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

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/ A

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

For the quarterly period ended September 30, 2001
or

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

For the transition period from to

Commission file number 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

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

3965 Freedom Circle

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

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

138,455,083 shares of the registrant s common stock, $0.01 par value, were outstanding as of September 30, 2001.

EXPLANATORY NOTE:

THIS 10-Q/ A IS BEING FILED FOR THE PURPOSE OF AMENDING AND RESTATING ITEMS 1, 2 AND 3 OF PART I OF FORM 10-Q TO REFLECT THE RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE PERIODS ENDED SEPTEMBER 30, 2000 AND 2001. WE HAVE MADE NO FURTHER CHANGES TO THE PREVIOUSLY FILED FORM 10-Q. ALL INFORMATION IN THE FORM 10-Q/ A IS AS OF SEPTEMBER 30, 2001 AND DOES NOT REFLECT ANY SUBSEQUENT INFORMATION OR EVENTS OTHER THAN THE RESTATEMENT.

THIS DOCUMENT CONTAINS 56 PAGES.
THE EXHIBIT INDEX IS ON PAGE 53.

TABLE OF CONTENTS

Table of Contents

NETWORKS ASSOCIATES, INC.

FORM 10-Q/ A

September 30, 2001

CONTENTS

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2001	December 31, 2000
	(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	$ 640,255	$ 275,539
Short-term marketable securities	67,369	85,721
Accounts receivable, net	124,316	122,315
Prepaid expenses, income taxes and other current assets	34,239	50,346
Deferred taxes	136,049	86,771
Total current assets	1,002,228	620,692
Long-term marketable securities	249,225	332,893
Fixed assets, net	67,944	75,499
Deferred taxes	104,490	120,261
Intangibles and other assets	215,455	242,275
Total assets	$ 1,639,342	$ 1,391,620
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 24,906	$ 46,816
Accrued liabilities	294,445	254,282
Deferred revenue	209,747	151,566
Total current liabilities	529,098	452,664
Deferred taxes	5,850	7,971
Deferred revenue, less current portion	32,639	26,592
Convertible debt	690,636	396,336
Other long-term debt and liabilities	858	532
Total liabilities	1,259,081	884,095
Commitments and contingencies (Note 10)		
Minority interest	11,849	11,067
Common stock, $0.01 par value; Authorized: 300,000,000; Issued: 139,328,528 shares at September 30, 2001 and December 31, 2000; Outstanding: 138,455,083 shares at September 30, 2001 and 138,089,775 shares at December 31, 2000.	1,393	1,381
Treasury stock, at cost: 873,445 shares at September 30, 2001 and 1,238,753 shares at December 31, 2000.	(20,873)	(23,186)
Additional paid-in capital	691,761	685,423
Accumulated other comprehensive loss	(30,352)	(31,266)
Accumulated deficit	(273,517)	(135,894)
Total stockholders equity	368,412	496,458
Total liabilities, minority interest, and stockholders equity	$ 1,639,342	$ 1,391,620

