,021	$ 6,772	$1,699,793
Accounts payable	$ 22,590	$	$ 22,590
Accrued liabilities	245,961	28,965	274,926
Deferred revenue	223,418		223,418
Current portion of convertible debt	236,611		236,611
Total current liabilities	728,580	28,965	757,545
Deferred taxes	18,050		18,050
Deferred revenue, less current portion	36,292		36,292
Convertible debt, less current portion	345,000		345,000
Other long term debt and liabilities	524		524
Total liabilities	1,128,446	28,965	1,157,411
Minority interest	20,597		20,597
Common stock	1,468		1,468
Additional paid-in capital	829,391		829,391
Accumulated other comprehensive loss	(34,044)		(34,044)
Accumulated deficit	(252,837)	(22,193)	(275,030)
Total stockholders equity	543,978	(22,193)	521,785

Total liabilities, minority interest and stockholders equity	$1,693,021	$ 6,772	$1,699,793

Balance Sheet as of December 31, 2001

	As Previously Reported	Cumulative Effect of Prior Year Changes	As Restated
Cash and cash equivalents	$ 612,832	$	$ 612,832
Short-term marketable securities	135,761		135,761
Accounts receivable, net	136,366		136,366
Prepaid expenses, income taxes and other current assets	54,959		54,959
Deferred taxes	142,869		142,869
Total current assets	1,082,787		1,082,787
Long-term marketable securities	194,357		194,357
Fixed assets, net	64,040		64,040
Land	4,414		4,414
Deferred taxes	77,627	6,772	84,399
Intangible assets, excluding goodwill, net	28,124		28,124
Goodwill, net	156,930		156,930
Other assets	18,853		18,853
Total assets	$ 1,627,132	$ 6,772	$ 1,633,904
Accounts payable	$ 26,368	$	$ 26,368
Accrued liabilities	264,618	28,965	293,583
Deferred revenue	250,048		250,048
Total current liabilities	541,034	28,965	569,999
Deferred taxes	20,445		20,445
Deferred revenue, less current portion	24,312		24,312
Convertible debt	578,850		578,850
Other long term debt and liabilities	393		393
Total liabilities	1,165,034	28,965	1,193,999
Minority interest	17,311		17,311
Common stock	1,406		1,406
Additional paid-in capital	742,315		742,315
Accumulated other comprehensive loss	(30,345)		(30,345)
Accumulated deficit	(268,589)	(22,193)	(290,782)
Total stockholders equity	444,787	(22,193)	422,594
Total liabilities, minority interest and stockholders equity	$ 1,627,132	$ 6,772	$ 1,633,904

3. Business Segment Information

The Company has concluded that it has two businesses consisting of the Infrastructure business (Infrastructure) and McAfee.com. The Infrastructure business markets and sells computer security, management and availability software and hardware for corporate and government users. McAfee.com markets and sells PC security and management software on the Internet to consumers and small to medium-sized businesses. Management measures profitability based on these two businesses; however, within the Infrastructure business the Company s operating segments are defined by six geographic regions. The segments are evidence of the operating structure of the Company s internal organization. The Company operates in one industry: computer security, management and availability software, hardware and related services for, primarily, corporate and government users.

The Infrastructure business markets and sells, through its geographic segments, anti-virus and security software, hardware and services; network management software, hardware and services; and help desk software and services. These products and services are marketed and sold through a direct sales force to corporate and government users, as well as through resellers, distributors, systems integrators and retailers, worldwide. In addition, the Infrastructure business includes managed security and availability applications to corporations and governments on the Internet.

McAfee.com is an application service provider targeted at consumers and small to medium-sized businesses. The McAfee.com web site provides a suite of online products and services personalized for the user based on the user s PC configuration, attached peripherals and resident software.

Following is the summary of the Company s revenue and income (loss) from operations by business and by geographic segment. To reconcile to the consolidated financial statements, where applicable, Corporate represents costs and expenses associated with corporate activities. Corporate activities include general and administrative expenses; corporate marketing expenses of $10.6 million and $16.1 million for the three months ended March 31, 2002 and 2001, respectively; amortization of intangibles; stock-based compensation charges; and restructuring costs. These corporate expenses are not considered attributable to any specific geographic segment. Summarized financial information concerning the Company s net revenue and income (loss) from operations by business and by geographic segment is as follows (in thousands):

	Three Months Ended March 31,	
	2002	**2001**
Net revenue by segment:		
United States	$101,961	$ 89,185
Europe	67,461	33,505
Japan	11,712	5,135
Canada	10,871	6,182
Asia-Pacific (excluding Japan)	6,575	4,571
Latin America	3,368	4,498
Infrastructure net revenue	201,948	143,076
McAfee.com net revenue	18,764	12,816
Net revenue	$220,712	$155,892
Income (loss) from operations by segment:		
United States	$ 10,438	$ (3,828)
Europe	27,574	328
Japan	3,273	(3,915)
Canada	5,450	810
Asia-Pacific (excluding Japan)	(162)	(568)
Latin America	(140)	1,090
Corporate	(38,778)	(51,064)
Infrastructure operating income (loss)	7,655	(57,147)
McAfee.com operating income (loss)	5,228	(2,718)
Income (loss) from operations	$ 12,883	$ (59,865)

Revenue information on a product and service basis is as follows for the three months ended March 31 (in thousands):

	2002	2001
Software licenses	$111,137	$ 48,199
Maintenance	56,918	42,113
Hardware	17,019	34,088
Retail	8,787	8,200
Consulting	9,073	8,356
Training	3,707	4,572
Hosting arrangements	11,764	8,350
Other	2,307	2,014
Total	$220,712	$155,892

4. Sale of Net Assets and Technology

On October 9, 2001, the Board of Directors of the Company approved a plan to integrate the activities of the Company s PGP product group into its McAfee Security and Sniffer Technologies product groups. In addition to the integration plan, the Company began to look for a buyer for the PGP desktop encryption and Gauntlet firewall product. On February 13, 2002, the Company announced the sale of Gauntlet firewall/ VPN product to Secure Computing. As a result of the transaction, the Company received common shares of Secure Computing in exchange for the Gauntlet assets. The Company recorded a gain on sale of net assets of $6.7 million.

