

NETWORKS ASSOCIATES INC/

Form 10-K

February 08, 2002

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2001

or

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

For the transition period from to

Commission file number: 0-20558

Networks Associates, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

**3965 Freedom Circle
Santa Clara, California**

(Address of principal executive offices)

77-0316593

*(I.R.S. Employer
Identification Number)*

95054

(Zip Code)

Registrant's telephone number, including area code: (408) 988-3832

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

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$.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 No

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

The aggregate market value of the voting stock held by non-affiliates of the issuer as of December 31, 2001 was approximately \$3,582,411,290. The number of shares outstanding of the issuer's common stock as of December 31, 2001 was 140,699,222.

DOCUMENTS INCORPORATED BY REFERENCE

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Items 10, 11, 12, and 13 of Part III are incorporated by reference from the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held May 15, 2002.

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PART I

Item 1. Business

General

Some of the statements contained in this Annual Report on Form 10-K 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-K that are not purely historical are forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward looking statements included in this Report on Form 10-K are based on information available to us on the date hereof, 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 those discussed in Risk Factors beginning on page 11 in this document.

Networks Associates, Inc. was formed in December 1997, by the combination of McAfee Associates, Inc. and Network General Corporation. Following the combination, McAfee changed its legal name to Networks Associates, Inc. and we do business under the name Network Associates. In 1999, our subsidiary McAfee.com sold to the public its Class A common stock as a part of its initial public offering.

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 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, 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 fourth quarter of 2001, we substantially completed integrating the activities of our PGP product group into our McAfee and Sniffer product groups. The PGP product group accounted for approximately 6%

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of our net revenue in 2001. Former PGP products now marketed and sold as McAfee products include the McAfee VPN, McAfee Desktop Firewall (our distributed firewall) for corporate users and the McAfee E-Business Server. The CyberCop vulnerability assessment technology was integrated into the Sniffer product line. We are seeking buyers for the PGP desktop encryption and Gauntlet firewall products.

In 2001, our infrastructure business, including the recently integrated PGP product group, accounted for approximately \$772.5 million in net revenue and a net operating loss of \$82.0 million. In 2001, McAfee.com accounted for approximately \$62.0 million in net revenue and a net operating loss of approximately \$192,000.

McAfee Product Group

McAfee'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 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 product group also includes distributed firewalls and virtual private network products for corporate users. McAfee's services are provided by McAfee's Anti-Virus Emergency Response Team (AVERT). AVERT augments McAfee's product offerings by identifying new viruses and deploying anti-virus solutions to our customers. McAfee 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.

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As of December 31, 2001, we owned 36.0 million shares of McAfee.com Class B common stock, entitled to three votes per share and representing approximately 76% of McAfee.com's outstanding common stock and 90% of its total voting power.

Professional Services & Technical Support

As our products and computer networks become more complex, customers increasingly require greater professional assistance in the design, installation, configuration and implementation of their networks and acquired products. To meet these evolving customer needs, we have established Professional Services and Technical Support. Professional Services is focused on two service segments: Consulting Services and Education Services. Technical Support consists primarily of one program called PrimeSupport.

Consulting Services supports product integrations and deployment with an array of standardized and custom offerings. Consulting Services also offers other services ranging from proactive and emergency troubleshooting to network design, planning and simulation. We supplement our consulting service capabilities through the use of outside professional service providers, including system integrators. Our consulting services organization is organized around our three product groups.

Education Services represents the combined training organizations of Sniffer University, McAfee University and Magic University. Together, these training organizations offer customers an extensive curriculum of computer network technology courses, including protocol analysis and troubleshooting, security, help-desk and network management tools. Education Services provides public classes and customized on-site training at customer locations.

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

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

PrimeSupport Connect Provides toll-free telephone access to technical support during regular business hours and access to the online KnowledgeCenter.

PrimeSupport Priority Provides support for critical operations with priority, unlimited, toll-free telephone access to technical support 24 hours a day, 7 days a week and access to the online KnowledgeCenter.

PrimeSupport Enterprise Offers proactive, personalized service for the most business critical operations and includes an assigned technical support engineer from our elite Enterprise support team, proactive support contact (telephone or email) with customer-defined frequency, election of five designated customer contacts and access to the online KnowledgeCenter.

NAI Labs

NAI Labs is our research and development organization dedicated to advanced network and information systems security technology. NAI Labs is actively conducting research in the areas of network security, cryptography, security infrastructure and other network security and network defense projects. NAI Labs has ongoing projects funded through DARPA (the U.S. Defense Advanced Research Projects Agency), Air Force, Navy, Army, NSA and other Department of Defense and U.S. government agencies. NAI Labs makes a number of its research prototypes available as open source software and support several open source community initiatives.

Product Licensing Model

We typically license our products to corporate and government customers on a subscription basis, for a period of two years or on a perpetual basis. Beginning in October 2000, we began selling our two-year

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subscription licenses with one-year (first year) of maintenance. Previously, our two-year subscription licenses included two years of maintenance. During the first year of the two-year subscription license, the customer has the option to purchase the second year of maintenance. The purchase price for the second year of maintenance is set at the time of purchase of the two-year subscription license. As the software licenses or maintenance contracts near expiration, we contact customers to renew their licenses or maintenance contracts, as applicable. We believe that providing the customer the option to purchase the second year of maintenance provides the customer greater flexibility in selecting the appropriate level of maintenance support. Electronic distribution of our products and upgrades allows us to offer upgrades and updates on a more regular basis than companies using traditional distribution methods.

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

We also provide single user and corporate user licenses for our products under traditional perpetual licenses with product updates, upgrades and support available to customers under separate maintenance contracts. As compared to subscription licenses, sales of perpetual licenses typically result in significantly higher up-front revenue and lower recurring and future revenues as the sales price for upgrades and updates tends to be significantly lower than that of a perpetual license. We typically sell perpetual licenses in connection with sales of our hardware-based Sniffer and E-ppliance products where software is bundled with the hardware platform.

Hosted Applications Subscription Model

For our ASP or hosted products and services, customers essentially rent the use of our software. Because our ASP services are version-less, or self updating, customers using these services are assured of using the most recent version of the software application, eliminating the need to purchase product updates or upgrades. McAfee.com provides software using a related subscription model. Paid McAfee Clinic subscribers receive a time-based subscription to the service.

In 2001, the McAfee Product Group introduced its ASaP offerings. These are hosted products and services which provide the most up-to-date anti-virus software to corporate customers. These offerings include VirusScan ASaP, which provides anti-virus protection to desktops and file servers, VirusScreen ASaP, which screens e-mails to detect and quarantine viruses and infected attachments, and WebShield e500 ASaP, which combines a McAfee WebShield e-ppliance with hosted monitoring services that keep the e-ppliance continuously up to date to stop viruses at the Internet gateway before they enter an organization.

Sales and Marketing

To augment and capitalize upon our marketing efforts, our sales and marketing activities are directed primarily at large corporate and government customers, as well as to resellers, distributors and system integrators worldwide through the channels listed below.

United States Direct Sales

Our United States direct sales force, constituting the majority of our sales force, is organized by product group, with three separately focused sales organizations selling by product group. Each of these sales organizations consists of field sales representatives who are located regionally and outbound telesales representatives who actively market our individual product groups, focusing on small customers and transactions. Our corporate telesales representatives also respond to prospective customers who contact us as a result of a particular marketing program or after electronically evaluating one of our products. To augment our sales organization, our executives are involved with sales to many major accounts.

All of our United States sales representatives are responsible for developing new business as well as the renewal of our existing licenses. Prior to expiration of a license, a sales representative contacts the customer and

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encourages the customer to renew the expiring license and determines if the number of computers licensed needs adjustment and, additionally, markets new products and product groups to this existing customer.

International Sales

We have sales and support operations in Europe, Japan, Canada, Asia-Pacific and Latin America. In 2001, international revenues accounted for approximately 35% of our net revenues. In 2001, we announced our intention to significantly expand our international sales activities, and we hired new heads of our Asia-Pacific, European and Latin American operations.

We recently organized our international sales forces by region. In addition to the United States, the principal geographic regions are Europe, Japan, Canada, Asia-Pacific, and Latin America. Within these regions, sales forces are organized by country where appropriate. Our international direct sales force is organized by our three product groups when and where local demand and sales force considerations make this action advisable. Outside of the United States, each product group's sales force reports to the regional sales head.

Resellers and Distributors

To complement our direct sales efforts, we market many of our products through corporate resellers and distributors, and indirectly through retailers. We currently utilize corporate resellers, including ASAP Software, Corporate Software & Technology, Softmart, Software House International and Software Spectrum, which focus primarily on selling site licenses of our software to corporate customers.

Independent software distributors who currently market our products include Ingram Micro, Merisel America, MOCA and Tech Data. These distributors market our products primarily to large retailers, value added resellers, or VARs, and mail order companies. Through our authorized distributors, we sell our retail packaged products to several of the larger computer and software retailers in the United States, including Best Buy, Comp USA, Fry's, Office Depot, Office Max and Staples. Several members of our channel sales force work closely with our major reseller and distributor accounts to manage orders, promotions and selling activities.

Our top ten distributors typically account for between 37% and 42% of our net revenue each quarter. Our agreements with our distributors are not exclusive and may be terminated by either party without cause. Terminated distributors may not continue to represent our products. If one of our significant distributors terminated its relationship with us, we could experience a significant interruption in the distribution of our products.

Commencing January 1, 2001, we implemented a sell-through business model for distributors under which we recognize revenue on products sold through distributors at the time our distributors resell the products to their customers. Under this business model, our distributors are permitted to purchase software licenses at the same time they fill customer orders and to pay for hardware and retail products only when these products are resold to the distributors' customers. In addition, prior to the resale of our products, our distributors are permitted unlimited unconditional rights of return. After sale by the distributor to its customer, there is no right of return from the distributor to us with respect to such product, unless we approve the return from the final customer to the distributor.

Original Equipment Manufacturers

Original Equipment Manufacturers, or OEMs, license our products and bundle them with PC hardware or software. OEMs typically sublicense a single version of our products to end users who must contact us in order to receive their updates. We typically receive a per-copy royalty from our OEMs. Subject to limited exceptions, our OEM activities are conducted through McAfee.com.

Other Marketing Activities

Our principal means of marketing our products and services is through the Internet. In addition to the NAI.com website, each of our product groups and McAfee.com have their own individual websites. A number

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of these websites are localized to serve the various geographic regions in which we operate. Not only do each of these websites contain various marketing materials and information about our products, but website visitors may download and purchase products or obtain free trials of our products or trial subscriptions for hosted products and services. We also promote our products and services through advertising activities in trade publications and direct mail campaigns and strategic arrangements. In addition, we attend trade shows, sponsor conferences and publish a quarterly newsletter, which is mailed to existing and prospective customers.

Customers

We primarily market our products to large corporate and government customers directly through our direct sales organization and indirectly through resellers and distributors. A majority of our products are distributed indirectly through resellers and distributors. In the U.S., substantially all our indirect sales are through four major distributors. In Europe, substantially all indirect sales are made through five major distributors. During 2001, one customer, Ingram Micro, accounted for approximately 27% of our net revenue.

We primarily market our products directly to individual consumers through online distribution channels and indirectly through traditional distribution channels, such as retail stores. McAfee.com is responsible for online distribution of our products sold to individual consumers over the Internet or for Internet-based products and for the licensing of technology to OEMs for sale to individual consumers, subject to certain exceptions.

Product Development and Acquisition

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

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

Excluding stock-based compensation charges, we expended \$142.1 million, \$171.6 million and \$148.2 million in 2001, 2000 and 1999, respectively, on research and development.

Manufacturing and Suppliers

Our manufacturing operations consist primarily of assembly, testing and quality control of materials, components, subassemblies and systems for our Sniffer hardware-based and E-ppliance products. We use a limited number of third-party manufacturers for these manufacturing operations. Reliance on third-party manufacturers involves a number of risks, including the lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. The loss of one of our third-party manufacturers could disrupt our business. Hardware-based products entail other risks, such as the unavailability of critical components which are supplied by a limited number of parties and greater obsolescence risks.

We have developed software-only versions of some of our Sniffer products. Purchasers of these Sniffer software products are required to already own, or purchase directly from the manufacturer or other vendors, the necessary hardware products, such as computer platforms and components. Customers may require that we continue to provide the necessary hardware products.

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Competition

The markets for our products are intensely competitive and we expect competition to increase in the near-term. We believe that the principal competitive factors affecting the markets for our products include:

performance;

functionality;

quality;

customer support;

breadth of product group;

frequency of upgrades and updates;

integration of products;

manageability of products;

brand name recognition;

reputation; and

price.

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

Anti-Virus. Our principal competitor in the anti-virus market is the Norton Product Group of Symantec. Trend Micro remains the strongest competitor in the Asian anti-virus market, with Dr. Ahn's making recent inroads, particularly in Japan and Korea.

Network Security. Our principal competitors in the security market vary by product type. For firewalls, our principal competitors include CheckPoint, Symantec, and larger companies such as Cisco Systems and Microsoft. For intrusion detection products, we compete with Cisco Systems, Internet Security Systems and Symantec. The markets for encryption and virtual private network, or VPN, products are highly fragmented with numerous small and large vendors. VPN competitors include hardware and software vendors, including telecommunications companies and traditional networking suppliers.

Network Management. Our principal competitor in the network management market is Agilent. Other competitors include Acterna Corporation, Cisco Systems, Computer Associates, Compuware, Concord Communications, DeskTalk Systems, GN Nettest, Network Instruments, Radcom Technologies, Shomiti Systems and WildPackets.

Help Desk. Our principal competitors in the help desk market are Computer Associates, FrontRange Solutions and Peregrine Systems.

Other Competitors. We also face competition from large software companies such as HP, Intel, Microsoft and Novell, which may offer network security and management products as enhancements to their operating systems.

Proprietary Technology

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Our success depends significantly upon proprietary software technology. We rely on a combination of contractual rights, trademarks, trade secrets and copyrights to establish and protect proprietary rights to our software. However, these protections may be inadequate or competitors may independently develop technologies or products that are substantially equivalent or superior to our products. We do not typically obtain signed

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license agreements from customers who license products directly from us. Rather we include an electronic version of a shrink-wrap license in all of our electronically distributed software and a printed license in the box for our products. Since none of these licenses are signed by the licensee, many legal authorities believe that such licenses may not be enforceable under the laws of many states and foreign jurisdictions. In addition, the laws of some foreign countries either do not protect these rights at all or offer only limited protection for these rights. The steps taken by us to protect our proprietary software technology may be inadequate to deter misuse or theft of this technology. For example, we are aware that a substantial number of users of our anti-virus products have not paid any registration or license fees to us.