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

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	**2000**	**2001**	**2000**
	(As reclassified See Note 2)	**(As restated and reclassified See Note 2)**	**(As reclassified See Note 2)**	**(As restated and reclassified See Note 2)**
	(In thousands, except per share data) (Unaudited)			
Net revenue:				
Product	$134,888	$170,249	$ 359,757	$474,241
Services and support	70,382	51,524	193,671	154,761
Total net revenue	205,270	221,773	553,428	629,002
Cost of net revenue:				
Product	28,304	29,518	77,185	81,521
Services and support	14,115	10,508	41,575	29,420
Total cost of net revenue	42,419	40,026	118,760	110,941
Operating costs and expenses:				
Research and development(1)	33,882	45,893	108,741	129,953
Marketing and sales(2)	100,121	97,961	303,365	286,976
General and administrative(3)	22,210	21,330	71,232	59,218
Amortization of intangibles	15,479	16,443	47,996	45,805
Total operating cost and expenses	171,692	181,627	531,334	521,952
Income (loss) from operations	(8,841)	120	(96,666)	(3,891)
Interest and other income and expense, net	1,693	5,336	11,223	18,905
Gain on sale of investments, net				40,373
Write-down of strategic and other investments	(1,000)		(19,138)	
Income (loss) before provision for income tax, minority interest and extraordinary item	(8,148)	5,456	(104,581)	55,387
Provision for income taxes (income tax benefit)	4,028	9,577	(7,144)	38,076
Income (loss) before minority interest and extraordinary item	(12,176)	(4,121)	(97,437)	17,311
Minority interest in loss (income) of consolidated subsidiaries	(152)	1,050	569	3,386
Income (loss) before extraordinary item	(12,328)	(3,071)	(96,868)	20,697
Extraordinary item gain on redemption of debt (net of $718 tax)	1,077		1,077	
Net income (loss)	$ (11,251)	$ (3,071)	$ (95,791)	$ 20,697

Other comprehensive income, net	537	11,624	913	7,739
Comprehensive income (loss)	$ (10,714)	$ 8,553	$ (94,878)	$ 28,436
Basic net income (loss) per share:				
Income (loss) before extraordinary item	$ (0.09)	$ (0.02)	$ (0.71)	$ 0.15
Extraordinary item, gain on redemption of debt, net of taxes	0.01		0.01	
Net income (loss)	$ (0.08)	$ (0.02)	$ (0.70)	$ 0.15
Shares used in per share calculation basic	137,750	137,482	137,256	138,144
Diluted net income (loss) per share:				
Income (loss) before extraordinary item	$ (0.09)	$ (0.02)	$ (0.71)	$ 0.15
Extraordinary item, gain on redemption of debt, net of taxes	0.01		0.01	
Net income (loss)	$ (0.08)	$ (0.02)	$ (0.70)	$ 0.15
Shares used in per share calculation diluted	137,750	137,482	137,256	142,454

(1) Includes stock-based compensation charge of $144 and $3,319 for the three months ended September 30, 2001 and 2000, respectively, and $342 and $4,167 for the nine months ended September 30, 2001 and 2000, respectively.

(2) Includes stock-based compensation charge of $228 and $5,831 for the three months ended September 30, 2001 and 2000, respectively, and $541 and $7,176 for the nine months ended September 30, 2001 and 2000, respectively.

(3) Includes stock-based compensation charge of $448 and $2,957 for the three months ended September 30, 2001 and 2000, respectively, and $2,800 and $3,689 for the nine months ended September 30, 2001 and 2000, respectively.

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

Table of Contents

NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2001	Nine Months Ended September 30, 2000 (As restated See Note 2)
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income (loss)	$ (95,791)	$ 20,697
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization and bad debt expense	71,631	63,514
Interest on convertible notes	16,585	13,555
Realized (gain) loss on investments	(3,876)	141
Write-down of strategic investments	19,138	
Extraordinary item gain on redemption of debt, net of tax	(1,077)	
Minority interest	(569)	(3,386)
Deferred taxes	(35,542)	(12,358)
Stock compensation charges	3,683	15,032
Gain on sale of Goto.com investment		(28,551)
Gain on sale of Network Associates Japan investment		(11,947)
Changes in assets and liabilities:		
Accounts receivable	3,596	(21,857)
Prepaid expenses, taxes and other	9,303	(31,370)
Accounts payable and accrued liabilities	3,172	49,764
Deferred revenue	63,240	14,008
Net cash provided by operating activities	53,493	67,242
Cash flows from investing activities:		
Purchase of marketable securities	(427,721)	(347,213)
Proceeds from sale of marketable securities	528,063	386,137
Purchase of equity investments		(21,650)
Proceeds from Goto.com investment		36,750
Proceeds from sale of shares of Network Associates Japan		11,947
Purchase of shares of Network Associates Japan	(10,655)	
Acquisitions by subsidiary		(1,959)
Additions to fixed assets	(20,096)	(37,844)
Net cash provided by investing activities	69,591	26,168
Cash flows from financing activities:		
Repayment of notes payable		(67)
Proceeds from issuance of stocks from option plan and stock purchase plans	18,564	37,937
Repurchase of common stock	(53,800)	(92,681)
Issuance of 5.25% convertible notes	335,081	
Redemption of zero coupon convertible debenture	(61,950)	
Proceeds from sale of put options		13,890
Other	(314)	950