In March 2002, the Company purchased a one-year collar consisting of 300,354 purchased puts options with a strike price of $17.31 and the same number of written calls options with a strike price of $22.04. The underlying of both the put and call options are the Secure computing shares. The Company designated the purchased collar as a fair value hedge of the Secure Computing available-for-sale securities in accordance with Statement of Financial Accounting Standards No. 133 Accounting for Derivative Instruments and Hedging Activities. At the inception of the hedge, the Company assessed that the collar is highly effective based upon expected changes in the collar s intrinsic value. On an ongoing basis, changes in the fair value of Secure Computing shares within the collar s range of $17.31 and $22.04 are recorded as part of accumulated other comprehensive income within stockholders equity. Changes in the fair value of Secure Computing s shares outside of the collar range of $17.31 and $22.04 are recorded immediately in earnings. Changes in the fair value of the collar are measured using an option pricing model and are recorded immediately in earnings. As of March 31, 2002, the fair value of Secure Computing s shares were within the collar range. During the first quarter of 2002, the Company recognized a loss of $164,000 in the earnings relating to the fair value of the collar.

5. Restructuring

As part of the plan to integrate certain activities of the Company s PGP product group onto its McAfee Security and Sniffer Technologies product group and to dispose of other product lines, the Company sold its Gauntlet business and discontinued other product lines during the first quarter of 2002. In connection with this process, a restructuring charge of approximately $1.1 million was recorded during the first quarter of 2002. The restructuring charge consists of costs of severance packages for 44 employees as well as related legal and outplacement services.

The following table sets forth the Company s restructuring accrual established in February 2002 and the activity against the accrual during the three months ended March 31, 2002 (in thousands):

	Other Costs	Severance and Benefits	Total
Balance, February 2002	$190	$ 926	$1,116
Paid out	(90)	(470)	(560)
Balance, March 31, 2002	$100	$ 456	$ 556

The remaining balance is expected to be paid out during the second quarter of 2002.

6. Recent Accounting Pronouncements

In May 2000, the Emerging Issues Task Force (EITF) issued EITF Issue No. 00-14, Accounting for Certain Sales Incentives. EITF Issue No. 00-14 addresses the recognition, measurement, and income statement classification for sales incentives that a vendor voluntarily offers to customers (without charge), which the customer can use in, or exercise as a result of, a single exchange transaction. Sales incentives that fall within the scope of EITF Issue No. 00-14 include offers that a customer can use to receive a reduction in the price of a product or service at the point of sale. The EITF changed the transition date for Issue 00-14, concluding that a company should apply this consensus no later than the company s annual or interim financial statements for the periods beginning after December 15, 2001. In June 2001, the EITF issued EITF Issue No. 00-25, Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor s Products, effective for periods beginning after December 15, 2001. EITF Issue No. 00-25 addresses whether consideration from a vendor to a reseller is (a) an adjustment of the selling prices of the vendor s products and, therefore, should be deducted from revenue when recognized in the vendor s statement of operations or (b) a cost incurred by the vendor for assets or services received from the reseller and, therefore, should be included as a cost or expense when recognized in the vendor s statement of operations. Upon application of these EITFs, financial statements for prior periods presented for comparative purposes should be reclassified to comply with the income statement display requirements under these Issues. In September of 2001, the EITF issued EITF Issue No. 01-09, Accounting for Consideration Given by Vendor to a Customer or a Reseller of the Vendor s Products , which is a codification of EITF Issues No. 00-14, No. 00-25 and No. 00-22 Accounting for Points and Certain Other Time-or Volume-Based Sales Incentive Offers and Offers for Free Products or Services to be Delivered in the Future. During the three months ended March 31, 2002, the Company adopted EITF 01-09. As a result, the Company reclassed a total amount of $14.7 million from marketing and sales expense to revenue for the first quarter of 2001.

In November 2001, the Financial Accounting Standards Board (FASB) discussed Topic D-103, recharacterized as EITF Issue No. 01-14, Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred. This issue deals with classification in the income statement of incidental expenses, that in practice are commonly referred to as out-of-pocket expenses, incurred by entities that provide services as part of their central ongoing operations. The Task Force reached a consensus that reimbursements received for out-of-pocket expenses incurred should be characterized as revenue in the income statement. This issue is effective for fiscal years beginning after December 15, 2001. During the quarter ended March 31, 2002, the Company adopted EITF 01-14. As a result, the Company reclassed a total amount of $0.3 million from cost of revenue to revenue for the first quarter of 2001.

In October 2001, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS 144). SFAS 144 establishes a single accounting model, based on the framework established in Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (SFAS 121), for long-lived assets to be disposed of by sale, and resolves implementation issues related to SFAS 121. The Company is currently assessing the impact of SFAS 144 on its operating results and financial condition. The Company is required to adopt SFAS 144 no later than the first quarter of fiscal 2003.

In May 2002, the FASB issued SFAS No. 145, Rescission of SFAS Nos. 4, 44, and 64, Amendment of SFAS No. 13, and Technical Corrections (SFAS 145). Among other things, SFAS 145 rescinds various pronouncements regarding early extinguishment of debt and allows extraordinary accounting treatment for early extinguishment only when the provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions are met. SFAS 145 provisions regarding early extinguishment of debt are generally effective for fiscal years beginning after May 15, 2002. The Company is currently assessing the impact of SFAS 145 on its financial statements.