Network Associates/ McAfee.com Intercompany Agreements

For the purposes of defining our ongoing relationship with McAfee.com, our publicly traded subsidiary, we have entered into a number of ongoing agreements. These agreements are filed as exhibits to the public disclosure documents that we file with the Securities and Exchange Commission and are described briefly below. The description is subject in all respects to the terms of the actual agreements.

License Agreement. Under the terms of our license agreement:

Licensed Technology. Network Associates and McAfee.com granted to each other limited rights to each others' patents, copyrights, trademarks and trade secrets for use in defined markets. McAfee.com granted us worldwide, non-exclusive rights to McAfee.com's patents and exclusive rights to use McAfee.com's copyrights, trademarks and trade secrets to deliver products and services to enterprise customers and individual consumers by any means other than the Internet. Under the agreement, McAfee.com was granted worldwide, non-exclusive rights to our patents and exclusive rights to use our copyright, trademark and trade secret rights to create and deliver products and services directly or indirectly to individual consumers over the Internet or for Internet-based products. Each party is also permitted to create products derived from the technology licensed to it by the other. The creating party retains ownership of their newly derived products but these derived products are licensed to the other party subject to the terms of the license agreement.

Royalty Payments. In consideration for the rights granted under the license agreement, we are required to pay McAfee.com a flat quarterly royalty of \$250,000. In consideration for the rights granted by us to McAfee.com under the license agreement, McAfee.com is required to pay us a 7% royalty on revenues recognized from product and subscription sales that include our technology.

Limitations on Offered Products. During the term of the agreement, each party has agreed that it will not offer products incorporating third-party technology if those products are competitive with the products offered by the other party.

Indemnification. Under the agreement, each party has agreed to indemnify, defend and hold harmless the other for any losses incurred in connection with claims arising in the covered countries if the technology licensed under the agreement violates the patent, copyright, trademark or trade secrets or other proprietary rights of a third party. Covered countries are those countries that are party to the Berne Convention for the Protection of Literary and Artistic Works, which include the U.S. and substantially all U.N. member nations.

Term and Termination. The license agreement will remain in effect perpetually, but may be terminated, among other circumstances, by the non-defaulting party, in the event of a material breach by the other party that remains uncured for 30 days following notice of the breach, subject to mandatory dispute resolution prior to the effectiveness of any proposed termination.

Reseller Agreements. In March 2001, we entered into reseller agreements with McAfee.com. Under these agreements, McAfee.com may resell our products to business customers, except in Japan, and in certain countries, we may resell McAfee.com products to OEMs and end-users directly or through ASPs.

Services Agreement. Under this agreement, we provide services relating to tax, insurance, employee benefits and administration, corporate record keeping and information technology. For these services, we charge a portion of the cost of our provision of the services to McAfee.com, including all related expenses, which is allocated based on headcount, plus a ten percent mark-up. In addition, from time to time, we may

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provide additional services, including legal and accounting services. The services agreement may be terminated either by McAfee.com on 30 days notice or by us when we cease to own a majority of the outstanding voting stock of McAfee.com.

Registration Rights Agreement. Under this agreement, we, or any transferee of at least 10% of our McAfee.com shares, can include such shares of McAfee.com common stock in any future registration of common stock made by McAfee.com, other than any registration statement relating to an acquisition or stock option plan. In addition, we or any transferee of at least 10% of our McAfee.com shares can request that McAfee.com file a registration statement for the public sale of such shares of McAfee.com stock.

Joint Cooperation Agreement. The joint cooperation and master services agreement with McAfee.com governs the provision of technology services among the parties. Under this agreement, our anti-virus emergency response team, or AVERT, will provide McAfee.com with research and solutions for virus events. The agreement also contains standard terms and conditions governing the provision of technology services from one party to the other under statements of work that may be negotiated from time to time. We pay McAfee.com a fee for these services in an amount equal to 10% of McAfee.com's total quarterly technology costs plus a 10% service charge.

Tax Sharing Agreement. Under this agreement, McAfee.com pays federal, state and local income tax liability amounts to us, determined on a pro forma basis as if McAfee.com filed its own separate income tax returns for each year. We will not reimburse McAfee.com for McAfee.com's or any other group member's use of their net operating loss or other tax benefits in any consolidated or combined return. However, McAfee.com will be able, during the term of the agreement, to take into account its past and future net operating loss and other tax attributes for purposes of computing its hypothetical separate income tax return liability payment to, or refund from, us.

The tax sharing agreement will terminate if McAfee.com is no longer eligible to join us in the filing of a consolidated federal income tax return. In the event of such termination, any net operating losses or other carryforward amounts would not be available to McAfee.com upon departure from the group. Under the agreement, McAfee.com will not be reimbursed for any such loss of tax benefits.

Indemnification and Voting Agreement. Under this agreement, except as contemplated below, we will indemnify and defend McAfee.com harmless for all losses related to any third party claims relating to events or circumstances arising out of any action or inaction of us, including our subsidiaries and officers and directors, on or prior to December 2, 1999, the date on which McAfee.com completed its initial public offering. Matters for which we are not obligated to indemnify McAfee.com include:

any obligations assumed by McAfee.com, or payments required to be made by McAfee.com, under its agreements with us;

any losses resulting from third party claims that are related to intellectual property developed by McAfee.com between August 20, 1999 and December 2, 2000;

any obligations incurred by McAfee.com in the ordinary course of business;

any losses resulting from third parties claims made against McAfee.com alleging infringement of intellectual property rights unknown as of the closing of McAfee.com's initial public offering; and

any losses resulting from third parties claims related to or arising from a material misstatement contained in or material omission from the prospectus or the registration statement for McAfee.com's initial public offering.

In the event of a claim relating to a product that includes components supplied by McAfee.com and components supplied by us, we have the right to determine whether and to what extent McAfee.com is entitled to indemnification, after reasonable consultation with McAfee.com.

For so long as we own at least 20% of McAfee.com's outstanding voting power, we must vote our shares of McAfee.com's capital stock in favor of the election of two independent directors. Additionally, if, as described

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below under the stockholders agreement, we have a change of control which is not approved by our continuing directors, we have agreed to vote to elect a majority of independent directors to McAfee.com's board.

Stockholders Agreement. Under this agreement, we have agreed that if (1) without the prior approval of our continuing directors, as defined below, any person acquires or agrees to acquire 15% or more of our outstanding common stock or (2) our continuing directors cease to constitute a majority of serving directors, then for so long but only for so long as that condition exists:

our shares of McAfee.com Class B common stock are entitled to only one vote per share instead of three votes per share; and

we are obligated to vote our McAfee.com shares to cause, and to take such actions reasonably within our control to cause, and to seek to cause the McAfee.com directors appointed by us to cause, McAfee.com's board of directors to consist of at least a majority of independent directors.

Our continuing directors will consist of our current directors and any subsequent directors approved or not objected to by a majority of our then-continuing directors.

Employees

As of December 31, 2001, we employed 3,659 individuals worldwide. Competition for qualified management and technical personnel is intense in the software industry. Our continued success depends in part upon our ability to attract and retain qualified personnel. With limited exceptions, none of our employees are represented by a labor union and we believe that our employee relations are good.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we deem immaterial may also impair our business operations. Any of the following risks could materially adversely affect our business, operating results and financial condition and could result in a complete loss of your investment

Our Financial Results Will Likely Fluctuate.

We were not profitable in 2001, 2000 and 1999. In 2001, we had a net loss of \$100.7 million on net revenues of \$834.5 million compared to a net loss of \$102.7 million on net revenues of \$745.7 million in 2000 and a net loss of \$159.9 million on net revenues of \$683.7 million in 1999.

Our revenues and operating results have varied significantly in the past. We expect fluctuations in our operating results to continue. As a result, we believe that period-to-period comparisons of our financial results should not be relied on as an indicator of our future results. Our expense levels are based in part on our expectations regarding future revenues and in the short term are relatively fixed. We may be unable to adjust our expenses in time to compensate for any unexpected revenue shortfall.

Operational Factors.

Operational factors that may cause our revenues, gross margins and operating results to fluctuate significantly from quarter to quarter include:

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

introduction of new products, product upgrades or updates by us or our competitors;

the mix of products we sell and whether those products are sold directly by us or indirectly through distributors and whether, in the case of software licenses, the licenses are time-based subscription licenses or perpetual licenses;

costs or charges related to our acquisitions or dispositions, including our planned disposition of the Gauntlet firewall and our PGP desktop and wireless encryption product lines;

the components of our revenue, particularly that portion attributable to our ASP/MSP subscription model, that are deferred; and

stock-based compensation charges and costs related to extraordinary events, including litigation and any reductions in forces.

Seasonal and Macroeconomic Factors.

Our net revenue is typically higher in the fourth quarter, as many customers complete annual budgetary cycles, and lower in the summer months when many businesses experience lower sales, particularly in the European market. In recent periods, poor economic conditions in Asia, particularly Japan, and Latin America have hurt our business. Customer concerns about weakening U.S. and global economic conditions and the uncertainties following the terrorist attacks of September 11, 2001 could also harm our business.

It Is Difficult For Us To Estimate Operating Results Prior To The End Of A Quarter.

Because we do not maintain a significant level of backlog, product revenues in any quarter are dependent on contracts entered into or orders booked and shipped in that quarter. Historically, we have experienced a trend toward more product orders, and therefore, a higher percentage of revenue shipments, in the last month of a quarter. Some customers believe they can enhance their bargaining power by waiting until the end of a quarter to place their order.

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We Face Risks Associated With The Integration Of Our PGP Product Group Into Our McAfee And Sniffer Product Groups.

We recently integrated most of the PGP products into our McAfee and Sniffer product groups and are seeking buyers for the remaining assets. Risks related to the integration and possible sales include:

we may not realize our estimated expense reductions of approximately \$50 million in 2002 in full or on a timely basis;

we may experience increased customer dissatisfaction or customer losses, particularly from customers licensing the Gauntlet firewall and PGP desktop and wireless encryption technologies that we plan to sell; and

we may be unable to sell the Gauntlet firewall and PGP desktop and wireless encryption technologies on favorable terms, on a timely basis, or at all.

We Have Recently Experienced Significant Changes In Senior Management And Plan To Add New Members Of Senior Management.

On January 3, 2001, our board of directors appointed George Samenuk as our chief executive officer and president. In April 2001, Stephen C. Richards was appointed as our executive vice president and chief financial officer and was recently named our chief operating officer. In October 2001, Zachary Nelson, who was recently named our chief strategy officer, left that position. We have also recently hired new heads of our Asia-Pacific, European and Latin American operations. In December 2001, Gene Hodges, the president of our McAfee product group, was appointed president of Network Associates and we hired Art Matin to replace Gene Hodges as the president of the McAfee product group. We intend to continue to add new members to senior management. Changes in management may be disruptive to our business and may result in the departure of existing employees and/or customers. It may take significant time to locate, retain and integrate qualified management personnel.

Critical Personnel May Be Difficult To Attract, Assimilate And Retain.

Our success depends in large part on our ability to attract and retain technically qualified and highly skilled sales, consulting, technical, marketing and management employees. Competition for qualified employees is intense, resulting in upward pressure on wages. In addition to our recent management additions, we hired a significant number of new employees in 2000 and 2001. We may continue to add new employees to fill positions vacated by departing employees and to expand our business. There may be reduced levels of productivity as recent hires are trained and otherwise assimilate and adapt to our organization.

Other than executive management who have at will employment agreements, our employees are not typically subject to an employment agreement or non-competition agreement. We may be unsuccessful in retaining key personnel. For example, after April 22, 2000, the end of the 12-month lock-up period for options repriced in April 1999, we experienced a larger than normal level of employee departures as many of these employees elected to terminate their employment with us. We may also have difficulties in retaining employees because many of our employees hold options to purchase our stock at prices significantly above the current market price for our stock.

We Face Risks Related To Our International Operations.

For 2001 and 2000, net revenue from international sales represented approximately 35% and 37%, respectively, of our net revenue. We intend to focus on international growth and expect international revenue to account for a significant percentage of our net revenue. Related risks include:

longer payment cycles and greater difficulty in collecting accounts receivable;

increased costs and management difficulties related to the building of our international sales and support organization;

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the acceptance of the reorganization of our international sales forces by regions;

the need to train and integrate the new heads of Asia-Pacific, Europe and Latin America;

uncertainties relative to regional economic circumstances, including the continued economic weakness in Asia and a weak Euro;

currency fluctuations and risks related to hedging strategies;

political instability in emerging markets;

tariffs, trade barriers and export restrictions; and

a high incidence of software piracy in some countries.

We Depend On Revenue From Our Flagship Anti-Virus And Sniffer Products.

We have historically derived a majority of our net revenues from our flagship McAfee anti-virus software products and Sniffer network fault and performance management products. These products are expected to continue to account for a significant portion of our net revenues for the foreseeable future. Because of this revenue concentration, our business could be harmed by a decline in demand for, or in the prices of, these products as a result of, among other factors, any change in our pricing model, a maturation in the markets for these products or other risks described in this document.

Customers May Cancel Or Delay Product Purchases.

Weakening economic conditions, new product introductions and expansions of our business may increase the time necessary to sell our products and require us to spend more on our sales efforts. Our products may be considered to be capital purchases by our current or prospective customers. Capital purchases are often discretionary and, therefore, are canceled or delayed if the customer experiences a downturn in its business prospects or as a result of economic conditions in general.

We Face A Number Of Risks Related To Our Product Sales Through Distributors.

We sell a significant amount of our products through intermediaries such as distributors. Our top ten distributors typically represent approximately 37% to 42% of our net revenue in any quarter. Our largest distributor, Ingram Micro, accounted for approximately 27% of net revenue during 2001.

Loss of a Distributor.

Our distributor agreements may be terminated by either party without cause. If one of our significant distributors terminates its distribution agreement, we could experience a significant interruption in the distribution of our products.

Need for Accurate Distributor Information.

We recognize revenue on products sold by our distributors when distributors sell our products to their customers. To determine our business performance at any point in time or for any given period, we must timely and accurately gather sales information from our distributors information systems, at an increased cost to us. Our distributors information systems may be less accurate or reliable than our internal systems.