Net cash provided by (used in) financing activities	237,581	(39,971)
Effect of exchange rate fluctuations	4,051	(38,346)
Net increase in cash and cash equivalents	364,716	15,093
Cash and cash equivalents at beginning of period	275,539	316,784
Cash and cash equivalents at end of period	$ 640,255	$ 331,877

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

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

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 and nine month periods ended September 30, 2001 are not necessarily indicative of the results to be expected for the full year or for any future periods. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the restated audited consolidated financial statements contained in the Company s Annual Report on Form 10-K/A filed with the Securities and Exchange Commission on June 28, 2002. The balance sheet at December 31, 2000 has been derived from the audited financial statements as of and for the year ended December 31, 2000, but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements.

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

2. Restatement and Adoption of New Accounting Pronouncements

On April 25, 2002, the Company announced that it had discovered accounting inaccuracies in certain prior period financial statements, requiring restatement of the financial statements for these periods. The Company conducted an internal investigation under the direction of the Audit Committee of its Board of Directors to determine the scope and magnitude of these inaccuracies. On May 17, 2002, the Company announced that the Audit Committee of its Board of Directors had completed its internal accounting investigation. As a result of the internal accounting investigation, the Company s statements of operations, cash flows and stockholders equity for the years ended December 31, 2000, 1999 and 1998 and the balance sheets as of December 31, 2000, 1999 and 1998 are being restated. In addition, to give effect to accumulated prior period adjustments and their related tax impacts, the Company announced the restatement of its December 31, 2001 and March 31, 2002 balance sheets. As a result, the Company is also restating its condensed consolidated statements of operations and cash flows for the three and nine months ended September 30, 2000 and condensed consolidated balance sheet as of September 30, 2001, which are included in this Form 10-Q/A. The statements of operations and cash flows for the periods ended September 30, 2001 were not impacted by this restatement.

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

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

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

The condensed consolidated balance sheets as of September 30, 2001 and December 31, 2000 and condensed consolidated statements of operations for the three and nine months ended September 30, 2000 contained herein have been restated to incorporate the adjustments described herein and the related tax effects. In addition, the Company reclassified amounts of approximately $3.8 million and $6.0 million for the three months ended September 30, 2001 and 2000, respectively, and $21.9 million and $20.6 million for the nine months ended September 30, 2001 and 2000, respectively, from marketing and sales expense to revenue upon the adoption of EITF 01-09.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Balance Sheet as of September 30, 2001

	As Previously Reported	Cumulative Effect of Prior Year Changes	As Restated
Cash and cash equivalents	$ 640,255	$	$ 640,255
Short-term marketable securities	67,369		67,369
Accounts receivable, net	124,316		124,316
Prepaid expenses, income taxes and other current assets	34,239		34,239
Deferred taxes	136,049		136,049
Total current assets	1,002,228		1,002,228
Long-term marketable securities	249,225		249,225
Fixed assets, net	67,944		67,944
Deferred taxes	97,718	6,772	104,490
Intangible assets and other assets	215,455		215,455
Total assets	$ 1,632,570	$ 6,772	$ 1,639,342
Accounts payable	$ 24,906	$	$ 24,906
Accrued liabilities	265,480	28,965	294,445
Deferred revenue	209,747		209,747
Total current liabilities	500,133	28,965	529,098
Deferred taxes	5,850		5,850
Deferred revenue, less current portion	32,639		32,639
Convertible debt	690,636		690,636
Other long term debt and liabilities	858		858
Total liabilities	1,230,116	28,965	1,259,081
Minority interest	11,849		11,849
Common stock	1,393		1,393
Treasury stock	(20,873)		(20,873)
Additional paid in capital	691,761		691,761
Accumulated other comprehensive loss	(30,352)		(30,352)
Accumulated deficit	(251,324)	(22,193)	(273,517)
Total stockholders equity	390,605	(22,193)	368,412
Total liabilities, minority interest and stockholders equity	$ 1,632,570	$ 6,772	$ 1,639,342