7. Goodwill and Other Intangible Assets

In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 142, Goodwill and Other Intangible Assets, which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. During the three months ended March 31, 2002, the Company has adopted SFAS 142 and has ceased to amortize approximately $156.9 million of goodwill. In lieu of amortization, the Company is required to perform an impairment review of its goodwill balance upon the initial adoption of SFAS No. 142. The impairment review will involve a two-step process as follows:

Step 1 the Company will compare the fair value of its reporting units to the carrying value, including goodwill of each of those units. For each reporting unit where the carrying value, including goodwill, exceeds the unit s fair value, the Company will move on to step 2. If a unit s fair value exceeds the carrying value, no further work is performed and no impairment charge is necessary.

Step 2 the Company will perform an allocation of the fair value of the reporting unit to its identifiable tangible and non-goodwill intangible assets and liabilities. This will derive an implied fair value for the reporting unit s goodwill. The Company will then compare the implied fair value of the reporting unit s goodwill with the carrying amount of the reporting unit s goodwill. If the carrying amount of the reporting unit s goodwill is greater than the implied fair value of its goodwill, an impairment charge must be recognized for the excess.

The Company expects to complete the initial review during the second quarter of 2002. The Company does not expect to record an impairment charge upon completion of the initial review, however, there can be no assurance that at the time the review is completed a material impairment charge will not be recorded.

The following table presents comparative information showing the effects that non-amortization of goodwill would have had on the income statement for the three months ended March 31, 2001 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2002	**2001**
Reported net income (loss)	$15,752	$(47,361)
Goodwill amortization		10,721
Adjusted net income	$15,752	$(36,640)
Basic net income (loss) per share	$ 0.11	$ (0.35)
Goodwill amortization		0.08
Adjusted basic net income per share	$ 0.11	$ (0.27)
Diluted net income (loss) per share	$ 0.10	$ (0.35)
Goodwill amortization		0.08
Adjusted diluted net income per share	$ 0.10	$ (0.27)

Goodwill information is as follows (in thousands):

	January 1, 2002	**Goodwill Acquired**	**Adjustments**	**Effects of Foreign Currency Exchange**	**March 31, 2002**
Goodwill	$156,930	$	$	$(38)	$156,892

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

	March 31, 2002			**December 31, 2001**		
	Gross Carrying Amount	**Accumulated Amortization**	**Net Carrying Amount**	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Other Intangible assets:						
Purchased technologies	$43,522	$(40,435)	$ 3,087	$43,954	$(40,050)	$ 3,904
Trademarks, patents and other intangibles	48,351	(26,177)	22,174	48,351	(24,131)	24,220
	$91,873	$(66,612)	$25,261	$92,305	$(64,181)	$28,124

The aggregate amortization expenses for the intangible assets listed above totaled $3.5 million and $2.9 million for the three months ended March 31, 2001 and 2002, respectively.

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

Fiscal Years:	
2002	$ 7,474
2003	6,862
2004	5,184
2005	3,801
2006	1,735
Thereafter	205
	$25,261

8. Net Income (Loss) Per Share

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

	Three Months Ended March 31,	
	2002	2001
Numerator Basic		
Net income (loss)	$ 15,752	$ (47,361)
Numerator Diluted		
Net income (loss)	$ 15,752	$ (47,361)
Interest on convertible debentures(1)		
Net income (loss), adjusted	$ 15,752	$ (47,361)
Denominator Basic		
Weighted average shares of common stock outstanding	144,675	137,140
Less: weighted average shares of common stock subject to repurchase	(239)	
Basic weighted average common shares outstanding	144,436	137,140
Denominator Diluted		
Basic weighted average common shares outstanding	144,436	137,140
Effective of dilutive securities:		
Common stock options and subject to repurchase(2)	10,148	
Warrants(3)	198	
Diluted weighted average shares	154,782	137,140
Basic net income (loss) per share:		
Net income (loss) per share Basic	$ 0.11	$ (0.35)
Diluted net income (loss) per share:		
Net income (loss) per share Diluted	$ 0.10	$ (0.35)

(1) 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 23.3 million and 7.6 million for the three months ended March 31, 2002 and 2001, respectively.

(2) At March 31, 2002 and 2001, 2.3 million and 31.1 million options to purchase common stock, respectively, were excluded from the calculation since the effect was anti-dilutive.

(3) At March 31, 2001, warrants to purchase 0.2 million shares of the Company s common stock were excluded from the determination of diluted net loss per share as the effect of such warrants was anti-dilutive.

9. Litigation

General

From time to time, the Company has been subject to litigation including the pending litigation described below. The Company s current estimated range of liability related to some of the pending litigation below is based on claims for which management can estimate the amount and range of loss. The Company has recorded the minimum estimated liability related to those claims, where there is a range of loss. Because of the uncertainties related to both the 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 be costly, could cause the diversion of management s attention and could upon resolution, have a material adverse effect on the business, results of operations, financial condition and cash flow.