Sale of Competing Products.

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

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Payment Difficulties.

Some of our distributors may experience financial difficulties, which could adversely impact our collection of accounts receivable. Our allowance for doubtful accounts was approximately \$8.4 million at December 31, 2001 and \$15.3 million at December 31, 2000. In 1999, one of our large European distributors, CHS, entered bankruptcy requiring us to record a related accounts receivable write-off of approximately \$28.7 million. Also in 1999, Pinacor, a U.S. distributor, entered bankruptcy requiring us to record a related accounts receivable write-off of approximately \$6.0 million. We regularly review the collectibility and credit-worthiness of our distributors to determine an appropriate allowance for doubtful accounts. Our uncollectable accounts could exceed our current or future allowances.

We Expect Significant Stock-Based Compensation Charges.

We expect to incur stock-based compensation charges related to employee options repriced in April 1999. The size of these charges could be significant depending on movements in the market value of our common stock and, in some cases, the market value of McAfee.com common stock. On December 31, 2001, the market value of our common stock and McAfee.com's common stock was \$25.85 and \$33.91, respectively. Subject to a number of assumptions and limitations, including the timing and number of option exercises, for each \$1.00 increase in the price of our common stock or McAfee.com's common stock, at March 31, 2002 we could expect a stock-based compensation charge of approximately \$2.3 million and \$235,000, respectively. We may also incur additional stock-based compensation charges related to executive compensation arrangements.

We Face The Risk Of Future Non-Recurring Charges In The Event Of Impairment And Will Experience Significant Amortization Charges Related to Purchased Technology.

We adopted SFAS 142 beginning in 2002 and, as a result, we no longer amortize goodwill. However, we will continue to have significant amortization related to purchased technology, trademarks, patents and other intangibles, and we must evaluate our intangible assets, including goodwill and purchased technology, at least annually for impairment. For 2001, our amortization charge for purchased technology and other intangibles was \$13.0 million, and our amortization charge for goodwill was \$51.1 million. If we determine that these items are impaired, we will be required to take a related non-recurring charge to earnings.

We May Need To Use A Large Portion Of Our Cash Balances, Issue A Significant Amount Of Our Common Stock Or Incur Additional Indebtedness To Repurchase Our Outstanding Debentures.

On February 13, 1998, we issued zero coupon debentures having an aggregate face amount at maturity of \$885.5 million and generating net proceeds (after deducting fees and expenses) to us of approximately \$337.6 million. The initial price for the debentures was \$391.06 per \$1,000 of principal amount at maturity. At the option of the holder, we are required to repurchase the debentures as of February 13, 2003 at a repurchase price equal to the initial issue price plus the accretion of original issue discount on the debentures to such date (or \$494.52 per \$1,000 of principal amount at maturity). In the case of such a required repurchase, at our option, we may pay the aggregate repurchase price in cash, shares of our common stock or a combination of cash and common stock. The number of shares of common stock so issued by us would be based on the fair value of our common stock at the time of any required repurchase. On the same date and at the same repurchase price, we may at our option redeem the outstanding debentures for cash.

As of December 31, 2001, we had used \$173.7 million of our cash to repurchase zero coupon debentures having an aggregate face amount at maturity of \$387.0 million. Assuming that as of February 13, 2003, all zero coupon debentures outstanding as of December 31, 2001 are redeemed, the aggregate redemption price would equal approximately \$246.5 million. As of December 31, 2001, our aggregate cash, cash equivalents and marketable securities were approximately \$943.0 million, including \$102.5 million held by McAfee.com.

In anticipation of any repurchase or optional redemption of the debentures, we may issue additional indebtedness to pay all or a portion of the repurchase or redemption price. This indebtedness may be issued in a greater amount than, or on terms less favorable than, the outstanding debentures or notes.

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We Face Risks Related To The Organization Of Our U.S. Professional Services Organization And Sales Efforts By Product Groups.

Our U.S. sales force and related professional service organization are organized by product group: McAfee, Sniffer Technologies and Magic Solutions. Risks related to this structure include:

customer confusion or irritation related to multiple sales calls from different members of our sales forces;

potential losses of cross-selling opportunities and lead sharing between the separate product groups sales representatives;

possible failures by our centralized general and administrative group to meet each product group s individualized infrastructure and support requirements; and

one or more of our product groups lacking sufficient qualified professional services personnel to support its products.

We Face Risks Associated With Past And Future Transactions.

Acquisitions.

We may buy or make investments in complementary companies, products and technologies. Since 1995, we have completed a large number of significant acquisitions involving both public and private companies including the acquisition of CyberMedia and Dr. Solomon s in 1998 and Network General in 1997. We and McAfee.com have also completed a number of smaller acquisitions and we have acquired a number of our international distributors.

Integration of an acquired company or technology involves a complex, time consuming and expensive process. The successful integration of an acquisition requires, among other things, that we:

integrate and retain key management, sales and other personnel;

integrate the acquired products into our product offerings both from an engineering and sales and marketing perspective;

integrate and support preexisting supplier, distribution and customer relationships;

coordinate research and development efforts; and

consolidate duplicate facilities and functions.

The geographic distance between the companies, the complexity of the technologies and operations being integrated, and the disparate corporate cultures being combined may increase the difficulties of integrating an acquired company or technology. Management s focus on the integration of operations may distract attention from our day-to-day business and may disrupt key research and development, marketing or sales efforts. In addition, it is common in the technology industry for aggressive competitors to attract customers and recruit key employees away from companies during the integration phase of an acquisition.

Our available cash and securities may be used to buy or invest in companies or products, possibly resulting in significant acquisition-related charges to earnings and dilution to our stockholders. Moreover, if we buy a company, we may have to incur or assume that company s liabilities, including liabilities that are unknown at the time of acquisition.

Investments.

We have made a number of venture and minority investments in private and publicly-traded companies with complementary products, services and technologies. As of December 31, 2001, the minority venture investments we continue to hold totaled \$2.4 million consisting of investments in public and private companies, amounting to \$2.2 million and \$200,000, respectively. During 2001, we recorded a \$20.6 million impairment charge in connection with these investments. We may make additional strategic investments.

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We Could Experience Customer And Market Confusion Due To Similarities In The Names Used By Our Different Product Groups And Subsidiaries.

Network Associates, our product groups and our subsidiaries, often have similar and potentially confusing names, products and Web addresses. For example, our online consumer anti-virus products are sold by our publicly traded McAfee.com subsidiary, our retail and large corporate anti-virus products are sold by our retail division, which is called McAfee Retail, and our hosted anti-virus products are marketed and sold by our McAfee product group. Customers of our McAfee product group are frequently confused by the need to access information regarding our products and services at www.mcafeeb2b.com. The web address www.mcafee.com is utilized by our publicly traded subsidiary McAfee.com.

We Face Risks Related To Our Application Service Provider Strategy.

Customers of our ASP or hosted products and services essentially rent the use our software. For example, McAfee ASaP offers hosted services to corporate customers and McAfee.com is dedicated to updating, upgrading and managing PCs over the Internet for consumers and small to medium-sized businesses. This web-based model is a relatively new concept, and our ASP products and services may fail to maintain or increase market acceptance. The growth, market acceptance and ultimate profitability of our ASP services is highly uncertain and subject to a number of factors, including:

our ability to successfully adapt existing products or develop new or enhanced products that operate in a fast, secure and reliable manner over the Internet;

increased expenditures associated with the creation of a new business or delivery platform, such as product development, marketing and technical and administrative support;

the introduction of new products by third-party competitors; and

our ability to properly price our products and services to generate the greatest revenue opportunities.

Our Managed Service Provider Strategy Exposes Us To Risks In Addition To Those Generally Experienced As An ASP.

We also make our hosted products and services available over the Internet in what we refer to as a managed environment. Unlike our ASP solutions, these managed service provider, or MSP, solutions are customized, monitored and updated by networking professionals for a specific customer. To successfully offer MSP services we must:

effectively monitor and customize each customer's managed services;

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

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

We also allow intermediaries, such as Internet Service Providers, to sell and host our products and services in a managed environment. This MSP reseller strategy exposes us to additional risks:

we must select, train and maintain qualified and financially stable MSP resellers;

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

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

our MSP resellers may compete with our own MSP efforts.

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We Face Risks Related To Our Relationship With McAfee.com.

We have entered into various inter-company arrangements with McAfee.com, our publicly traded subsidiary. Pursuant to our cross license agreement with McAfee.com, we have licensed all our technology to McAfee.com for use in the markets specified below and McAfee.com has licensed its technology to us for our use outside of McAfee.com's markets. Our license and other agreements with McAfee.com expose us to risks, including:

subject to the reseller agreement described below, McAfee.com has the exclusive right to use the licensed technology for providing single-user consumer licenses for our products and services sold over the Internet or for Internet-based products and licensing the technology to original equipment manufacturers for sale to individual consumers;

we may not offer a product incorporating third-party technology if those products are competitive with products offered by McAfee.com;

the license agreement is perpetual and may only be terminated by us if McAfee.com fails to cure a material breach of the license within 30 days after we notify it of the breach, subject to mandatory dispute resolution prior to the effectiveness of any proposed termination; and

we are required to indemnify McAfee.com with respect to litigation related to our licensed technology.

These risks manifest themselves, among other ways, in terms of customer confusion, sales force confusion over market boundaries and possible conflicts between the companies.

In March 2001, we entered into reseller agreements with McAfee.com. Under these agreements, McAfee.com may resell our products to business customers, except in Japan, and, in certain countries, we may sell McAfee.com products to OEMs and end-users directly or through ASPs.

We Are Subject To Intense Competition In The Network Management And Security Markets And We Expect To Face Increased Competition In The Future.

The markets for our products are intensely competitive and we expect competition to increase in the near-term. Some of our competitors have longer operating histories, greater name recognition, larger technical staffs, established relationships with hardware vendors and/or greater financial, technical and marketing resources.

Anti-Virus Software.

Our principal competitor in the anti-virus market is the Norton Product Group of Symantec. Trend Micro remains the strongest competitor in the Asian anti-virus market, with Dr. Ahn's making recent inroads, particularly in Japan and Korea. Other anti-virus competitors include numerous smaller companies and shareware authors that may in the future develop competing software or be consolidated into larger competitors.

Network Security.

Our principal competitors in the security market vary by product type. For firewalls, our principal competitors include CheckPoint, Symantec, and larger companies such as Cisco Systems and Microsoft. For intrusion detection products, we compete with Cisco Systems, Internet Security Systems and Symantec. The markets for encryption and virtual private network, or VPN, products are highly fragmented with numerous small and large vendors. VPN competitors include hardware and software vendors, including telecommunications companies and traditional networking suppliers.

Network Management.

Our principal competitor in the network management market is Agilent. Other competitors include Acterna Corporation, Cisco Systems, Computer Associates, Compuware, Concord Communications,

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DeskTalk Systems, GN Nettek, Network Instruments, Radcom Technologies, Shomiti Systems and WildPackets.

Helpdesk.

Our principal competitors in the help desk market are Computer Associates, FrontRange Solutions and Peregrine Systems.

Other Competitors.

We also face competition from large software companies such as HP, Intel, Microsoft and Novell, which may offer network security and management products as enhancements to their operating system.

We Face Product Development Risks Associated With Rapid Technological Changes In Our Market.

The network security and management market is highly fragmented and characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements. Our success depends on our ability to timely and effectively:

offer a broad range of network security and management software products;

enhance existing products and expand product offerings;

respond promptly to new customer requirements and industry standards; and

remain compatible with popular operating systems such as Linux, NetWare, Windows XP, Windows 2000, Windows 98 and Windows NT, and develop products that are compatible with new or otherwise emerging operating systems.

We may experience delays in software development as we have at times in the past. Complex software products like ours may contain undetected errors or version compatibility problems, particularly when first released, which could delay or harm market acceptance.

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

Competitors May Include Products Similar To Ours In Their Hardware Or Software And Render Our Products Obsolete, And If There Are Fewer Weaknesses In Third-Party Software, The Perceived Need For Our Software May Decline.

Vendors of hardware and of operating system software or other software (such as firewall or e-mail software) may enhance their products or bundle separate products to include network security and management software similar to our products. From time to time, Microsoft has indicated that it would incorporate its own anti-virus software or functionality into its products. The widespread inclusion of products that perform the same or similar functions as our products within computer hardware or other software could render our products obsolete and unmarketable. Furthermore, even if these incorporated products are inferior or more limited than our products, customers may elect to accept the incorporated products rather than purchase our products. If we are unable to develop new network security and management products to further enhance operating systems or other software and to successfully replace any obsolete products, our business could suffer.

Many current viruses exploit known weaknesses in third-party software. If these weaknesses are corrected or, if there are fewer third-party software weaknesses, the perceived need for our products may decline.

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Our Hardware Based Products Face Manufacturing, Supply, Inventory, Licensing And Obsolescence Risks.

Third-Party Manufacturing.

We rely on a small number of third parties to manufacture some of our hardware-based Sniffer and E-ppliance products. We expect the number of our hardware-based products and our reliance on third-party manufacturers to increase as software-only network security and management solutions become less viable. Reliance on third-party manufacturers involves a number of risks, including the lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. If any of our third party manufacturers cannot or will not manufacture our products in required volumes, on a cost-effective basis, in a timely manner, or at all, we will have to secure additional manufacturing capacity. Even if this additional capacity is available at commercially acceptable terms, the qualification process could be lengthy and could cause interruptions in product shipments. The unexpected loss of any of our manufacturers would be disruptive to our business.

Sourcing.

Our hardware-based products contain critical components supplied by a single or a limited number of third parties. Any significant shortage of components or the failure of the third-party supplier to maintain or enhance these products could lead to cancellations of customer orders or delays in placement of orders.

Third-Party Licenses.

Some of our hardware-based products incorporate licensed software. We must be able to obtain reasonably priced licenses and successfully integrate this software with our hardware.

Obsolescence.

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

We Rely On The Continued Prominence Of Microsoft Technology.

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

We May Fail To Support Operating Systems Which Successfully Compete With Microsoft's Technology, Including Competing Versions Of The Unix Operating System.

We are expanding our product support to include the Unix operating system and the Linux operating system. Sales of our products could be materially and adversely impacted by our failure to support those operating systems or competing operating systems that receive broad market acceptance. The Unix system encompasses many separate operating systems of which we only support a few, including for example, Sun Microsystems Solaris Unix operating system.