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Balance Sheet as of December 31, 2000

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

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Statement of Operations

For the Three Months Ended September 30, 2000

	As Previously Reported	Inaccuracies	EITF No. 01-09 Reclassifications	As Restated and Reclassified
Net revenue:				
Product	$187,213	$(11,000)	$(5,964)	$170,249
Services and support	51,524			51,524
Total net revenue	238,737	(11,000)	(5,964)	221,773
Cost of net revenue:				
Product	29,518			29,518
Services and support	10,508			10,508
Total cost of net revenue	40,026			40,026
Operating costs and expenses:				
Research and development	45,893			45,893
Marketing and sales	103,925		(5,964)	97,961
General and administrative	21,730	(400)		21,330
Amortization of intangibles	16,443			16,443
Total operating costs and expenses	187,991	(400)	(5,964)	181,627
Income from operations	10,720	(10,600)		120
Interest and other income and expense, net	5,736	(400)		5,336
Income before provision for income taxes and minority interest	16,456	(11,000)		5,456
Provision for taxes	13,427	(3,850)		9,577
Net income (loss) before minority interest	3,029	(7,150)		(4,121)
Minority interest in consolidated subsidiaries	1,050			1,050
Net income (loss)	$ 4,079	$ (7,150)	$	$ (3,071)
Basic and diluted net income (loss) per share:				
Net income (loss) per share basic	$ 0.03			$ (0.02)
Net income (loss) per share diluted	$ 0.03			$ (0.02)
Basic shares	137,482			137,482
Diluted shares	140,989			137,482

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Statement of Operations

For the Nine Months Ended September 30, 2000

	As Previously Reported	Inaccuracies	EITF No. 01-09 Reclassifications	As Restated and Reclassified
Net revenue:				
Product	$532,104	$(37,288)	$(20,575)	$474,241
Services and support	154,761			154,761
Total net revenue	686,865	(37,288)	(20,575)	629,002
Cost of net revenue:				
Product	82,521	(1,000)		81,521
Services and support	29,420			29,420
Total cost of net revenue	111,941	(1,000)		110,941
Operating costs and expenses:				
Research and development	130,453	(500)		129,953
Marketing and sales	298,751	8,800	(20,575)	286,976
General and administrative	64,581	(5,363)		59,218
Amortization of intangibles	45,805			45,805
Total operating costs and expenses	539,590	2,937	(20,575)	521,952
Income from operations	35,334	(39,225)		(3,891)
Interest and other income and expense, net	16,305	2,600		18,905
Gain on investment, net	40,373			40,373
Income before provision for income taxes and minority interest	92,012	(36,625)		55,387
Provision for taxes	50,895	(12,819)		38,076
Net income before minority interest	41,117	(23,806)		17,311
Minority interest in consolidated subsidiaries	3,386			3,386
Net income	$ 44,503	$(23,806)	$	$ 20,697
Basic and diluted net income per share:				
Net income per share basic	$ 0.32			$ 0.15
Net income per share diluted	$ 0.31			$ 0.15
Basic shares	138,144			138,144
Diluted shares	142,454			142,454

3. Business Segment Information

In 1998, the Company established a subsidiary, McAfee.com, as a separate business entity. The Company evaluated its product segments in 2001 and concluded that it has two reportable segments consisting of computer security and management software, and managed security and availability application services to business users on the Internet (Infrastructure) and consumer PC security and management software on the

Internet (McAfee.com). Management measures profitability for its business based on these two segments.