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

Securities Cases

Between December 29, 2000 and February 7, 2001, the Company and certain of its current and former officers and directors were named in securities class action lawsuits filed in the United States District Court for the Northern District of California. On September 24, 2001, a consolidated class action complaint was filed which asserts claims against the Company, William Larson, Prabhat Goyal and Peter Watkins on behalf of a putative class of persons who purchased the Company s stock between July 19 and December 26, 2000. The complaint asserts causes of action (and seeks unspecified damages) for alleged violations of Exchange Act Section 10(b)/ SEC Rule 10b-5 and Exchange Act Section 20(a). In particular, the complaint alleges that defendants engaged in improper practices designed to increase the Company s revenues and earnings and that, as a result of those practices, the Company s class period financial statements were false and misleading and failed to comply with Generally Accepted Accounting Principles (GAAP). Defendants filed a motion to dismiss plaintiff s consolidated complaint on October 29, 2001. Plaintiff filed an opposition to the motion to dismiss on December 21, 2001 and defendants filed a reply to plaintiff s opposition on February 1, 2002. The hearing on the motion to dismiss was held on April 16, 2002. On April 26, 2002, the parties stipulated to the withdrawal of Defendants motion to dismiss. On April 29, 2002, the Court entered an order that defendants motion to dismiss is withdrawn and further ordered the parties to submit a stipulation and proposed order setting forth a schedule for the filing of a first amended consolidated complaint and the briefing of defendants motion to dismiss thereto.

On February 5, 2001, the Company was nominally sued in a derivative lawsuit filed in the Superior Court in Santa Clara County. The lawsuit, encaptioned *Mean Ann Krim v. William L. Larson, et al.*, Case No. CV795734, asserts claims against William Larson, Peter Watkins, Prabhat Goyal, Leslie Denend, Virginia Gemmell, Edwin Harper, Enzo Torresi, and others for breach of fiduciary duty, unjust enrichment and professional negligence against the accountants. In particular, the complaints allege that the defendants engaged in a course of conduct by which they improperly accounted for revenue from software license sales, and that, as a result of their actions, certain of the Company s financial statements were false and misleading and not in compliance with GAAP. The complaint seeks an unspecified amount of damages. Nominal defendant the Company filed a demurrer to the complaint on May 21, 2001. A hearing on the demurrer was held on June 29, 2001. On July 24, 2001, the Court sustained the demurrer with leave to amend. By order dated August 21, 2001, the Court granted plaintiff limited discovery for purposes of amending the complaint to meet the demand futility test imposed by Delaware law. Plaintiff filed an amended complaint on December 26, 2002. Nominal defendant Network Associates, Inc. filed a demurrer, which was joined by the individual defendants, to the amended complaint on January 30, 2002. A hearing on the demurrer was held on March 8, 2002. The Court entered an order on March 28, 2002 sustaining the demurrer without leave to amend and dismissing the amended complaint with prejudice.

In March 2002, several putative securities class action lawsuits were filed in the Court of Chancery in the State of Delaware, County of New Castle, and the Superior Court of the State of California, County of Santa Clara, arising out of the Company s proposed acquisition of McAfee.com Corporation (McAfee.com). The lawsuits name as defendants the Company and certain of McAfee.com s officers and directors, and with respect to the Delaware Court of Chancery actions, McAfee.com. The lawsuits filed in the Delaware Court of Chancery are *Bank v. McAfee.com Corp., et al.*, Civil Action No. 19481; *Birnbaum v. Sampath, et al.*, Civil Action No. 19482 NC; *Brown v. Sampath, et al.*, Civil Action No. 19483 NC; *Chin v. McAfee.com Corp., et al.,* Civil Action No. 19484 NC; *Monastero v. Sampath, et al.*, Civil Action No. 19485; and *Ebner v. Sampath,* *et al.*, Civil Action No. 19487. The lawsuit filed in Santa Clara County is encaptioned *Peyton v. Richards, et al.*, No. CV 806199. Another class action lawsuit was filed on April 9, 2002 in the United States District Court for the Northern District of California, encaptioned *Getty v. Sampath, et. al.*, Case No. C 02 1692. Collectively, the lawsuits allege that the defendants breached their fiduciary duties to the shareholders of McAfee.com in conjunction with the proposed acquisition by, among other things, failing to maximize the value of the shares of McAfee.com s common stock and failing to take adequate procedural measures to protect McAfee.com s shareholders. Each complaint seeks certification of a plaintiff class, declaratory and injunctive relief preventing the proposed acquisition, unspecified compensatory damages, and attorneys fees and costs. On April 2, 2002, defendants removed the California state action encaptioned *Peyton v. Richards, et al.*, No. CV 806199 to the United States District Court for the Northern District of California. On April 4, 2002, plaintiff moved for an order shortening time on his motion to remand the case to state court and for expedited discovery. On April 8, 2002, defendants filed a motion to dismiss the California case under the Securities Litigation Uniform Standards Act of 1998. The hearing date on this motion is not yet scheduled.

Other Matters

Crawford v. Digital River, Inc. et al., Case No. 1:01CV01770 RWR; United States District Court, District of Columbia. On August 21, 2001, Christopher Crawford filed a complaint for patent infringement of US Patent 6,014,651. The complaint alleges that seven different defendants, including the Company, infringed US Patent 6,014,651. The complaint alleges that the Company infringes the patent through several web sites, including the websites at www.nai.com and www.mcafee.com. A Stipulated Order of Dismissal was filed by plaintiff and the Company on May 6, 2002, effectively ending the Company s involvement in this litigation.

Foremost Systems v. Network Associates, No. CV 777301 (Santa Clara County). A former agent of the Company in India, Foremost Systems Pvt. Ltd., filed this action on October 14, 1998, in California State court and filed a Second Amended Complaint on February 18, 2000. The Company removed the action to the United States District Court, Northern District of California, San Jose Division. The Second Amended Complaint alleges that the Company wrongly terminated Foremost Systems in breach of their agency agreement and, in addition, contains counts for breach of oral contract, promissory estoppel, intentional and negligent misrepresentation, breach of fiduciary duty, tortious interference with contractual relations, unfair competition, and racketeering in violation of 18 U.S.C. 1962 et seq. The parties held a preliminary mediation session in this matter on April 5, 2000 and attended a full session on March 12, 2001. Discovery is ongoing.