We Rely Heavily On Our Intellectual Property Rights Which Offer Only Limited Protection Against Potential Infringers.

We rely on a combination of contractual rights, trademarks, trade secrets, patents and copyrights to establish and protect proprietary rights in our software. However, the steps taken by us to protect our

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proprietary software may not deter its misuse or theft. We are aware that a substantial number of users of our anti-virus products have not paid any registration or license fees to us. Competitors may also independently develop technologies or products that are substantially equivalent or superior to our products. Changing legal interpretations of liability for unauthorized use of our software, or lessened sensitivity by corporate, government or institutional users to avoiding infringement of intellectual property could also harm our business.

Intellectual Property Litigation In The Network Security And Management Market Is Common and Can Be Expensive.

Litigation may be necessary to enforce and protect trade secrets and other intellectual property rights that we own. Similarly, we may be required to defend against claimed infringement by others.

In addition to the expense and distractions associated with litigation, adverse determinations could:

result in the loss of our proprietary rights;

subject us to significant liabilities, including monetary liabilities;

require us to seek licenses from third parties; or

prevent us from manufacturing or selling our products.

The litigation process is subject to inherent uncertainties. We may not prevail in these matters, or we may be unable to obtain licenses with respect to any patents or other intellectual property rights that may be held valid or infringed upon by our products or us.

If we acquire a portion of software included in our products from third parties, our exposure to infringement actions may increase because we must rely upon these third parties as to the origin and ownership of any software being acquired. Similarly, exposure to infringement claims increase if we employ or hire software engineers previously employed by competitors, notwithstanding measures taken by us or our competitors to protect our competitors' intellectual property.

Pending Or Future Litigation Could Have A Material Adverse Impact On Our Results Of Operation And Financial Condition.

In addition to intellectual property litigation, from time to time, we have been subject to litigation. Where we can make a reasonable estimate of the liability relating to pending litigation, we record a related liability. As additional information becomes available, we assess the potential liability and revise estimates as appropriate. However, because of uncertainties relating to litigation, the amount of our estimates could be wrong. In addition to the related cost and use of cash, pending or future litigation could cause the diversion of management's attention and resources. A putative securities class action is currently pending against us, our directors and our former officers. The plaintiffs allege that we and the other defendants improperly engaged in a course of conduct by which we improperly accounted for revenue from our software license sales and that, as a result, certain of our financial statements were false and misleading and not in compliance with generally accepted accounting principles.

Product Liability And Related Claims May Be Asserted Against Us.

Our network security and management software products are used to protect and manage computer systems and networks that may be critical to organizations. As a result, our sale and support of these products involves the risk of potential product liability and related claims. Our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that the limitation of liability provisions may not be effective under the laws of certain jurisdictions, particularly in circumstances involving unsigned licenses.

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Computer Hackers May Damage Our Products, Services and Systems.

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

False Detection Of Viruses And Actual Or Perceived Security Breaches Could Adversely Affect Our Business.

Our anti-virus software products have in the past and may at times in the future falsely detect viruses that do not actually exist. These false alarms, while typical in the industry, may impair the perceived reliability of our products and may therefore adversely impact market acceptance of our products. In addition, we have in the past been subject to litigation claiming damages related to a false alarm, and similar claims may be made in the future. An actual or perceived breach of network or computer security at one of our customers, regardless of whether the breach is attributable to our products, could adversely affect the market's perception of our security products.

Business Interruptions May Impede Our Operations And Adversely Affect Our Business.

We face a number of potential business interruption risks that are beyond our control. The State of California has recently experienced intermittent power shortages, sharp increases in the cost of energy and even interruptions of service to some business customers.

Additionally, we may experience natural disasters that could interrupt our business. Our corporate headquarters is located near a major earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure and overall operations is not known. Despite safety precautions that have been implemented, there is no guarantee that an earthquake would not seriously disturb our entire business process. We are largely uninsured for losses and business disruptions caused by an earthquake and other natural disasters.

We Face Risks Associated With U.S. Government Contracting.

We are currently engaged in several research and development contracts with agencies of the U.S. government. The willingness of these government agencies to enter into future contracts with us depends in part on our continued ability to meet their expectations.

Minimum fee awards for companies entering into government contracts are generally between 3% and 7% of the costs incurred by them in performing their duties under the related contract. However, these fee awards may be as low as 1% of the contract costs. Furthermore, these contracts are subject to cancellation at the convenience of the government agencies. Although we have been awarded contract fees of more than 1% of the contract costs in the past, minimum fee awards or cancellations may occur in the future. Reductions or delays in federal funds available for projects we are performing could also have an adverse impact on our government business. Contracts involving the U.S. government are also subject to the risks of disallowance of costs upon audit, changes in government procurement policies, required competitive bidding and, with respect to contracts involving prime contractors or government-designated subcontractors, the inability of those parties to perform under their contracts.

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Our Cryptography Technology Is Subject To Export Restrictions.

Some of our network security products, particularly those incorporating encryption, may be subject to export restrictions. As a result, some products may not be exported to international customers without prior U.S. government approval. The list of products and end users for which export approval is required, and the regulatory policies with respect thereto, are subject to revision by the U.S. government at any time. The cost of compliance with U.S. and international export laws and changes in existing laws could affect our ability to sell certain products in certain markets, and could have a material adverse effect on our international revenues.

Our Stock Price Has Been Volatile And Is Likely To Remain Volatile, Which May Adversely Affect The Price Of Our Stock.

During 2001, our stock price was highly volatile ranging from a per-share high of \$27.27 to low of \$4.19. Announcements, litigation developments, and our ability to meet the expectations of investors with respect to our operating and financial results may contribute to current and future stock price volatility. We may not discover, or be able to confirm, revenue or earnings shortfalls until the end of a quarter, which could result in an immediate drop in our stock price. In addition, similar events with respect to McAfee.com, our publicly traded subsidiary, and fluctuations in its stock price, may also contribute to the volatility of our stock price. Securities class action litigation has been instituted following previous periods of volatility. A number of putative class actions were brought against our former officers, directors and us. This litigation, and any other litigation, could result in substantial costs and a diversion of management's attention and resources.

Future Sales Of Our Common Stock In The Public Market Or Option Exercises And Sales Could Lower Our Stock Price.

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

Our Charter Documents And Delaware Law, Our Rights Plan And Our Stockholders Agreement With McAfee.com May Impede Or Discourage A Takeover, Which Could Lower Our Stock Price.

Our Charter Documents and Delaware Law

Pursuant to our charter, our board of directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote of action by our stockholders. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock.

Our classified board and other provisions of Delaware law and our certificate of incorporation and bylaws, could also delay or make a merger, tender offer or proxy contest involving us more difficult.

Our Rights Plan

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

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Our Stockholders Agreement with McAfee.com

Under our McAfee.com stockholders agreement we agreed that if (1) without the prior approval of our continuing directors, as defined below, any person acquires or agrees to acquire 15% or more of our outstanding common stock or (2) our continuing directors cease to constitute a majority of our serving directors, then for so long but only for so long as that condition exists:

our shares of McAfee.com Class B common stock will be entitled to only one vote per share instead of three votes per share; and

we will be obligated to vote our McAfee.com shares to cause, and to take such actions reasonably within our control to cause, and shall seek to cause the McAfee.com directors appointed by us to cause, the McAfee.com board of directors to consist of at least a majority of independent directors.

Our continuing directors consist of our current directors and any subsequent directors approved or not objected to by a majority of our then-continuing directors.

Item 2. *Properties*

Our headquarters currently occupy 208,368 square feet in facilities located in Santa Clara, California under leases expiring in 2013. Worldwide, we lease facilities with approximately 1.0 million total square feet, with leases that expire at various times. Our primary international facilities are located in Australia, Brazil, Germany, Japan, the Netherlands and the United Kingdom. Other significant domestic sites include Maryland, Oregon and Texas. We believe that our existing facilities are adequate for the present and that additional space will be available as needed.

In 2001, we purchased 15.6 acres of land in Legacy Corporate Park, Plano, Texas to construct a new regional office in the Dallas area.

Item 3. *Legal Proceedings*

Information with respect to this item is incorporated by reference to Note 16 to the Notes to Consolidated Financial Statements included in this Form 10-K.

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

No matters were submitted to a vote of stockholders during the fourth quarter of the year ended December 31, 2001.

Table of Contents**PART II****Item 5. Market for the Registrant's Common Equity and Related Stockholder Matters****Price Range of Common Stock**

Since our initial public offering on October 6, 1992, our common stock has traded on the NASDAQ National Market. Since the combination with Network General Corporation on December 1, 1997, our common stock has traded under the symbol NETA. Prior thereto, our common stock traded under the symbol MCAF. Effective February 12, 2002, our common stock will commence trading on the New York Stock Exchange (NYSE) under the symbol NET and will no longer be traded on NASDAQ.

The following table sets forth, for the period indicated, the high and low closing sales prices for our common stock for the last eight quarters, all as reported by NASDAQ. The prices appearing in the tables below reflect over the counter market quotations, which reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	<u>High</u>	<u>Low</u>
Year Ended December 31, 2001		
First Quarter	\$ 8.38	\$ 4.19
Second Quarter	16.50	6.00
Third Quarter	16.84	10.56
Fourth Quarter	27.27	13.40
Year Ended December 31, 2000		
First Quarter	\$36.69	\$23.31
Second Quarter	29.25	19.75
Third Quarter	26.25	18.19
Fourth Quarter	23.00	4.13

Dividend Policy

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

Holders of Common Stock

As of December 31, 2001, there were 1,083 record owners of our common stock.

Table of Contents**Item 6. Selected Financial Data**

	Years Ended December 31,				
	2001	2000	1999	1998	1997
(In thousands, except for per share amounts)					
Statement of Operations Data:					
Net revenue	\$ 834,478	\$ 745,692	\$ 683,668	\$ 990,045	\$ 735,692
Income (loss) from operations	(81,966)	(151,967)	(138,199)	119,966	61,947
Income (loss) before income taxes, minority interest and extraordinary item	(91,383)	(97,751)	(130,998)	138,167	82,813
Income (loss) before extraordinary item	(102,381)	(102,721)	(159,901)	36,438	10,639
Extraordinary item, gain on redemption of debt, net of taxes	1,731				
Net income (loss)	(100,650)	(102,721)	(159,901)	36,438	10,639
Net income (loss) per share, before extraordinary item, basic	\$ (0.74)	\$ (0.74)	\$ (1.15)	\$ 0.27	\$ 0.08
Net income (loss) per share, before extraordinary item, diluted	\$ (0.74)	\$ (0.74)	\$ (1.15)	\$ 0.26	\$ 0.08
Extraordinary item, basic	\$ 0.01	\$	\$	\$	\$
Extraordinary item, diluted	\$ 0.01	\$	\$	\$	\$
Net income (loss) per share, basic	\$ (0.73)	\$ (0.74)	\$ (1.15)	\$ 0.27	\$ 0.08
Net income (loss) per share, diluted	\$ (0.73)	\$ (0.74)	\$ (1.15)	\$ 0.26	\$ 0.08
Shares used in per share calculation basic	137,847	138,072	138,695	133,075	126,662
Shares used in per share calculation diluted	137,847	138,072	138,695	138,609	132,729

	Years Ended December 31,				
	2001	2000	1999	1998	1997
Balance Sheet Data:					
Cash and cash equivalents	\$ 612,832	\$ 275,539	\$ 316,784	\$ 418,899	\$ 157,031
Working capital	541,753	196,993	285,665	537,056	247,811
Total assets	1,627,132	1,384,848	1,479,394	1,536,721	805,350
Deferred revenue and taxes	294,805	186,129	163,816	205,598	129,557
Long term debt and other liabilities	579,243	396,868	379,267	374,132	2,353
Total equity	444,787	518,651	660,106	722,838	492,501

Table of Contents**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**
Results Of Operations**Years Ended December 31, 2001, 2000 and 1999**

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

	Years Ended December 31,		
	2001	2000	1999
Net revenue:			
Product	67%	68%	69%
Services and support	33	32	31
	—	—	—
Total revenue	100	100	100
Cost of net revenue:			
Product	12	15	13
Services and support	7	6	6
	—	—	—
Total cost of net revenue	19	21	19
Operating costs and expenses:			
Research and development	18	23	22
Marketing and sales	52	54	54
General and administrative	13	11	12
Provision for doubtful accounts, net		2	7
Amortization of intangibles	8	9	9
Acquisition, restructuring and other related costs			(3)
	—	—	—
Total operating costs and expenses	91	99	101
	—	—	—
Loss from operations	(10)	(20)	(20)
Interest and other income	3	6	5
Interest expense	(3)	(2)	(3)
Gain (loss) on investments, net	1	4	(1)
Write down of strategic and other investments	(2)	(1)	
	—	—	—
Loss before provision for income taxes, minority interest, and extraordinary item	(11)	(13)	(19)
	—	—	—
Provision for income taxes	1	1	4
	—	—	—
Net loss before minority interest and extraordinary item	(12)	(14)	(23)
	—	—	—
Minority interest in loss of consolidated subsidiary		1	
	—	—	—
Net loss before extraordinary item	(12)	(13)	(23)
	—	—	—
Extraordinary item, gain on redemption of debt, net of taxes			
	—	—	—
Net loss	(12)%	(13)%	(23)%



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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. Each business operates in one industry: computer security, management, and availability software, hardware and related services for, primarily, consumer, corporate and government users.

Our infrastructure business is operated in six geographic regions: the United States, Europe, Japan, Canada, Asia-Pacific and Latin America. To more effectively market our infrastructure business products in these geographic regions, we have combined complementary products into three product groups: McAfee, Sniffer Technologies and Magic. McAfee.com is an ASP targeted at consumers and small to medium-sized businesses.