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

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
	(As reclassified See Note 2)	(As restated and reclassified See Note 2)	(As reclassified See Note 2)	(As restated and reclassified See Note 2)
Infrastructure:				
Net revenues	$189,100	$209,212	$510,033	$594,277
Segment operating income (loss)	$ (10,152)	$ 7,401	$ (94,620)	$ 19,214
McAfee.com:				
Net revenues	$ 16,170	$ 12,561	$ 43,395	$ 34,725
Segment operating income (loss)	$ 1,311	$ (7,281)	$ (2,046)	$ (23,105)
Total Company:				
Net revenues	$205,270	$221,773	$553,428	$629,002
Segment operating income (loss)	$ (8,841)	$ 120	$ (96,666)	$ (3,891)

	September 30, 2001	December 31, 2000
	(As restated See Note 2)	(As restated See Note 2)
Infrastructure:		
Total assets	$1,531,507	$1,293,488
McAfee.com:		
Total assets	$ 107,835	$ 98,132
Total Company:		
Total assets	$1,639,342	$1,391,620

4. Convertible Debt

In the three months ended September 30, 2001, the Company redeemed zero coupon convertible subordinated debentures, which had an aggregate face amount at maturity of $140.0 million, at a net price of $442.50 per $1,000 of principal amount at maturity. In accordance with the redemption, the Company recognized an extraordinary gain of $1.1 million, net of $718,000 in taxes. As of September 30, 2001, the Company s aggregate cash, cash equivalents and marketable securities were approximately $956.8 million, including $89.0 million held by McAfee.com. Assuming that as of February 13, 2003 all currently outstanding zero coupon convertible subordinated debentures are redeemed, the aggregate redemption price would equal approximately $368.6 million.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On August 17, 2001, the Company issued 5.25% convertible subordinated notes due 2006 with an aggregate principal amount of $345.0 million. The issuance generated net proceeds of approximately $335.1 million (after deducting fees and expenses). The notes mature on August 15, 2006, unless earlier redeemed by the Company at its option or converted at the holder s option. Interest is payable in cash semi-annually in arrears on February 15 and August 15 of each year, commencing February 15, 2002. At the option of the holder, 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 Company may redeem all or a portion of the notes for cash at any time on or after August 20, 2004 at a redemption price of 101.3125% of the principal amount between August 20, 2004 and August 14, 2005 and 100.0% of the principal amount after August 14, 2005. The notes are unsecured and are subordinated to all existing and future senior indebtedness and are pari passu with respect to the zero coupon convertible subordinated debentures due 2018.

5. Stock Option Repricing, Stock Based Charges and Stock Repurchase Plan

On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with exercise prices at the then current fair market value of the stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted at an exercise price of $11.063, which was based on the closing price of the Company s common stock on April 22, 1999. The new options vest at the same rate that they would have vested under previous option plans. As a result, options to purchase approximately 3.1 million shares at $11.063 were vested and outstanding at September 30, 2001.

In accordance with Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees, the Company incurred an initial stock based compensation charge in connection with this repricing. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately $495,000 and $1.2 million was expensed in the three months and nine months ended September 30, 2001, respectively, and $2.2 million and $5.1 million was expensed in the three months and nine months ended September 30, 2000, respectively.

In March 2000, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25 (Interpretation). Among other issues, this Interpretation clarified (a) the definition of employee for purposes of applying Opinion 25, (b) the criteria for determining whether a plan qualifies as a non-compensatory plan, (c) the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in a business combination. This guidance was effective as of July 1, 2000.

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

In addition, variable plan accounting as described above, applied to options issued to employees of McAfee.com and myCIO.com as a replacement for Company options which were subject to the repricing

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

described above. As a result, the Company will record variable charges based on the movements in the fair value of McAfee.com and myCIO.com common stock from July 1, 2000.