Homenexus Inc. f/k/a HomeRun Network, Inc. v. DirectWeb, Inc., et al, No. 99-CV-2316 (CRW) (E.D. Pa.). In this action, filed in federal court in the Eastern District of Pennsylvania on May 5, 1999, plaintiff Homenexus alleges that DirectWeb successfully conspired with all defendants, including the Company and William Larson, to wrongly misappropriate plaintiff s purported proprietary business plan and to deliberately infringe plaintiff s purported trade dress in its alleged web-site. The complaint further alleges that all defendants conspired to commit, and did commit, the torts of conversion and unfair competition. Without admitting any liability, the Company and William Larson entered into a Settlement Agreement with plaintiff settling the action and, on March 12, 2002, the Court dismissed the Company and William Larson from the action with prejudice.

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.

10. Stock-Based Compensation

The Company has recorded stock-based compensation charges of $0.7 million and $1.7 million in the three months ended March 31, 2002 and 2001, respectively. These charges are made up of the following (in thousands):

	Three Months Ended March 31,	
	2002	2001
Repriced options	$(1,144)	$ 314
Options issued below fair market value	1,218	
New and existing executives	580	209
Shares purchased outside Employee Stock Purchase Plan	60	
Warrants to outside consultants		530
Former executives		603
Total stock-based compensation	$ 714	$1,656

Repriced Options. During the three months ended March 31, 2002, the Company incurred negative charges of approximately $1.9 million related to options subject to variable plan accounting. During the three months ended March 31, 2001, the Company did not incur a charge related to options subject to variable plan accounting. For the three months ended March 31, 2002 and 2001, the Company s stock compensation charges related to options subject to variable plan accounting were based on quarter end per share prices of the Company s stock of $24.20 and $8.25, respectively, and per share prices of McAfee.com stock of $16.47 and $5.95, respectively. As of March 31, 2002 the Company and McAfee.com had options to purchase approximately 1.3 million shares and 0.2 million shares, respectively, which were outstanding and subject to variable plan accounting.

The Company also incurred a stock-based compensation charge in connection with the initial issuance of the repriced options. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately $0.8 million and $0.3 million was expensed during the three months ended March 31, 2002 and 2001, respectively.

Options Issued Below Fair Market Value. During the three months ending March 31, 2002, the Company recorded a one-time stock compensation charge of $1.2 million for stock options granted below fair market value. This charge relates to options granted in prior periods, which were identified in the first quarter of 2002 as having been granted below market value. The amount was determined to be immaterial for the periods when the grants were made and for the current period. The related charge is being recorded in the first quarter of 2002.

New and Existing Executives. On January 3, 2001, the Company entered into an employment agreement with George Samenuk to become the Company s president and chief executive officer. In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. During the three months ended March 31, 2002 and 2001, the Company recorded approximately $396,000 and $209,000, respectively, related to stock compensation associated with Mr. Samenuk s restricted stock.

On January 15, 2002, the Company s board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk, the Company s 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 fair 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 March 31, 2002, the Company recorded approximately $184,000 related to stock compensation associated with Mr. Samenuk s restricted stock.

Shares Purchased Outside Employee Stock Purchase Plan. On January 31, 2002, the Company experienced a shortfall in the number of shares available under the 1994 Employee Qualified Stock Purchase Plan to meet the requirements of the open purchase period. Although the Company reduced the number of shares available for purchase by plan participants by a pro rata amount, additional shares were required to be purchased outside of the plan. As a result, the Company recorded a one-time stock compensation charge of approximately $60,000 in the three months ending March 31, 2002. The charge was based on the difference between the fair value of the shares purchased outside of the plan and the exercise price.

Warrants to Outside Consultants. In January 2001, upon completion of the search for the Company s current chief executive officer, the Company issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 166,667 shares of the Company s common stock. The weighted-average exercise price of the underlying shares is $2.97 per share. The warrants are immediately exercisable and expire in January 2004. The combined fair value of the warrants was determined to be approximately $530,000 and was estimated using the Black-Scholes model with the following assumptions: risk free interest rate of 4.82%; contractual life of 3 years; dividend yield of 0%; and expected volatility of 91%. The fair market value of the warrants was included as stock compensation during the three months ended March 31, 2001 and included in general and administrative expenses in the accompanying statement of operations.

Former Executives. In January 2001, the Company s board of directors appointed the Company s current chief executive officer. Effective January 2001, the Company s former chief executive officer, former chief financial officer, and former president and chief operating officer, became special advisors. Options held by these individuals continued to vest during 2001 while they each served their one-year terms as special advisors. As a result, the Company recorded a one-time stock compensation charge of approximately $603,000 during the three months ended March 31, 2001.

11. Subsequent Events

On April 25, 2002, the Company announced its discovery of accounting inaccuracies in its prior financial statements, requiring the restatement of certain financials. The Company conducted an internal investigation under the direction of the Audit Committee of its Board of Directors to determine the scope and magnitude of these inaccuracies. On May 17, 2002, the Company announced that the Audit Committee of its Board of Directors had completed its internal accounting investigation. As a result of the internal accounting investigation, the Company s statement of operations, cash flows and stockholders equity for the years ended December 31, 2000, 1999 and 1998 and the balance sheets as of December 31, 2000, 1999 and 1998 are being restated. In addition, to give effect to accumulated prior period adjustments and their related tax impacts, the Company announced the restatement of its December 31, 2001 and March 31, 2002 balance sheets. (See Note 2 of the Notes to Condensed Consolidated Financial Statements.)