PGP Integration and Disposition. In the fourth quarter of 2001, we substantially completed integrating the activities of our PGP product group into our McAfee and Sniffer product groups. In 2001, the PGP product group accounted for approximately 6% of net revenue. We are seeking buyers for the PGP desktop encryption and Gauntlet firewall products. In connection with the PGP integration, we recorded a restructuring charge of approximately \$3.8 million during the fourth quarter of 2001, consisting primarily of the costs related to severance packages for 100 affected employees. Related to this integration, we also expect, among other things:

to record an additional restructuring charge of approximately \$5.0 million related to the divestiture of those PGP Security products that were not integrated into our Sniffer and McAfee product groups;*

expense reductions of up to approximately \$50 million in 2002, primarily in the areas of cost of services and support, research and development, marketing and sales and to a lesser extent, general and administrative expenses;* and

overall revenue to be adversely impacted in at least the near-term due to, among other things, possible uncertainty on the part of those customers purchasing the PGP Security products being sold.*

Change in Distributor Business Model. We market a significant portion of our products to end-users through intermediaries, including distributors. In December 2000, in light of the business decision by some of our distributors, including our largest distributor, to reduce inventory levels, and due to the unpredictability of demand in the distribution channel, we began a transition from a sell-in to a sell-through business model. Commencing January 1, 2001, we moved to the sell-through business model for each distributor. Under this model, we recognize revenue on products sold to distributors when the products are resold by the distributor to their customers.

Results reported for the quarter and year ended December 31, 2000, include a significant reduction to net revenue due to some of our distribution partners' business decision to reduce their inventory levels by not replenishing their inventory and requesting returns over and above their contractual rights. Under the terms of their distribution agreements at that time, our distributors had title to, and risk of loss with respect to, the distributor inventory subject to these requested returns. As of December 31, 2000, goods that were held by our distributors and not subject to a returns allowance totaled \$10.9 million.

Net Revenue. Net revenue increased 12% to \$834.5 million in 2001 from \$745.7 million in 2000, including a \$15.2 million increase in revenue from McAfee.com. Net revenue increased 9% to \$745.7 million in 2000 from \$683.7 million in 1999, including a \$22.4 million increase in revenue from McAfee.com.

* 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 11 of this document.

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

	Years Ended December 31,		
	2001	2000	1999
Product	67%	68%	69%
Services and support	33	32	31
Net revenue	100%	100%	100%

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

	Years Ended December 31,		
	2001	2000	1999
Subscription licenses	37%	44%	42%
Perpetual licenses	33	23	25
Hardware	16	18	11
Retail	13	13	19
Royalties and other	1	2	3
Product revenue	100%	100%	100%

Product revenue includes revenue from software licenses, hardware, our retail product and royalties. Product revenue increased 10% to \$557.0 million in 2001 from \$505.9 million in 2000. The increase in product revenue from 2000 to 2001 was attributable to an increase in new customer purchases of our anti-virus suite of products and the successful introduction of several new anti-virus products during the year. Product revenue increased 7% to \$505.9 million in 2000 from \$474.1 million in 1999. In 1999, product revenue was impacted by our decision to limit distributor orders in an effort to realign channel inventory levels as a result of Year 2000 concerns and increasing sales cycles for our products. The increase in product revenue from 1999 to 2000 is due to an increase in new customer purchases of our anti-virus suite of products and network fault and performance suite of products. In 2000, we also experienced positive results from our organization into separate product groups, with separate sales groups focused on selling their respective products.

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.

	Years Ended December 31,		
	2001	2000	1999
Support and maintenance	64%	67%	75%
Consulting	14	14	13
Training	7	8	11
Hosting arrangements	15	11	1

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Services and support revenue	100%	100%	100%
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Services and support revenues include revenues from software support and maintenance contracts, consulting, training and hosting arrangements. Service revenues increased 16% to \$277.4 million in 2001 from \$239.8 million in 2000. The increase in services and support revenues from 2000 to 2001 resulted from a \$14.8 million increase in hosting revenue generated by McAfee.com; a \$17.1 million increase in maintenance and support revenue, principally due to the growth of our installed customer base and the resulting renewal of

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support and maintenance contracts; and an increase of \$5.8 million in consulting and training revenue. Service revenues increased 14% to \$239.8 million in 2000 from \$209.6 million in 1999. The increase in services and support revenues from 1999 to 2000 resulted from a \$23.9 million increase in hosting revenue generated by McAfee.com and a \$6.3 million increase in all other categories of service revenues.

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 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 35%, 37% and 40%, of net revenue for 2001, 2000 and 1999, respectively. The decrease in international revenue as a percentage of net revenue from 2000 to 2001 was due to under-performance in sales operations in Europe; the weak economy in Japan; and, changes in sales management in our Asia-Pacific region. The decrease in international net revenue as a percentage of net revenue from 1999 to 2000 was due to under-performance in sales operations and changes in sales management in Europe; the weak economy in Japan; and weakness in the Euro.

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, tariffs and other trade barriers, and difficulties staffing and managing foreign operations. These factors may have a material adverse effect on our future international revenue.

Cost of Net Revenue. Cost of net revenue increased 1% to \$158.1 million in 2001 from \$156.7 million in 2000, including an increase of \$4.5 million from McAfee.com. Cost of net revenue increased 20% to \$156.7 million in 2000 from \$130.8 million in 1999. The cost of net revenue from 2000 to 2001 decreased as a percentage of net revenue from 21% to 19% in 2001. The increase in the cost of net revenue from 1999 to 2000 was primarily due to the increase in net revenue. The cost of net revenue from 2000 to 2001 remained relatively flat due to an increase in the cost of service and support revenue offset by a decrease in cost of product revenue. The cost of net revenue increased as a percentage of net revenue from 19% in 1999 to 21% in 2000.

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 decreased 10% to \$103.1 million in 2001 from \$114.4 million in 2000. The decrease from 2000 to 2001 in the cost of product revenue relates to a \$10.2 million decrease in materials costs attributable to computer platforms and other hardware product costs; and, \$1.4 million in cost savings associated with discontinuing the myCIO.com business unit, offset by an increase in product costs associated with government contracts. Cost of product revenues increased 29% to \$114.4 million in 2000 from \$88.7 million in 1999. The increase in product cost of revenue from 1999 to 2000 was due to a \$27.0 million increase in materials costs attributable to computer platforms and other hardware product costs resulting from an increase in hardware revenue, offset by a decrease in product costs associated with government contracts. As a percentage of net product revenue, cost of product revenue was 19%, 23% and 19% in 2001, 2000 and 1999, respectively.

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 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 30% to \$55.0 million in 2001 from \$42.3 million in 2000. The increase from 2000 to 2001 was due almost exclusively to additional technical support and customer service personnel hired during 2001 to meet our customers' technical support needs. The cost of services and support revenue remained relatively flat at \$42.3 million in 2000 and \$42.1 million in 1999. Cost of services and support revenue as a percentage of net services and support revenue, was 20%, 18% and 20% in 2001, 2000 and 1999, respectively.

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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 in absolute terms and as a percentage of net revenue in future periods.* We expect savings of up to approximately \$5.4 million in cost of service and support in 2002 as a result of the PGP integration and disposition.*

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 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):

	Years Ended December 31,		
	2001	2000	1999
Research and development(1)	\$ 142,097	\$ 171,574	\$ 148,213
Marketing and sales(2)	424,907	396,293	362,924
General and administrative(3)	100,711	82,317	79,860
Provision for doubtful accounts	(1,473)	15,784	44,809
Amortization of intangibles	64,110	66,282	58,400
Acquisition, restructuring and related charges(4)	3,302		(18,732)
	<hr/>	<hr/>	<hr/>
Total operating costs and expenses, excluding the effects of stock-based compensation	\$ 733,654	\$ 732,250	\$ 675,474
	<hr/>	<hr/>	<hr/>

- (1) Excludes stock-based compensation charge of \$4,604, \$1,894 and \$4,515 for 2001, 2000 and 1999, respectively.
- (2) Excludes stock-based compensation charge of \$10,354, \$4,570 and \$7,162 for 2001, 2000 and 1999, respectively.
- (3) Excludes stock-based compensation charge of \$9,235, \$2,250 and \$3,893 for 2001, 2000 and 1999, respectively.
- (4) Excludes stock-based compensation charge of \$519, \$0 and \$0 for 2001, 2000 and 1999, 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 \$4.6 million and \$1.9 million in 2001 and 2000, respectively, research and development expenses decreased 17% to \$142.1 million in 2001 from \$171.6 million in 2000. Of the total decrease, approximately \$15.1 million was attributable to the discontinuance of certain previously out-sourced development efforts; \$11.2 million was attributable to the conversion of temporary personnel into full-time employees; and the balance was due to overall efficiencies achieved by our research and development group.

Excluding the effects of stock-based compensation of \$1.9 million and \$4.5 million in 2000 and 1999, respectively, research and development expenses increased 16% to \$171.6 million in 2000 from \$148.2 million in 1999. Of the increase, approximately \$19.0 million was due to the increase in out-sourced development efforts and the balance was due to an increase in the number of permanent and temporary personnel to support growth in our product and service offerings.

As a percentage of net revenue, research and development expenses were 18%, 23% and 22% in 2001, 2000 and 1999, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, research and development expenses were 17%, 23% and 22% in 2001, 2000 and 1999, respectively. We believe that continued investment in product development is critical to attaining our strategic objectives and, as a result, expect product development expenses to increase in future periods. We anticipate that research and development

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expenses will continue to increase in absolute dollars, but will continue to fluctuate as a percent of net revenue.* We expect savings of up to approximately \$19.4 million in research and development expenses in 2002 as a result the PGP integration and disposition.* Excluding stock-based compensation charges, we expect research and development expenses in 2002 to range between 15% and 17% 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 \$10.4 million and \$4.6 million in 2001 and 2000, respectively, marketing and sales expenses increased 7% to \$424.9 million in 2001 from \$396.3 million in 2000. Of the total increase, approximately \$17.3 million was due to an increase in commission expense associated with increases in our revenues. The balance of the increase was due to additional salary and other personnel costs associated with additional international marketing and sales personnel hired during 2001.

Excluding the effects of stock-based compensation of \$4.6 million and \$7.2 million in 2000 and 1999, respectively, marketing and sales expenses increased 9% to \$396.3 million from \$362.9 million in 1999. Approximately \$20.9 million of this increase relates to the use of out-sourced marketing and other professional services related to additional marketing and sales activities associated with advertising and promotions for McAfee.com. The balance of the increase is related to hiring and training of our enterprise level sales force.

As a percentage of net revenue, marketing and sales expense was 52%, 54% and 54% in 2001, 2000 and 1999, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, marketing and sales expense was 51%, 53% and 53% in 2001, 2000 and 1999, respectively. We anticipate that marketing and sales expenses will continue to increase in absolute dollars, but will continue to fluctuate as a percentage of net revenue.* We expect savings of up to approximately \$24.3 million in marketing and sales expenses in 2002 as a result of the PGP integration and disposition.* Excluding stock-based compensation charges, we expect marketing and sales expenses in 2002 to range between 45% and 50% of net revenue.*

General and Administrative. General and administrative expenses consist principally of salary and benefit costs for executive and administrative personnel, professional services and other general corporate activities. Excluding the effect of stock-based compensation of \$9.2 million and \$2.3 million for 2001 and 2000, respectively, general and administrative expenses increased 22% to \$100.7 million in 2001 from \$82.3 million in 2000. Of the total increase, approximately \$9.9 million related to an increase in legal fees and litigation related charges and approximately \$2.2 million related to severance for our former executives. The balance of the increase was related to an increase in personnel and recruiting services costs associated with hiring our chief executive officer, chief financial officer, international executives and additional finance, accounting, and administrative personnel.

Excluding the effects of stock-based compensation of \$2.3 million and \$3.9 million in 2000 and 1999, respectively, general and administrative expenses increased 3% to \$82.3 million in 2000 from \$79.9 million in 1999. The increase in general and administrative expenses from 1999 to 2000 was related almost exclusively to the increase in the charges related to the expansion of our worldwide information technology infrastructure.

As a percentage of net revenues, general and administrative expenses were 13%, 11% and 12% in 2001, 2000 and 1999, respectively. Excluding stock-based compensation charges, as a percentage of net revenue, general and administrative expenses, were 12%, 11% and 12% in 2001, 2000 and 1999, respectively. We expect our 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.* We expect savings of up to approximately \$1.2 million in general and administrative expenses in 2002 as a result the PGP integration and disposition.* Excluding stock-based compensation charges, we expect general and administrative expenses in 2002 to range between 9% and 11% of net revenue.*

Provision for Doubtful Accounts, Net. Provision for doubtful accounts consists of our estimates for the uncollectability of receivables, net of recoveries of amounts previously written off. The provision for doubtful accounts became a net recovery of \$1.5 million in 2001 from a provision of \$15.8 million in 2000. Of this change, approximately \$11.4 million related to previously reserved receivables from two distributors who were undergoing restructurings of their business operations and experiencing cash flow difficulties at the end of

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2000. The balance is due to improved quality in our overall receivables. The provision for doubtful accounts decreased by 65% to \$15.8 million in 2000 from \$44.8 million in 1999. In 1999, one of our largest European distributors entered bankruptcy requiring us to record a related provision of approximately \$28.7 million. Also in 1999, Pinacor, a U.S. distributor, entered bankruptcy requiring us to record a related accounts receivable write-off of approximately \$6.0 million.

Amortization of Intangibles. We expensed \$64.1 million, \$66.3 million and \$58.4 million of amortization related to intangibles in 2001, 2000 and 1999, respectively. Intangibles consist of purchased goodwill, purchased technology and other identifiable intangible assets. The decrease in amortization in 2001 was a result of certain purchased technology and other intangible assets being fully amortized during 2001, decreasing the annual amortization by \$4.2 million, partially offset by an increase in amortization amounting to \$2.0 million in trademarks and patents acquired during 2001. The increase in amortization in 2000 resulted from a \$3.6 million impairment charge recognized by McAfee.com (described below), an increase of \$3.3 million of amortization for the additions to goodwill related to McAfee.com's acquisitions during 2000, a \$1.3 million increase in amortization expense associated with additions to patents and trademarks, offset by a slight decrease of \$0.3 million related to certain other intangible assets being fully amortized during 2000. During 2000, McAfee.com performed a review of the carrying value of the goodwill associated with one of its acquisitions and recognized an impairment charge of \$3.6 million. McAfee.com determined that certain storage technology purchased as part of the original acquisition was not able to be incorporated into future products. Accordingly, the full carrying value of the unamortized goodwill and purchased technology was written off.

Acquisition, Restructuring and Other Related Costs. Acquisition accruals were established in 1997 and 1998 in connection with various pooling of interest transactions. In the quarters ended June 30, 1999 and September 30, 1999, we reassessed these estimated accruals and concluded that no additional costs were to be incurred related to these pooling transactions. As such, in 1999 the unused acquisition accruals of \$18.7 million were released back into acquisition, restructuring and other related costs.