During the three months and nine months ended September 30, 2001, the Company did not incur charges to earnings related to options subject to variable plan accounting as the Company s stock price was below $20.375. As of September 30, 2001 the Company and McAfee.com had options amounting to 3.6 million and 59,650, respectively, which were outstanding and subject to variable plan accounting. Depending on movements in the market value of the Company s common stock, the accounting treatment may result in significant additional compensation charges in future periods.

On January 3, 2001, the Company s board of directors appointed George Samenuk as the Company s chief executive officer and president. Effective January 1 and 2, 2001, William Larson, former chief executive officer, Prabhat Goyal, former chief financial officer, and Peter Watkins, former president and chief operating officer, became special advisors to the Company. Options held by Mr. Larson, Mr. Goyal, and Mr. Watkins continue to vest while they each serve one-year terms as special advisors to the Company. As a result, the Company recorded a one-time stock compensation charge in the three months ended March 31, 2001 amounting to approximately $603,000.

On January 3, 2001, the Company entered into an employment agreement with George Samenuk to become the Company s chief executive officer (CEO). In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase such shares will lapse as follows: 12.5% on the first four quarterly anniversaries of Mr. Samenuk s employment with the Company with the remaining 50% on the second year anniversary of Mr. Samenuk s employment with the Company. The fair value of the restricted stock was determined to be approximately $1.7 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of the Company s common stock on Mr. Samenuk s employment commencement date. In the three months and nine months ended September 30, 2001, the Company recognized $209,000 and $627,000, respectively, related to stock compensation associated with Mr. Samenuk s restricted stock.

On April 3, 2001 the Company entered into an employment agreement with Stephen C. Richards to become executive vice president and chief financial officer (CFO). In accordance with the terms of the agreement, the Company issued 50,000 shares of stock to Mr. Richards for $0.01 per share. In the three months ended June 30, 2001, the Company recognized $350,000 related to stock compensation associated with the stock issued to Mr. Richards.

In May 1999, the board of directors authorized the Company to repurchase up to $100 million of its common stock in the open market over a two-year period. In July 2000, the board of directors authorized the Company to repurchase additional common stock of up to $50 million in the open market over a two-year period. Through September 30, 2001, the Company repurchased 7.0 million shares of its common stock, including the repurchase of 2.0 million shares on February 2, 2001 relating to the settlement of the outstanding put options. Cash outlay, net of proceeds from put options described below, to September 30, 2001 was approximately $147.5 million. The timing and size of any future stock repurchases are subject to market conditions, stock prices, the Company s cash position and other cash requirements.

On August 3, 1999, February 16, 2000 and May 31, 2000, the Company sold European style put options for 3.0 million shares of the Company s common stock as part of its stock repurchase plan. The strike prices for these put options were $20.00, $30.00 and $24.07, respectively. The Company received total proceeds of approximately $19.1 million from the sale. In August 2000, put options sold on August 2, 1999 for 1.0 million shares were exercised in the Company s stock. The strike price for these put options was $20.00. In February 2001, the Company settled the remaining put options, which resulted in the purchase of 2.0 million shares of the Company s common stock for approximately $53.8 million.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Stockholders Equity

Stock Option Plans

On January 24, 2001, the Company s board of directors authorized the reservation of an additional 3.0 million options for the 2000 Nonstatutory Stock Option Plan.

The Company s board of directors authorized the reservation of an additional 5.0 million options for the 1997 Stock Incentive Plan. These additional options were approved at the Company s 2001 annual meeting held May 24, 2001.

Warrants

In January 2001, upon completion of the search for the Company s CEO, the Company issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 166,667 shares of the Company s common stock. The weighted-average exercise price of the underlying shares is $2.97 per share. The warrants are immediately exercisable and expire in January 2004. The combined fair value of the warrants was determined to be approximately $530,000 and was estimated using the Black-Scholes model with the following assumptions: risk free interest rate of 4.82%; expected life of 3 years; dividend yield of 0%; and expected volatility of 91%. 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 financial statements.