On March 18, 2002, the Company announced its plans to commence an exchange offer for all outstanding publicly held shares of McAfee.com Class A common stock. The offer was a tax-free exchange of each outstanding shares of McAfee.com Class A common stock for 0.675 shares of the Company s common stock. On April 25, 2002, the Company withdrew its exchange offer to acquire the Class A common stock of McAfee.com Corporation in light of the restatement discussed above.

On May 1, 2002, the Company redeemed outstanding zero coupon convertible subordinated debentures due 2018 with an aggregate face amount of $40.0 million for approximately $18.8 million.

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

This 10-Q/ A is being filed for the purpose of amending and restating Items 1, 2 and 3 of Part I of Form 10-Q to reflect the restatement of our Condensed Consolidated Balance Sheets as of March 31, 2002 and December 31, 2001. We have made no further changes to the previously filed Form 10-Q. All information in this Form 10-Q/ A is as of March 31, 2002 and does not reflect any subsequent information or events other than the restatement.

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.

Some of the statements contained in this Report on Form 10-Q/ A are forward-looking statements, including but not limited to those specifically identified as such, that involve risks and uncertainties. The statements contained in the Report on Form 10-Q/ A 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/ A are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results to differ materially from those implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, believes, estimates, predicts, continue or the negative of these terms or other comparable terminology. In some instances, we have also indicated forward-looking statements with an asterisk (*). 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. Moreover, neither any other person nor we assume responsibility for the accuracy and completeness of such statements. Important factors that may cause actual results to differ from expectations include, but not limited to, those discussed in Risk Factors and elsewhere in this Report on Form 10-Q/ A.

Overview

We are a leading supplier of network security and network management solutions. We operate through two businesses consisting of our infrastructure business and McAfee.com, our publicly traded subsidiary. Our infrastructure business is operated in six geographic regions: the United States, Europe, Japan, Canada, Asia-Pacific and Latin America. McAfee.com is an application service provider, or ASP, targeted at consumers and small to medium-sized businesses.

The majority of our net revenue has historically been derived from our McAfee Security anti-virus products and our Sniffer Technologies network fault and performance products. In addition to these two flagship products, we have focused our efforts on building a full line of complementary network security and network management solutions. On the network security side, we strengthened our anti-virus lineup by adding complementary products in the firewall, intrusion detection, encryption, and virtual private networking categories. On the network management side, we built upon our Sniffer Technologies line by adding products in the help desk, asset management, network monitoring, and network reporting categories. We continuously seek to expand our product lines.

To more effectively market our infrastructure products in our various geographic regions, we have combined complementary products into separate product groups, as follows:

McAfee Security, which delivers world-class anti-virus and security products and services;

Sniffer Technologies, which is a leader in network availability and system security products; and

Magic Solutions, which is a leading provider of web-based service desk solutions.

In the three months ended March 31, 2002, our infrastructure business accounted for approximately $201.9 million in net revenue and a net operating income of $7.7 million. In the three months ended

March 31, 2002, McAfee.com accounted for approximately $18.8 million in net revenue and a net operating income of approximately $5.2 million.

McAfee Security Product Group

McAfee Security s products and services provide solutions designed to enforce anti-virus policies and measure the performance of anti-virus activities and deliver network security. The McAfee Security product group includes products and services that provide multi-layer anti-virus protection, management and reporting for desktops, servers, GroupWare, Internet technologies, and wireless technologies. The McAfee Security product group also includes distributed firewalls and virtual private network products for corporate users. McAfee Security s services are provided by McAfee Security s Anti-Virus Emergency Response Team (AVERT). AVERT augments McAfee Security s product offerings by identifying new viruses and deploying anti-virus solutions to our customers. McAfee Security customers are primarily corporate customers, including customers in the managed service market (such as ASPs, and managed service providers, or MSPs).

Sniffer Technologies Product Group

Sniffer Technologies products and services provide customers with network and application management solutions designed to maximize network availability and performance and system security. Sniffer Technologies products capture data, monitor network traffic and collect key network statistics. Sniffer Technologies products are also designed to optimize network and application performance and increase network reliability by uncovering and analyzing network problems and system vulnerabilities and recommending solutions to such problems, automatically and in real-time for mid-level and high-speed networks. Sniffer Technologies products also proactively monitor and diagnose network and application-level problems on complex, multi-segment networks from centralized locations as well as troubleshooting high-speed telecommunications and Internet service provider networks. Sniffer Technologies customers are primarily corporate customers, including customers in the managed service market.

Magic Solutions Product Group

Magic Solutions products provide customers with a web-based set of tools to manage their customer support and problem management needs. Magic Solutions product group consists of products that promote information sharing, facilitate workflow, and improve service delivery. Magic Solutions products include the Magic Total Service Desk Suite, a 100% browser-based service desk and problem management solution. In addition, Magic Solutions stand-alone products include Magic HelpDesk, Self Service Desk, Remote Desktop and Event Management. Magic Solutions customers are primarily corporations.

McAfee.com Our Publicly Traded Subsidiary

McAfee.com is a security ASP delivering security applications software and related services through an Internet browser. The McAfee.com applications allow users 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. McAfee.com also offers customers access to McAfee.com Personal Firewall, McAfee.com Wireless Security Center and McAfee.com Internet Privacy Service.

Under the terms of our licensing agreement with McAfee.com, McAfee.com s business has historically been targeted exclusively at consumers. In March 2001, we entered into a reseller agreement with McAfee.com allowing it to expand its product offerings with McAfee.com for Business. McAfee.com for Business is a website serving the security needs for small and medium-sized businesses, delivering managed applications services that allow businesses to provide anti-virus and firewall security for their desktop PCs.

As of March 31, 2002, we owned 36.0 million shares of McAfee.com Class B common stock, entitled to three votes per share and representing approximately 75% of McAfee.com s outstanding common stock and 90% of its total voting power.