In connection with the PGP integration and planned disposition, we recorded a restructuring charge of approximately \$3.8 million during the fourth quarter of 2001. The restructuring charge consists of the costs related to severance packages for 100 affected employees.

The following table sets forth our restructuring accrual established in 2001, and the activity against the accrual during 2001 (in thousands):

	Direct Transaction Costs	Severance & Benefits	Non-cash Stock Based Compensation Charge	Total
Balance, October 9, 2001.	\$ 116	\$ 3,186	\$ 519	\$ 3,821
Paid out/non-cash	(116)	(3,186)	(519)	(3,821)
Balance, December 31, 2001	\$	\$	\$	\$

Severance and benefits and direct transaction costs were paid in cash during 2001. In the first quarter of 2002, we anticipate incurring an additional \$5.0 million of restructuring costs related to the planned PGP disposition.*

Interest and Other Income. Interest and miscellaneous income decreased to \$28.6 million in 2001 from \$42.0 million in 2000 and \$30.7 million in 1999. Interest and other income decreased from 2000 to 2001 due to lower interest income from our marketable securities due to lower average cash balances and yields. Interest and other income increased from 1999 to 2000, due to an increase in higher average cash balances invested at slightly higher interest rates.

Interest Expense. Interest and other expense increased to \$24.7 million in 2001 from \$18.2 million in 2000 and from \$17.3 million in 1999. Interest expense increased during 2001 due to the issuance in August 2001 of our 5.25% convertible subordinated notes due 2006.

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Gain (Loss) on Investments. In 2001, we recognized a \$7.3 million gain on the sale of equity and debt securities. In 2000, we recognized a net gain of \$28.5 million on the sale of our venture and strategic investments and a gain of \$11.9 million on the sale of shares of Network Associates Company Limited (Japan). In 1999, we recognized a loss of \$6.1 million on our equity and debt securities, including a loss of \$2.5 million on the liquidation of our DirectWeb investment, a related party.

Write Down of Strategic and Other Investments. For 2001 and 2000, we recorded an impairment charge of \$20.6 million and \$10.0 million, respectively, related to an other than temporary decline in the value of some of our venture and strategic investments. As of December 31, 2001, the minority venture investments we continue to hold totaled \$2.4 million at estimated fair value, consisting of investments in public and private companies, amounting to \$2.2 million and \$200,000, respectively.

Provision for Income Taxes. Our provision for income taxes was \$11.4 million, \$9.9 million and \$29.2 million in 2001, 2000 and 1999, respectively. Our effective tax rate for 2001, 2000 and 1999 was 13%, 10% and 22%, respectively. The increase in the effective tax rate from 2000 to 2001 was attributable to taxes on earnings from our foreign subsidiaries. The effective tax rate was higher in 1999 compared to 2000 due to an increase in non-deductible acquisition related expenses and an increase in taxes on earnings from our foreign subsidiaries.

The valuation allowance for our deferred tax assets increased from 2000 to 2001, as well as, from 1999 to 2000. The increase in the valuation allowance was due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire.

Extraordinary gain. In 2001, we redeemed a portion of our zero coupon convertible subordinated debentures due 2018 for approximately \$173.7 million. The aggregate accreted value of the debentures was \$179.7 million, which resulted in an extraordinary gain of \$1.7 million, net of \$1.2 million in taxes.

STOCK-BASED COMPENSATION

We expensed \$24.7 million, \$8.7 million and \$15.6 million in 2001, 2000 and 1999, respectively. Stock-based compensation charges relate to the repricing of employee stock options and the issuance of McAfee.com stock options to our executives and employees, as well as non-recurring stock compensation charges primarily related to executive compensation. We do not expect to incur charges related to these McAfee.com option grants in the future.* However, we do expect significant stock-based compensation charges related to repriced employee stock options.*

Our stock based compensation charges are made up of the following for the years presented (in thousands):

	Years Ended December 31,		
	2001	2000	1999
Repriced options	\$ 17,396	\$ 8,714	\$ 8,834
McAfee.com options and shares issued to Network Associates personnel			6,736
Warrants to outside consultants	1,049		
Former executives	2,668		
New executives	3,080		
PGP restructuring	519		
	—————	—————	—————
Total stock-based compensation	\$ 24,712	\$ 8,714	\$ 15,570
	—————	—————	—————

Repriced options. On April 22, 1999, we offered to substantially all of our employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price of \$11.063, the then current fair market value of the stock. Options to purchase a total of 10.3 million shares were

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cancelled and the same number of new options were granted. These new options vest at the same rate that they would have vested under previous option plans and are subject to variable accounting. Accordingly, we have and will continue to remeasure compensation cost for these repriced options until these options are exercised, cancelled, or forfeited without replacement. The first valuation period began July 1, 2000.

Subsequent to April 22, 1999, some employees, who received repriced options became employees of McAfee.com. In connection with this transfer their repriced options were canceled and replaced with options for McAfee.com stock. Variable plan accounting as described above, also applies to these replacement options and we will record variable charges based on the movements in the fair value of McAfee.com common stock from July 1, 2000.

The amount of stock-based compensation recorded was 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 our and McAfee.com's common stock on July 1, 2000, which was \$20.375 and \$26.063, respectively. 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. At December 31, 2001, these Network Associates and McAfee.com options are substantially fully vested. Depending upon movements in the market value of our and McAfee.com's common stock, this accounting treatment may result in additional stock-based compensation charges in future periods.

During 2001 and 2000, we incurred charges to earnings of approximately \$15.6 million and \$2.0 million related to options subject to variable plan accounting. For 2001 and 2000, our stock compensation charges related to options subject to variable plan accounting were based on a year end per share price of our stock of \$25.85 and \$4.19, respectively, and a per share price of McAfee.com stock of \$33.91 and \$5.00, respectively. As of December 31, 2001, we and McAfee.com had options to purchase 2.2 million shares and 0.2 million shares, respectively, which were outstanding and subject to variable plan accounting.

We also incurred an initial 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 \$1.8 million, \$6.7 million and \$8.8 million was expensed during 2001, 2000 and 1999, respectively.

McAfee.com options and shares issued to Network Associates personnel. During 1999, McAfee.com granted 1.7 million options to purchase shares of its Class A common stock and issued 379,000 shares of its Class A common stock to executives and employees of Network Associates. In connection with these grants, McAfee.com recorded a stock based compensation charge of \$6.7 million.

Warrants to outside consultants. In January 2001, upon completion of the search for our chief executive officer, we issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 166,667 shares of our 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. The fair market value of the warrants was included as stock compensation during 2001 and included in general and administrative expenses in the accompanying statement of operations.

In April 2001, upon completion of the search for our chief financial officer, we issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 66,667 shares of our 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. The fair market value of the warrants was included as a stock compensation charge during 2001 and included in general and administrative expenses in the accompanying statement of operations.

In November 2001, upon completion of the search for two executives for international operations, we issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be

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exchanged for 20,833 shares of our common stock. The weighted-average exercise price of the underlying shares is \$19.64 per share. The warrants are immediately exercisable and expire in 2004. The combined fair value of the warrants was determined to be approximately \$239,000. The fair market value of the warrants was included as a stock compensation charge during 2001 and included in general and administrative expenses in the accompanying statement of operations.

Former executives. In January 2001, our board of directors appointed George Samenuk as our chief executive officer and president. Effective January 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. Options held by Mr. Larson, Mr. Goyal and Mr. Watkins continued to vest during 2001 while they each served during their one-year terms as special advisors. As a result, we recorded a one-time stock compensation charge of approximately \$603,000 during 2001.

In December 2001, we terminated the employment of three executives. Upon termination, the options held by these executives were modified. As a result, we recorded a one-time stock compensation charge of \$2.1 million during 2001.

New executives. On January 3, 2001, we entered into an employment agreement with George Samenuk to become our chief executive officer. In accordance with the terms of the agreement, we 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 our right to repurchase such shares will lapse as follows: 12.5% on the first four quarterly anniversaries of Mr. Samenuk's employment with us with the remaining 50% on the second year anniversary of Mr. Samenuk's employment with us. 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 our common stock on Mr. Samenuk's employment commencement date. During 2001, we recorded approximately \$836,000 related to stock compensation associated with Mr. Samenuk's restricted stock.

On April 3, 2001, we entered into an employment agreement with Stephen C. Richards to become executive vice president and chief financial officer. In accordance with the terms of the agreement, we issued 50,000 shares of stock to Mr. Richards for \$0.01 per share. During 2001, we recorded approximately \$350,000 related to stock compensation associated with Mr. Richards' stock.

On October 30, 2001, we entered into an employment agreement with Arthur R. Matin to become executive the president of our McAfee product group. In accordance with the terms of the agreement, we issued 100,000 shares of restricted stock to Mr. Matin for \$0.01 per share. During 2001, we recorded approximately \$1.9 million related to stock compensation associated with Mr. Matin's stock.

PGP restructuring. In connection with the integration of the PGP product group, we accelerated the vesting of 45,600 options held by the 100 employees terminated during 2001. As a result of this modification, we recorded a stock based compensation charge of \$519,000 with restructuring expense in our statement of operations. The charge was calculated based on the intrinsic value of the modified options on the date the acceleration was approved by our board of directors.

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CRITICAL ACCOUNTING POLICIES

Our critical accounting policies are as follows:

revenue recognition;

estimating valuation allowances and accrued liabilities, specifically sales returns and other allowances, the allowance for doubtful accounts, and assessment of the probability of the outcome of our current litigation;

accounting for income taxes;

valuation of long-lived and intangible assets and goodwill; and

determining functional currencies for the purposes of consolidating our international operations.

Revenue recognition. We derive our revenue from primarily two sources (i) product revenue, which includes software license, hardware and royalty revenue, and (ii) services and support revenue which includes software license maintenance, training, consulting and hosting arrangements revenue. As described below, significant management judgments and estimates must be made and used in connection with the revenue recognized in any accounting period. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments or utilized different estimates.

We license our software products on a one and two-year time basis or on a perpetual basis. Our two-year time-based licenses include the first year of maintenance and support. Our hosting arrangements require customers to pay a fixed fee and receive service over a period of time, generally one or two years. Customers do not pay any set up fee.

We apply the provisions of Statement of Position 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions to all transactions involving the sale of software products and hardware transactions where the software is not incidental. For hardware transactions where software is not incidental, we do not bifurcate the fee and we do not apply separate accounting guidance to the hardware and software elements. For hardware transactions where no software is involved we apply the provisions of Staff Accounting Bulletin 101 Revenue Recognition. In addition, we apply the provisions of Emerging Issues Task Force Issue No. 00-03 Application of AICPA Statement of Position 97-2 to Arrangements that Include the Right to Use Software Stored on Another Entity's Hardware to our hosted software service transactions.

We recognize revenue from the sale of software licenses when persuasive evidence of an arrangement exists, the product has been delivered, the fee is fixed and determinable and collection of the resulting receivable is reasonably assured. Delivery generally occurs when product is delivered to a common carrier.

At the time of the transaction, we assess whether the fee associated with our revenue transactions is fixed and determinable and whether or not collection is reasonably assured. We assess whether the fee is fixed and determinable based on the payment terms associated with the transaction. If a significant portion of a fee is due after our normal payment terms, which are 30 to 90 days from invoice date, we account for the fee as not being fixed and determinable. In these cases, we recognize revenue as the fees become due.

We assess collection based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. We do not request collateral from our customers. If we determine that collection of a fee is not reasonably assured, we defer the fee and recognize revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

For all sales, except those completed over the Internet, we use either a binding purchase order or signed license agreement as evidence of an arrangement. For sales over the Internet, we use a credit card authorization as evidence of an arrangement. Sales through our distributors are evidenced by a master agreement governing the relationship together with binding purchase orders on a transaction by transaction basis.

For arrangements with multiple obligations (for example, undelivered maintenance and support), we allocate revenue to each component of the arrangement using the residual value method based on the fair value of the undelivered elements, which is specific to Network Associates. This means that we defer revenue from the

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arrangement fee equivalent to the fair value of the undelivered elements. Fair values for the ongoing maintenance and support obligations for both our two year time based licenses and perpetual licenses are based upon separate sales of renewals to other customers or upon renewal rates quoted in the contracts. Fair value of services, such as training or consulting, is based upon separate sales by us of these services to other customers.

Our arrangements do not generally include acceptance clauses. However, if an arrangement includes an acceptance provision, acceptance occurs upon the earlier of receipt of a written customer acceptance or expiration of the acceptance period.

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

Sales returns and other allowances, allowance for doubtful accounts and litigation. The preparation of financial statements requires our management to make estimates and assumptions that affect the reported amount of assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Specifically, our management must make estimates of potential future product returns related to current period product revenue. Management analyzes historical returns, current economic trends, and changes in customer demand and acceptance of our products when evaluating the adequacy of the sales returns and other allowances. Significant management judgments and estimates must be made and used in connection with establishing the sales returns and other allowances in any accounting period. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates. The provision for sales returns and other allowances amounted to \$125.9 million in 2001. Similarly, our management must make estimates of the uncollectability of our accounts receivables. Management specifically analyzes accounts receivable and analyzes historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our accounts receivable balance was \$136.4 million, net of allowance for doubtful accounts of \$8.4 million as of December 31, 2001.

Management's current estimated range of liability related to some of the pending litigation is based on claims for which our management can estimate the amount and range of loss. We have 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, we will assess the potential liability related to our pending litigation and revise our estimates. Such revisions in our estimates of the potential liability could materially impact our results of operation and financial position.

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

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We have

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recorded a valuation allowance of \$135.6 million as of December 31, 2001, due to uncertainties related to our ability to utilize some of our deferred tax assets, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations.

The net deferred tax asset as of December 31, 2001 was \$200.1 million, net of a valuation allowance of \$135.6 million.

Valuation of long-lived and intangible assets and goodwill. We assess the impairment of identifiable intangibles, long-lived assets and related goodwill and enterprise level goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

our market capitalization relative to net book value.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill and enterprise level goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. Net intangible assets, long-lived assets, and goodwill amounted to \$185.1 million as of December 31, 2001.

In 2002, Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets became effective and as a result, we will cease to amortize approximately \$156.9 million of goodwill. We had recorded approximately \$51.1 million of amortization on these amounts during 2001 and would have recorded approximately \$55.1 million of amortization during 2002. In lieu of amortization, we are required to perform an initial impairment review of our goodwill in 2002 and an annual impairment review thereafter. We expect to complete our initial review during the first quarter of 2002.