In April 2001, upon completion of the search for the Company s CFO, the Company issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 66,667 shares of the Company s common stock. The weighted-average exercise price of the underlying shares is $4.50 per share. The warrants are immediately exercisable and expire in April 2004. The combined fair value of the warrants was determined to be approximately $280,000 and was estimated using the Black-Scholes model with the following assumptions: risk free interest rate of 4.27%; expected 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 June 30, 2001 and included in general and administrative expenses in the accompanying financial statements.

7. Recent Accounting Pronouncements

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

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 agreed to change the transition date for Issue 00-14, dictating that a company should apply this consensus no later than the company s annual or interim

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. 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. 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. As part of the restatement discussed in Note 2 of these Notes to Condensed Consolidated Financial Statements, the Company adopted EITF 01-09. See Note 2 of these Notes to Condensed Consolidated Financial Statements.

In July 2001, the FASB issued SFAS No. 141, Business Combinations. SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The Company believes that the adoption of SFAS No. 141 will not have a significant impact on its financial statements.

In July 2001, the 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. The Company is currently assessing but has not yet determined the impact of the adoption of SFAS No. 142 on its financial position and results of operations.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 addresses significant issues relating to the implementation of SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and develops a single accounting method under which long-lived assets that are to be disposed of by sale are measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and its provisions are to be applied prospectively. The Company is currently assessing the impact of SFAS No. 144 on its financial position and results of operations.

Table of Contents

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Net Income (Loss) per Share

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2000	2001	2000
		(As restated see Note 2)		(As restated see Note 2)
Numerator Basic:				
Income (loss) before extraordinary item	(12,328)	(3,071)	(96,868)	20,697
Extraordinary item gain on redemption of debt, net of tax	1,077		1,077	
Net income (loss)	$ (11,251)	$ (3,071)	$ (95,791)	$ 20,697
Numerator Diluted:				
Income (loss) before extraordinary item	(12,328)	(3,071)	(96,868)	20,697
Interest on convertible debentures(1)				
Income (loss) before extraordinary item, adjusted	(12,328)	(3,071)	(96,868)	20,697
Extraordinary item gain on redemption of debt, net of tax	1,077		1,077	
Net income (loss), adjusted	$ (11,251)	$ (3,071)	$ (95,791)	$ 20,697
Denominator Basic:				
Weighted average shares of common stock outstanding	138,050	137,482	137,606	138,144
Less: Weighted average shares of common stock Subject to repurchase	(300)		(350)	
Basic weighted average common shares outstanding	137,750	137,482	137,256	138,144
Denominator Diluted:				
Basic weighted average common shares outstanding	137,750	137,482	137,256	138,144
Effective of dilutive securities:				
Common stock options(2)				4,128
Warrants(3)				
Put Options				182
Diluted weighted average shares	137,750	137,482	137,256	142,454
Basic net income (loss) per share:				
Income (loss) before extraordinary item	$ (0.09)	$ (0.02)	$ (0.71)	$ 0.15
Extraordinary item gain on redemption of debt, net of taxes	0.01		0.01	

Net income (loss)	$ (0.08)	$ (0.02)	$ (0.70)	$ 0.15
Diluted net income (loss) per share:				
Income (loss) before extraordinary item	$ (0.09)	$ (0.02)	$ (0.71)	$ 0.15
Extraordinary item gain on redemption of debt, net of taxes	0.01		0.01	
Net income (loss)	$ (0.08)	$ (0.02)	$ (0.70)	$ 0.15

NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(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 25.5 million for the three months and nine months ended September 30, 2001 and 7.6 million for the three months and nine months ended September 30, 2000.

(2) At September 30, 2001 and 2000, 33.0 million and 16.8 million common stock options, respectively, were excluded from the determination of diluted net income per share as the effect of such options is anti-dilutive.