Results Of Operations, as restated

You should read the following discussion in conjunction with the restated condensed consolidated financial statements for the three months ended March 31, 2001 and 2000 and the related notes of Networks Associates appearing elsewhere in this Form 10-Q/ A.

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

The Audit Committee s investigation determined that inaccurate accounting entries were made in 2000, 1999 and 1998, which required restatement. In 2000, these entries (a) recorded payments to a distributor in a balance sheet tax liability account instead of reducing Net revenue, (b) reclassified amounts from a tax liability account to the general and administrative and marketing and sales liability accounts, understanding general and administrative and marketing and sales expenses, (c) recorded additions to sales return reserves as tax expense rather than as a reduction of Net revenue, (d) increased a tax liability account by reducing Net revenue and (e) adjusted the foreign currency accounts resulting in an overstatement of Net revenue and an understatement of Interest and other income. Additional entries had the effect of overstating Net revenue, overstating Operating costs and expenses, and understating Interest and other income. In the aggregate for 2000, the adjustments for these entries and related tax effects increased previously reported net loss by $21.2 million from $102.7 million to $123.9 million, and increased previously reported basic and diluted net loss by $0.16 per share.

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

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

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

A summary of the impact of the inaccurate accounting entries on our previously issued condensed consolidated balance sheets for March 31, 2002 and December 31, 2001 is presented in Note 2 to the Notes to Condensed Consolidated Financial Statements.

The following table sets forth, for the periods indicated, the percentage of net revenue represented by certain items in our Statements of Operations.

	Three Months Ended March 31,	
	2002	2001
Net revenue:		
Product	63%	59%
Services and support	37	41
Total revenue	100	100
Cost of net revenue:		
Product	11	15
Services and support	7	9
Total cost of net revenue	18	24
Operating costs and expenses:		
Research and development	16	26
Marketing and sales	46	65
General and administrative	12	20
Provision for doubtful accounts, net		(6)
Amortization of intangibles	1	10
Restructuring charge	1	
Total operating costs and expenses	76	115
Income (loss) from operations	6	(39)
Interest and other income	3	7
Interest expense	(3)	(3)
Gain on sale of assets	3	
Write down of strategic and other investments		(3)
Income (loss) before provision for income taxes and minority interest	9	(38)
Provision for (benefit from) income taxes	1	(7)
Net income (loss) before minority interest	8	(31)
Minority interest in net loss (income) of consolidated subsidiary	(1)	1
Net income (loss)	7%	(30)%

Net Revenue. Net revenue increased 42% to $220.7 million from $155.9 million in the three months ended March 31, 2002 and 2001, respectively, including a $5.9 million increase in revenue from McAfee.com.

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

	Three Months Ended March 31,	
	2002	2001

Product	63%	59%
Services and support	37	41
Net revenue	100%	100%

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

	Three Months Ended March 31,	
	2002	2001
Subscription licenses	34%	29%
Perpetual licenses	46	23
Hardware	12	37
Retail	6	9
Royalties and other	2	2
Product revenue	100%	100%

Product revenue includes revenue from software licenses, hardware, our retail products and royalties. Product revenue increased 50% from $92.5 million to $139.2 million in the three months ended March 31, 2001 and 2002, respectively. The increase in product revenue is attributable to the increase in new customer purchases of our anti-virus suite of products, specifically perpetual and subscription licenses. This explains the increase of perpetual and subscription license as a percentage of the total product revenue. The product revenue for the three months ended March 31, 2001 were adversely effected by our completion of the sell-through business model.

We may experience higher overall revenue in the near-term but lower future software license revenue due to increased levels of perpetual licenses.* Sales of perpetual licenses typically result in significantly higher up-front revenue and lower recurring and future revenues as the sales price for related upgrades and updates tends to be significantly lower than that of the initial perpetual license.

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

	Three Months Ended March 31,	
	2002	2001
Support and maintenance	70%	67%
Consulting	11	13
Training	5	7
Hosting arrangements	14	13
Services and support revenue	100%	100%

Services and support revenues include revenues from software support and maintenance contracts, consulting, training and hosting arrangements. Service revenues increased 29% from $63.4 million to $81.5 million in the three months ended March 31, 2001 and 2002, respectively. The increase in service revenue is attributable to the growth of our installed customer base and the resulting renewal of support and maintenance contracts over the past periods. In addition, we experienced growth in our Managed Service Provider (MSP) and Application Service Provider (ASP) service offerings, including those offered by McAfee.com, for the three months ended March 31, 2002.

Our future profitability and rate of growth, if any, will be directly affected by increased price competition and an increasingly higher revenue base from which to grow. Our growth rate and net revenue depend significantly on renewals of existing orders, as well as our ability to respond successfully to the pace of

* This statement and other statements similarly marked are forward-looking statements reflecting current expectations. There can be no assurance that our actual performance will meet current expectations. See Risk Factors discussion beginning on page 30 of this document.

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.

International revenue accounted for approximately 45% and 35% of net revenue for the three months ended March 31, 2002 and 2001, respectively. The increase in international revenue as a percentage of net revenue was attributable to the focus on sales execution in regions around the world.

We have announced our intentions to increase our international revenues.* 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, risks associated with currency fluctuations and hedging, tariffs and other trade barriers, and difficulties staffing and managing international operations. Poor economic conditions in Asia, particularly Japan and Latin America have hurt our business and may impact our ability to expand international revenue. These factors may have a material adverse effect on our future international revenue.

Cost of Net Revenue. Cost of net revenue increased 10% to $40.6 million from $37.0 million in the three months ended March 31, 2002 and 2001, respectively, including a decrease of $0.1 million from McAfee.com. As a percentage of net revenue, cost of net revenue decreased from 24% to 18% for the three months ended March 31, 2001 and 2002, respectively. The decrease is primarily due to a decrease in the cost of product revenue as a percentage of revenue, explained below.