We currently do not expect to record an impairment charge upon completion of the initial impairment review. However, there can be no assurance that at the time the review is completed a material impairment charge will not be recorded.*

Determining functional currencies for the purpose of consolidation. We have several foreign subsidiaries which together account for approximately 35% of our net revenues, 12% of our assets and 12% of our total liabilities as of December 31, 2001.

In preparing our consolidated financial statements, we are required to translate the financial statements of the foreign subsidiaries from the currency in which they keep their accounting records, generally the local currency, into United States dollars. This process results in exchange gains and losses which, under the relevant accounting guidance are either included within the statement of operations or as a separate part of our net equity under the caption cumulative translation adjustment.

Under the relevant accounting guidance the treatment of these translation gains or losses is dependent upon our management's determination of the functional currency of each subsidiary. The functional currency is determined based on management judgment and involves consideration of all relevant economic facts and circumstances affecting the subsidiary. Generally, the currency in which the subsidiary transacts a majority of

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its transactions, including billings, financing, payroll and other expenditures would be considered the functional currency but any dependency upon the parent and the nature of the subsidiary's operations must also be considered.

If any subsidiary's functional currency is deemed to be the local currency, then any gain or loss associated with the translation of that subsidiary's financial statements is included in cumulative translation adjustments. However, if the functional currency is deemed to be the United States dollar then any gain or loss associated with the translation of these financial statements would be included within our statement of operations. If we dispose of any of our subsidiaries, any cumulative translation gains or losses would be realized into our statement of operations. If we determine that there has been a change in the functional currency of a subsidiary to the United States dollar, any translation gains or losses arising after the date of change would be included within our statement of operations.

Based on our assessment of the factors discussed above, we consider the relevant subsidiary's local currency to be the functional currency for each of our international subsidiaries. Accordingly we had cumulative translation losses of approximately \$35.1 million and \$34.1 million which were included as part of accumulated other comprehensive loss within our balance sheet at December 31, 2001 and 2000, respectively. During 2001, 2000 and 1999, translation adjustments of \$1.0 million, \$24.0 million and \$6.8 million, respectively, were included under accumulated other comprehensive loss. Had we determined that the functional currency of our subsidiaries was the United States dollar, these losses would have increased our loss for each of the years presented.

The magnitude of these gains or losses is dependent upon movements in the exchange rates of the foreign currencies in which we transact business against the United States dollar. These currencies include the Japanese Yen, the Euro, the United Kingdom Pound Sterling and Australian and Canadian dollars. Any future translation gains or losses could be significantly higher than those noted in each of these years. In addition, if determine that a change in the functional currency of one of our subsidiaries has occurred at any point in time we would be required to include any translation gains or losses from the date of change in our statement of operations.

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 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 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. We are currently assessing the impact of the adoption of these issues on our financial statements.

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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. We believe that the adoption of SFAS No. 141 will not have a significant impact on our 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. Upon adoption of SFAS 142 we will cease to amortize approximately \$156.9 million of goodwill, we had recorded approximately \$51.1 million of amortization on these amounts during 2001 and would have recorded approximately \$55.1 million of amortization during 2002. In addition we will be required to perform an impairment review of our goodwill balance upon the initial adoption of SFAS No. 142. The impairment review will involve a two-step process as follows:

Step 1 We will compare the fair value of our 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, we 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 We 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. We will then compare the implied fair value of the reporting unit's goodwill with the carrying amount of 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 loss must be recognized for the excess.

We expect to complete this review during the first quarter of 2002. We do 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 may not be recorded.

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. We are currently assessing the impact of SFAS No. 144 on our financial position and results of operations.

Liquidity and Capital Resources

At December 31, 2001, we had \$612.8 million in cash and cash equivalents and \$330.1 million in marketable securities, for a combined total of \$942.9 million.

Net cash provided by (used in) operating activities was \$145.7 million, \$26.7 million and \$(18.1) million in 2001, 2000 and 1999, respectively.

Net cash provided by operating activities in 2001 resulted primarily from net income before non-cash charges and minority interest. Non-cash charges include depreciation, amortization, provision for doubtful accounts, interest on our zero coupon convertible debentures, stock-based compensation charges, write-down of our strategic investments, net gains on investments and extraordinary items. After excluding the effects of non-cash charges, our net income was approximately \$66.5 million during 2001. Additional cash was

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generated from an increase of \$96.4 million in our deferred revenue balance which results from deferral, in accordance with our revenue recognition policy, of a portion of fees received from our customers. This increase was partially offset by an increase in our other net working capital balances, primarily an increase in our accounts receivable of \$18.9 million in 2001 offset by an increase in our accounts payable and accrued liabilities balance of \$12.5 million.

Net cash provided by operating activities in 2000 resulted primarily from increases in our deferred revenue resulting from the deferral of a portion of fees received from our customers in our sales arrangements. Before non-cash charges, our net loss was \$1.6 million during 2000.

Net cash used in operating activities in 1999 resulted primarily from decrease in deferred revenue and changes in deferred tax assets which was partly offset by a decrease in our other net working capital generated by a combined reduction of accounts receivable and increase in accounts payable. Before non-cash charges, our cash basis net loss was \$5.1 million during 2000.

Our accounts receivable balance as a percentage of sales may increase due to our increased emphasis on large accounts and expanding international sales, both of which typically have longer payment terms. Additionally, our receivable collection has become more dependent on the longer payment cycle for VARs, distributors and system integrators. To address this increase in accounts receivable and to improve cash flow, we may from time to time take actions to encourage earlier payment of receivables or sell receivables. During 1999, 2000 and 2001, we sold receivables aggregating approximately \$48 million, \$12.7 million and zero, respectively. These receivables were sold at a customary discount of up to 3.5% of face amount without recourse to us. The discounts were recorded as an operating expense. As of December 31, 1999 and 2000, no receivables sold in 1999 and 2000, as applicable, remained outstanding. To the extent that our accounts receivable balance increases, we will be subject to greater credit risk with respect thereto.

Net cash provided by (used in) investing activities was \$20.8 million, \$10.4 million and \$(173.8) million in 2001, 2000 and 1999, respectively, primarily reflecting transactions in marketable securities and additions to fixed assets. In 2001, the activity in the portfolio of our investment in marketable securities generated net cash proceeds of \$76.1 million. This proceeds were offset by our purchase of shares of our Japanese subsidiary owned by minority stockholders for \$10.6 million and by our purchases of fixed assets and technologies totaling \$43.7 million. In 2000, we obtained cash proceeds of \$36.8 million and \$11.9 million from the sale of our shares in Goto.com and the sale of less than 5% of our shares in our Japanese subsidiary, respectively. Our disbursements related to purchases of fixed assets, technologies and other investments for a total of \$88.1 million were partly offset by net cash proceeds of \$51.9 million from the activity in our investment portfolio.

Net cash provided by financing activities in 2001 amounted to \$158.9 million, primarily consisting of issuance of convertible notes for \$335.1 million, as well as issuance of common stock under our stock option plan and employee stock purchase plan for \$51.1 million. In addition, as described below, we settled all outstanding put options for a payment of approximately \$53.8 million in February 2001. These proceeds were offset by our repurchase of zero coupon convertible debentures for \$173.7 million. Net cash used in financing activities was \$39.4 million in 2000 consisting primarily of the repurchase of our common stock which represented approximately \$100.4 million. The repurchases of our common stock were slightly offset by proceeds associated with the exercise of our stock options and employee stock purchase plan including the sale of put options, for a total of \$60.4 million. Net cash provided by financing activities was \$96.6 million in 1999 consisting primarily of the proceeds from McAfee.com's initial public offering for \$78.9 million as well as proceeds associated with the exercise of our stock options and sale of put options, for a total of \$33.2 million. These proceeds were offset by the disbursements we made to purchase back some of our common stock and repay notes payable.

During 2001, a significant portion of our cash inflows were generated by our operations. Because our operating results may fluctuate significantly, as a result of decrease in customer demand or decrease in the acceptance of our future products, our ability to generate positive cash flow from operations may be jeopardized.

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Future payments due under debt and lease obligations as of December 31 (in thousands):

	Zero Coupon Convertible Debentures due 2018(1)	5.25% Convertible Subordinated Notes due 2006(2)	Non Cancelable Operating Leases	Total
2002	\$	\$	\$ 20,550	\$ 20,550
2003	246,501		14,924	261,425
2004			12,673	12,673
2005			11,802	11,802
2006		345,000	10,296	355,296
2007 and thereafter			61,606	61,606
	<u>\$ 246,501</u>	<u>\$ 345,000</u>	<u>\$ 131,851</u>	<u>\$ 723,352</u>

(1) As discussed below, in February 2003, we may be required to use a significant portion of our cash balance to redeem our outstanding zero coupon debentures. The redemption value corresponds to the aggregate face value outstanding of \$498.5 million less the related unamortized discount of \$252.0 million on February 13, 2003.

(2) In 2002, 2003, 2004, 2005 and 2006, we will make interest payments of \$18.1 million.

We believe that our available cash and anticipated cash flow from operations will be sufficient to fund our working capital and capital expenditure requirements for at least the next twelve months.*

Convertible Debt

On February 13, 1998, we issued zero coupon convertible subordinated debentures due 2018, which have an aggregate face amount at maturity of \$885.5 million and generated net proceeds to us of approximately \$337.6 million (after deducting fees and expenses). The initial price for the debentures was \$391.06 per \$1,000 of principal amount at maturity. At the option of the holder, we are required to redeem the debentures as of February 13, 2003, February 13, 2008 and February 13, 2013 at purchase prices equal to the initial issue price plus the accretion of the discount on the debentures to such dates (or \$494.52, \$625.35 and \$790.79 per \$1,000 of principal amount at maturity, respectively). In the case of such a required redemption, at our option, we may pay the aggregate redemption price in cash, shares of our common stock or a combination of cash and common stock. The number of shares of common stock so issued by us would be based on the fair value of our common stock at the time of any required redemption. On the same dates and at the same redemption prices, we may at our option redeem the outstanding debentures for cash. The debentures may also be redeemed at the option of the holder if there is a Fundamental Change (as defined in the related indenture) at a price equal to the issue price plus the accretion of the discount on the debenture to the date of redemption, subject to adjustment. The accretion of the discount on the debentures is calculated using the effective interest method.

During 2001, we redeemed zero coupon convertible subordinated debentures, which had an aggregate face amount at maturity of \$387.0 million, at a net price of \$173.7 million, which was financed from the Company's investment portfolio. In connection with the redemption, we recognized an extraordinary gain of approximately \$1.7 million, net of approximately \$1.2 million in taxes. If and when appropriate opportunities present themselves, we may use a portion of our cash balances to buy back additional amounts of our zero coupon convertible subordinated debentures.*

As of December 31, 2001, our aggregate cash, cash equivalents and marketable securities were approximately \$943.0 million, including \$102.5 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 \$246.5 million.

On August 17, 2001, we issued 5.25% convertible subordinated notes due 2006 with an aggregate principal amount of \$345.0 million. The issuance generated net proceeds to us of approximately \$335.1 million

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(after deducting fees and expenses). The notes mature on August 15, 2006, unless earlier redeemed by us at our option or converted at the holder's option. Interest is payable semi-annually in cash in arrears on February 15 and August 15 of each year, commencing February 15, 2002. At the option of the holder, the notes may be converted into our common stock at any time, unless previously redeemed, at a conversion price of \$18.07 per share. We 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 of our existing and future Senior Indebtedness (as defined in the related Indenture) and are pari passu with respect to the zero coupon subordinated debentures due 2018.

Derivatives

We conduct our operations globally. Consequently the results of our operations are exposed to movements in foreign currency exchange rates. We enter into forward exchange contracts to reduce exposures associated with nonfunctional currency accounts receivable and accounts payable denominated in Euros, Canadian and Australian dollars and several European currencies. The forward contracts range from one to three months in original maturity. In general, we do not hedge anticipated foreign currency cash flows nor do we enter into forward contracts for trading purposes. We do not use any derivatives for trading or speculative purposes.

The forward contracts do not qualify for hedge accounting and accordingly are marked to market at the end of each reporting period with any unrealized gain or loss being recognized in the statement of operations.

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

	2001	
	Fair Value	Carrying Value
Australian Dollar	\$ 5	\$ 5
Canadian Dollar	7	7
Other European Currencies	90	90
	—	—
	\$ 102	\$ 102
	■	■
	2000	
	Fair Value	Carrying Value
Australian Dollar	\$ (8)	\$ (8)
Canadian Dollar	27	27
Euro	(50)	(50)
Other European Currencies	(1)	(1)
	—	—
	\$ (32)	\$ (32)
	■	■

The carrying value is based on the fair value of the underlying contracts based on quoted market values.

Net realized gains and losses arising from settlement of our forward foreign exchange contracts were not significant in 2001, 2000, and 1999.

Stock Repurchase Program

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In May 1999, our board of directors authorized the repurchase of up to \$100.0 million of our common stock in the open market. In July 2000, our board of directors authorized the repurchase of up to an additional \$50.0 million of common stock in the open market. Through December 31, 2000, we repurchased 5.0 million shares of our common stock bringing total cash outlay to date to approximately \$112.9 million. The timing and size of any future stock repurchases are subject to market conditions, stock prices, cash position and other cash

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requirements. Such repurchases are intended to cover our issuances under the Employee Stock Purchase Plan (ESPP), the 1997 Plan, and issuances related to potential mergers and acquisitions.

On August 2, 1999, February 16, 2000 and May 31, 2000, we sold European style put options for 3.0 million shares of our common stock as part of our stock repurchase plan. On August 3, 2000, put options sold on August 2, 1999 for 1.0 million shares were exercised in our stock. In February 2001, we settled the remaining put options, which resulted in the purchase of 2.0 million shares of our stock for approximately \$53.8 million. We do not currently expect to make any further repurchases of our common stock under this stock repurchase program.*

Euro

On January 1, 1999, the Euro was introduced. On that day, the exchange ratios of the currencies of the eleven countries participating in the first phase of the European Economic and Monetary Union were fixed. The Euro became a currency in its own right and the currencies of the participating countries, while continuing to exist for a three-year transition period, are now fixed denominations of the Euro. The conversion to the Euro will have significant effects on the foreign exchange markets and bond markets and is requiring significant changes in the operations and systems within the European banking industry. Our information system is designed to accommodate multi-currency environments. As a result, we have the flexibility to transact business with vendors and customers in either Euro or traditional national currency units.