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. Cost of product revenues increased 8% to $25.3 million from $23.5 million for the three months ended March 31, 2002 and 2001, respectively. The increase in the cost of net product revenue relates to the increase in product revenue to $139.2 million from $92.5 million for the three months ended March 31, 2002 and 2001, respectively. As a percentage of net product revenue, however, cost of product revenue decreased from 25% to 18% in the three months ended March 31, 2001 and 2002, respectively. The decrease in the percentage of net product revenue is due to the change in product mix of hardware and software product revenue. In the three months ended March 31, 2002, we sold more software licenses, which carries a lower cost of revenue.

Due to new hardware-based anti-virus product introductions during the second half of 2001 and anticipated growth in our hardware-based network fault and performance products, we expect that the cost of product revenue will increase both in absolute terms and as a percentage of product revenue in future periods.*

Cost of services and support revenue consists principally of salaries and benefits related to employees providing customer support and consulting services. The cost of services and support revenue increased 13% to $15.3 million from $13.5 million in the three months ended March 31, 2002 and 2001, respectively. The increase in the cost of services and support revenue was due almost exclusively to additional technical support and customer service personnel hired to meet our customers technical support needs. Cost of services and support revenue as a percentage of net services and support revenue was 19% and 21% in the three months ended March 31, 2002 and 2001, respectively.

Due to new service introductions during 2001, including anti-virus hosted services, anticipated growth in hosted services by McAfee.com, increased maintenance and support orders and an increase in consulting and training services, we expect that the cost of service revenue will increase both in absolute terms and as a percentage of net revenue in future periods.*

We have excluded the effects of stock-based compensation in our discussion of operating costs and expenses below. The size and amount of our stock-based charges will vary from period to period based on

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* This statement and other statements similarly marked are forward-looking statements reflecting current expectations. There can be no assurance that our actual performance will meet current expectations. See Risk Factors discussion beginning on page 30 of this document.

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

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

	Three Months Ended March 31,	
	2002	**2001**
Research and development(1)	$ 34,487	$ 39,882
Marketing and sales(2)	102,299	100,673
General and administrative(3)	24,995	29,987
Provision for doubtful accounts	730	(9,269)
Amortization of intangibles	2,852	15,845
Restructuring charge	1,116	
Total operating costs and expenses, excluding the effects of stock-based compensation	$166,479	$177,118

(1) Excludes stock-based compensation charge of $118 and $91 for the three months ended March 31, 2002 and 2001, respectively.

(2) Excludes stock-based compensation charge of $175 and $144 for the three months ended March 31, 2002 and 2001, respectively.

(3) Excludes stock-based compensation charge of $421 and $1,421 for the three months ended March 31, 2002 and 2001, respectively.

Research and Development. Research and development expenses consist primarily of salary, benefits, and contractors fees for our development and technical support staff, and other costs associated with the enhancements of existing products and services and development of new products and services. Excluding the effects of stock-based compensation of approximately $118,000 and $91,000 for the three months ended March 31, 2002 and 2001, respectively, research and development expenses decreased 14% to $34.5 million from $39.9 million for the three months ended March 31, 2002 and 2001, respectively. Of the total decrease, approximately $3.8 million was attributable to cost savings as a result of the conversion of temporary personnel into full-time employees, and the balance was due to overall efficiencies achieved through a more focused product development strategy.

As a percentage of net revenue, research and development expenses were 16% and 26% for the three months ended March 31, 2002 and 2001, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, research and development expenses were 16% and 26% for the three months ended March 31, 2002 and 2001, respectively. We believe that continued investment in product and development is critical to attaining our strategic objectives and, as a result, expect product development expenses to increase in future periods. We anticipate that research and development expenses to increase in absolute dollars, but will continue to fluctuate as a percent of net revenue.*

Marketing and sales. Marketing and sales expenses consist primarily of salary, commissions and benefits for marketing and sales personnel and costs associated with advertising and promotions. Excluding the effects of stock-based compensation of $175,000 and $144,000 for the three months ended March 31, 2002 and 2001, respectively, marketing and sales expenses increased 2% to $102.3 million from $100.7 million for the three months ended March 31, 2002 and 2001, respectively. The increase is due to additional hiring in our sales force.

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As a percentage of net revenue, marketing and sales expenses were 46% and 65% for the three months ended March 31, 2002 and 2001, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, marketing and sales expenses were 46% and 65% for the three months ended March 31, 2002 and 2001, respectively. We anticipate that marketing and sales expenses to increase in absolute dollars, but will continue to fluctuate as a percent of net revenue.*

General and administrative. General and administrative expenses consist primarily 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 $421,000 and $1.4 million for the three months ended March 31, 2002 and 2001, respectively, general and administrative expenses decreased 17% to $25.0 million from $30.0 million for the three months ended March 31, 2002 and 2001, respectively. Of the total decrease, approximately $2.2 million was attributable to the decrease in legal fees and $1.9 million was attributable to cost savings as a result of the conversion of temporary personnel into full-time employees. The decrease was slightly offset by $1.9 million of expenses incurred by McAfee.com related to our exchange offer for all outstanding publicly held shares of McAfee.com Class A common stock.

As a percentage of net revenue, general and administrative expenses were 12% and 20% for the three months ended March 31, 2002 and 2001, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, general and administrative expenses were 11% and 19% for the three months ended March 31, 2002 and 2001, respectively. We anticipate that general and administrative expenses to increase in absolute dollars as we continue to expand our staff and incur additional infrastructure and other costs to support the anticipated growth of our business.*