Financial Risk Management

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

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

We maintain investment portfolio holdings of various issuers, types and maturities. These securities are classified as available-for-sale, and consequently are recorded on the balance sheet at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income (loss). These securities are not leveraged and are held for purposes other than trading.

We also maintain minority investments in private and publicly traded companies. These investments are reviewed for other than temporary declines in value on a quarterly basis. Reasons for other than temporary declines in value include whether the related company would have insufficient cash flow to operate for the next twelve months, significant changes in the operating performance or operating model and changes in market conditions. As of December 31, 2001, the minority venture investments we continue to hold totaled \$2.4 million at estimated fair value. The \$2.4 million in minority venture investments include investments in public and private companies, amounting to \$2.2 million and \$200,000, respectively. During 2001, we recorded a \$20.6 million impairment charge in connection with these investments.

The following tables present the hypothetical changes in fair values in the securities held at December 31, 2001 that are sensitive to the changes in interest rates. The modeling technique used measures the change in fair values arising from hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS),

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100 BPS and 150 BPS over six and twelve-month time horizons. Beginning fair values represent the market principal plus accrued interest and dividends at December 31, 2001. Ending fair values are the market principal plus accrued interest, dividends and reinvestment income at six and twelve month time horizons.

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

Issuer	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			No Change in Interest Rate	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	\$215.55	\$214.69	\$213.79	\$212.90	\$211.99	\$211.08	\$210.18
Municipal notes and bonds	12.21	12.21	12.21	12.21	12.21	12.21	12.21
Corporate notes, bonds and preferreds	607.47	607.16	606.79	606.43	605.67	605.67	605.71
Total	\$835.23	\$834.06	\$832.79	\$831.54	\$829.87	\$828.96	\$828.10

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

Issuer	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			No Change in Interest Rate	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	\$218.11	\$217.50	\$216.86	\$216.21	\$215.56	\$214.91	\$214.25
Municipal notes and bonds	12.28	12.29	12.30	12.30	12.31	12.31	12.32
Corporate notes, bonds and preferreds	608.52	608.34	608.11	607.88	607.38	607.42	607.45
Total	\$838.91	\$838.13	\$837.27	\$836.39	\$835.25	\$834.64	\$834.02

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

Quantitative and qualitative disclosure about market risk is set forth at Management's Discussion and Analysis of Financial Condition and Results of Operations under Item 6.

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

	Three Months Ended							
	December 31, 2001	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	September 30, 2000	June 30, 2000	March 31, 2000
(In thousands, except per share data)								
Statement of Operations and Other Data:								
Net revenues	\$ 259,183	\$ 209,042	\$ 195,914	\$ 170,339	\$ 58,827	\$ 238,737	\$ 233,672	\$ 214,456
Gross margin	219,865	166,623	156,260	133,652	14,073	198,711	194,770	181,443
Income (loss) from operations	14,700	(8,841)	(27,960)	(59,865)	(187,301)	10,720	16,147	8,467
Income (loss) before provision for income taxes, minority interest and extraordinary item	13,198	(8,148)	(37,930)	(58,503)	(189,763)	16,456	22,114	53,442
Income (loss) before extraordinary item	(5,513)	(12,328)	(37,179)	(47,361)	(147,224)	4,079	11,399	29,025
Extraordinary item, gain on redemption of debt, net of taxes	654	1,077						
Net income (loss)	(4,859)	(11,251)	(37,179)	(47,361)	(147,224)	4,079	11,399	29,025
Extraordinary item per share	\$	\$ 0.01	\$	\$	\$	\$	\$	\$
Diluted earnings (loss) per share	\$ (0.03)	\$ (0.08)	\$ (0.27)	\$ (0.35)	\$ (1.07)	\$ 0.03	\$ 0.08	\$ 0.21
Shares used in per share calculation diluted	139,616	137,750	136,879	137,140	137,857	140,989	142,238	144,372

We believe that period-to-period comparisons of our financial results should not be relied upon as an indication of future performance. For example, in the fourth quarter of 2000, our revenue decreased 75% from the prior quarter due to some of our distribution partners' business decision to reduce their inventory levels by not replenishing their inventory and requesting returns over and above their contractual rights.

Our revenues and results of operations have been subject to significant fluctuations, particularly on a quarterly basis, and our revenues and results of operations could fluctuate significantly quarter to quarter and year to year. Causes of such fluctuations may include the volume and timing of new orders and renewals, the sales cycle for our products, the introduction of new products, return rates, inventory levels, product upgrades or updates by us or our competitors, changes in product mix, changes in product prices and pricing models, seasonality, trends in the computer industry, general economic conditions (such as the recent economic slowdown), extraordinary events such as acquisitions or litigation and the occurrence of unexpected events.

Significant quarterly fluctuations in revenues will cause significant fluctuations in our cash flows and the cash and cash equivalents, accounts receivable and deferred revenue accounts on our balance sheet. In addition, the operating results of many software companies reflect seasonal trends, and our business, financial condition and results of operations may be affected by such trends in the future. These trends may include higher net revenue in the fourth quarter as many customers complete annual budgetary cycles, and lower net revenue in the summer months when many businesses experience lower sales, particularly in the European market.

Our Financial Statements and supplementary data required by this item are set forth at the pages indicated at Item 14(a).

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

Not applicable.

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PART III

Item 10. *Directors and Officers of the Registrant*

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 15, 2002.

We have revised our Insider Trading Policy to allow our directors, officers and other employees covered under the policy to establish, under limited circumstances contemplated by Rule 10b5-1 under the Securities Exchange Act of 1934, written programs that permit automatic trading of our stock or trading of our stock by an independent person (such as an investment bank) who is not aware of material inside information at the time of the trade. As of January 31, 2002, George Samenuk, our chief executive officer and chairman; Stephen C. Richards, our chief operating officer and chief financial officer; Vernon Gene Hodges, our president; Kent H. Roberts, our executive vice president and general counsel; and Bakulesh Mehta, the president of our Sniffer Technologies product group have adopted Rule 10b5-1 trading plans. The Company believes that additional directors, officers and employees may establish such programs. In the quarter ended December 31, 2001, no trades were made pursuant to Rule 10b5-1 trading plans.

Item 11. *Executive Compensation*

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 15, 2002.

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

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 15, 2002.

Item 13. *Certain Relationships and Related Transactions*

The information required hereunder is incorporated by reference from our Proxy Statement to be filed in connection with our annual meeting of stockholders to be held on May 15, 2002.

Table of Contents**PART IV****Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K***(a)(1) Financial Statements:*

	Page Number
Report of Independent Accountants	49
Consolidated Balance Sheets: December 31, 2001, and 2000	50
Consolidated Statements of Operations and Comprehensive Loss: Years ended December 31, 2001, 2000, and 1999	51
Consolidated Statements of Stockholders' Equity: Years ended December 31, 2001, 2000, and 1999	52
Consolidated Statements of Cash Flows: Years ended December 31, 2001, 2000, and 1999	53
Notes to Consolidated Financial Statements	54

(a)(2) Financial Statement Schedule

The following financial statement schedule of Networks Associates, Inc. for the years ended December 31, 2001, 2000, and 1999 is filed as part of this Form 10-K and should be read in conjunction with Networks Associates, Inc.'s Consolidated Financial Statements.

Schedule II Valuation and Qualifying Accounts S-2

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

(a)(3) Exhibits: See Index to Exhibits on Page 92. The Exhibits listed on the accompanying Index of Exhibits are filed or incorporated by reference as part of this report.

(b) Reports on Form 8-K:

On October 11, 2001, the Company filed a report on Form 8-K announcing the planned integration and disposition of its PGP security product group.

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders of

Networks Associates, Inc.:

In our opinion, the consolidated financial statements listed in the index appearing under Item 14(a)(1) on page 48 present fairly, in all material respects, the financial position of Networks Associates, Inc. and its subsidiaries at December 31, 2001 and 2000, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 14 (a)(2) on page 48 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

San Jose, California
January 17, 2001

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NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2001	2000
	(In thousands, except share and per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 612,832	\$ 275,539
Short-term marketable securities	135,761	85,721
Accounts receivable, net of allowance for doubtful accounts of \$8,394 and \$15,332, respectively	136,366	122,315
Prepaid expenses, income taxes and other current assets	54,959	50,346
Deferred taxes	142,869	86,771
	<u>1,082,787</u>	<u>620,692</u>
Total current assets		
Long-term marketable securities	194,357	332,893
Fixed assets, net	64,040	75,499
Land	4,414	
Deferred taxes	77,627	113,489
Intangible assets	185,054	220,255
Other assets	18,853	22,020
	<u>\$ 1,627,132</u>	<u>\$ 1,384,848</u>
Total assets		
LIABILITIES		
Current liabilities:		
Accounts payable	\$ 26,368	\$ 46,816
Accrued liabilities	264,618	225,317
Deferred revenue	250,048	151,566
	<u>541,034</u>	<u>423,699</u>
Total current liabilities		
Deferred taxes	20,445	7,971
Deferred revenue, less current portion	24,312	26,592
Convertible debentures	578,850	396,336
Other long term liabilities	393	532
	<u>1,165,034</u>	<u>855,130</u>
Total liabilities		
Commitments and contingencies (Notes 8 and 16)		
Minority interest	17,311	11,067
STOCKHOLDERS EQUITY		
Preferred stock, \$0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none in 2001 and none in 2000		
Common stock, \$0.01 par value:		
Authorized: 300,000,000 shares; Issued: 140,699,222 shares in 2001 and 139,328,528 shares in 2000; Outstanding: 140,699,222 shares in 2001 and 138,089,775 shares in 2000		
	1,406	1,381
Treasury stock, at cost: no shares in 2001 and 1,238,753 shares in 2000		(23,186)

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Additional paid-in capital	742,315	685,423
Accumulated other comprehensive loss	(30,345)	(31,266)
Retained earnings (accumulated deficit)	(268,589)	(113,701)
	<u> </u>	<u> </u>
Total stockholders' equity	444,787	518,651
	<u> </u>	<u> </u>
Total liabilities, minority interest and stockholders' equity	\$ 1,627,132	\$ 1,384,848
	<u> </u>	<u> </u>

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

Table of Contents**NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS**

	Years Ended December 31,		
	2001	2000	1999
(In thousands, except per share data)			
Net revenue:			
Product	\$ 557,042	\$ 505,914	\$ 474,097
Services and support	277,436	239,778	209,571
	<u>834,478</u>	<u>745,692</u>	<u>683,668</u>
Cost of net revenue:			
Product	103,052	114,394	88,729
Services and support	55,026	42,301	42,094
	<u>158,078</u>	<u>156,695</u>	<u>130,823</u>
Operating costs and expenses:			
Research and development(1)	146,701	173,468	152,728
Marketing and sales(2)	435,261	400,863	370,086
General and administrative(3)	109,946	84,567	83,753
Provision for doubtful accounts, net	(1,473)	15,784	44,809
Amortization of intangibles	64,110	66,282	58,400
Acquisition, restructuring and other related costs(4)	3,821		(18,732)
	<u>758,366</u>	<u>740,964</u>	<u>691,044</u>
Loss from operations	(81,966)	(151,967)	(138,199)
Interest and other income	28,631	42,024	30,678
Interest expense	(24,697)	(18,169)	(17,332)
Gain (loss) on investments, net	7,280	40,361	(6,145)
Write down of strategic and other investments	(20,631)	(10,000)	
	<u>(91,383)</u>	<u>(97,751)</u>	<u>(130,998)</u>
Loss before provision for income taxes, minority interest and extraordinary item	(91,383)	(97,751)	(130,998)
Provision for income taxes	11,409	9,924	29,243
	<u>(102,792)</u>	<u>(107,675)</u>	<u>(160,241)</u>
Net loss before minority interest and extraordinary item	(102,792)	(107,675)	(160,241)
Minority interest in loss of consolidated subsidiaries	411	4,954	340
	<u>(102,381)</u>	<u>(102,721)</u>	<u>(159,901)</u>
Loss before extraordinary item	(102,381)	(102,721)	(159,901)
Extraordinary item, gain on redemption of debt, net of taxes	1,731		
	<u>\$(100,650)</u>	<u>\$(102,721)</u>	<u>\$(159,901)</u>
Other comprehensive income (loss):			
Unrealized gain (loss) on marketable securities and investments	\$ 1,950	\$ 2,654	\$ (1,610)
Foreign currency translation loss	(1,029)	(23,963)	(6,813)

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Comprehensive loss	\$ (99,729)	\$ (124,030)	\$ (168,324)
<hr/>			
Basic and Diluted net loss per share:			
Loss before extraordinary item	\$ (0.74)	\$ (0.74)	\$ (1.15)
Extraordinary item, gain on redemption of debt, net of taxes	0.01		
<hr/>			
Net (loss) per share basic and diluted	\$ (0.73)	\$ (0.74)	\$ (1.15)
<hr/>			
Shares used in per share calculation basic and diluted	137,847	138,072	138,695
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- (1) Includes stock-based compensation charge of \$4,604, \$1,894 and \$4,515 in 2001, 2000 and 1999, respectively.
 - (2) Includes stock-based compensation charge of \$10,354, \$4,570 and \$7,162 in 2001, 2000 and 1999, respectively.
 - (3) Includes stock-based compensation charge of \$9,235, \$2,250 and \$3,893 in 2001, 2000 and 1999, respectively.
 - (4) Includes stock-based compensation charge of \$519, \$0 and \$0 in 2001, 2000 and 1999, respectively.

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

Table of Contents**NETWORKS ASSOCIATES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

	Common Stock		Treasury Stock	Additional Paid-In Stock	Accumulated Other Comprehensive Loss	Retained Earnings (Accumulated Deficit)	Total Stockholders Equity
	Shares	Amount					
(In thousands)							
Balances, December 31, 1998	137,123	\$ 1,371	\$	\$ 527,862	\$ (1,534)	\$ 195,139	\$ 722,838
Issuance of common stock upon exercise of stock options	1,196	12	1,414	17,348		(360)	18,414
Issuance of common stock upon exercise of stock options by McAfee.com				123			123
Issuance of common stock from Employee Stock Purchase Plan	578	6		8,929			8,935
Repurchase of common stock	(685)	(7)	(12,437)				(12,444)
FSA conversion of preferred stock to common stock	438	4					4
Exercise of warrants	85	1		458			459
Proceeds from sale of put options				5,250			