NETWORKS ASSOCIATES INC/
Form 10-Q
August 06, 2001
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended June 30, 2001

OR

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

For the transition period from ______ to ______ .

Commission file number 0-20558

NETWORKS ASSOCIATES, INC.

(Exact name of registrant as specified in its charter)

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

3965 Freedom Circle

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

Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

YES x NO o

137,374,939 shares of the registrant s common stock, $0.01 par value, were outstanding as of June 30, 2001.

THIS DOCUMENT CONTAINS 47 PAGES.

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NETWORKS ASSOCIATES, INC.

FORM 10-Q, June 30, 2001

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NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)
(Unaudited)

ASSETS

	June 30, 2001	December 31, 2000
Current assets:		
Cash and cash equivalents	$358,387	$275,539
Short-term marketable securities	73,281	85,721
Accounts receivable, net	86,523	122,315
Prepaid expenses, income taxes and other current assets	39,278	50,346
Deferred taxes	104,644	86,771
Total current assets	662,113	620,692
Long-term marketable securities	218,904	332,893
Fixed assets, net	71,705	75,499
Deferred taxes	110,640	113,489
Intangibles and other assets	210,659	242,275
Total assets	$1,274,021	$1,384,848

LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$21,360	$46,816
Accrued liabilities	224,910	225,317
Deferred revenue	183,292	151,566
Total current liabilities	429,562	423,699
Deferred taxes	6,500	7,971
Deferred revenue, less current portion	30,133	26,592
Convertible debentures	405,391	395,969
Other long-term debt and liabilities	427	899
Total liabilities	872,013	855,130
Contingencies (Note 8)		
Minority interest	10,656	11,067
Common stock, $0.01 par value; Authorized: 300,000,000; Issued: 139,328,528 shares at June 30, 2001 and December 31, 2000; Outstanding: 137,374,939 shares at June 30, 2001 and 138,089,775 shares at December 31, 2000	1,393	1,381
Treasury stock, at cost: 1,953,589 shares at June 30, 2001 and 1,238,753 shares at December 31, 2000	(52,411)	(23,186)
Additional paid-in capital	689,694	685,423
Cumulative other comprehensive loss unrealized gain (loss) on investments and foreign currency translation		

	(30,890)	(31,266)
Accumulated deficit	(216,434)	(113,701)
Total stockholders equity	391,352	518,651
Total liabilities, minority interest, and stockholders equity	$1,274,021	$1,384,848

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

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NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(in thousands, except per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	**2000**	**2001**	**2000**
Net revenue:				
Product	$135,720	$174,336	$242,964	$339,448
Services and support	60,194	59,336	123,289	108,680
Total net revenue				

	195,914	233,672	366,253	448,128
Cost of net revenue:				
Product	25,421	29,265	48,881	53,003
Services and support	13,109	8,810	23,562	17,315
Total cost of net revenue	38,530	38,075	72,443	70,318
Operating costs and expenses:				
Research and development(1)	34,886	42,885	74,859	84,560
Marketing and sales(2)	106,903	99,658	217,037	196,423
General and administrative(3)	26,883	21,975	57,222	42,851
Amortization of intangibles	16,672	14,932	32,517	29,362
Total operating cost and expenses	185,344	179,450	381,635	353,196

Income (loss) from operations	(27,960)	16,147	(87,825)	24,614
Interest and other income and expense, net	3,168	5,967	9,530	10,569
Gain (loss) on investments, net				40,373
Write-down of strategic and other investments	(13,138)		(18,138)	
Income (loss) before provision for income tax and minority interest	(37,930)	22,114	(96,433)	75,556
Provision for income taxes (income tax benefit)	(732)	11,928	(11,172)	37,468
Income (loss) before minority interest	(37,198)	10,186	(85,261)	38,088
Minority interest in loss of consolidated subsidiaries	19	1,213	721	2,336
Net income (loss)	$(37,179)	$11,399	$(84,540)	$40,424

Other comprehensive income (loss), net

	$8,705	$(7,550)	$376	$(3,885)
Comprehensive income (loss)	$(28,474)	$3,849	$(84,164)	$36,539
Net income (loss) per share basic	$(0.27)	$0.08	$(0.62)	$0.29
Shares used in per share calculation basic	136,879	138,072	137,010	138,475
Net income (loss) per share diluted	$(0.27)	$0.08	$(0.62)	$0.28
Shares used in per share calculation diluted	136,879	142,238	137,010	143,272

(1) Includes stock-based compensation charge of $107, $394, $198 and $848 for the three months and six months ended June 30, 2001 and 2000, respectively.

(2) Includes stock-based compensation charge of $169, $625, $313 and $1,345 for the three months and six months ended June 30, 2001 and 2000, respectively.

(3) Includes stock-based compensation charge of $931, $340, $2,352 and $732 for the three months and six months ended June 30, 2001 and 2000, respectively.

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

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NETWORKS ASSOCIATES, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Six Months Ended June 30, 2001	Six Months Ended June 30, 2000
Cash flows from operating activities:		
Net income (loss)	$(84,540)	$40,424
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization and bad debt expense	50,052	46,111
Interest on convertible notes	9,422	8,983
Realized (gain) loss on investments	(3,876)	141
Write-down of strategic investments	18,138	
Minority interest	(721)	(2,336)
Deferred taxes		

	(17,657)	(14,178)
Stock compensation charges	2,863	2,925
Gain on sale of Goto.com investment		(28,551)
Gain on sale of Network Associates Japan shares		(11,947)
Changes in assets and liabilities:		
Accounts receivable	34,168	(8,889)
Prepaid expenses, income taxes and other	7,938	(21,002)
Accounts payable and accrued liabilities	(23,120)	34,952
Deferred revenue	38,367	20,174
Net cash provided by operating activities	31,124	66,807
Cash flows from investing activities:		
Purchase of marketable securities	(300,052)	(247,969)
Proceeds from sale of marketable securities	421,698	254,111
Purchase of investments		(17,650)
Proceeds from sale of Goto.com investment		36,750
Purchase of shares in Network Associates Japan	(10,655)	
Proceeds from sale of Network Associates Japan shares		11,947
Acquisitions by subsidiary		(1,959)
Additions to fixed assets	(13,435)	(30,128)

Net cash provided by investing activities	97,556	5,102
Cash flows from financing activities:		
Repayment of notes payable		(67)
Proceeds from issuance of stocks from option plan and stock purchase plans	8,842	14,768
Repurchase of common stock	(53,800)	(62,859)
Other	(779)	1,606
Proceeds from sale of put options		13,890
Net cash used in financing activities	(45,737)	(32,662)
Effect of exchange rate fluctuations	(95)	(31,868)
Net increase in cash and cash equivalents	82,848	7,379
Cash and cash equivalents at beginning of period	275,539	316,784
Cash and cash equivalents at end of period	$358,387	$324,163

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

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The unaudited, condensed consolidated financial statements have been prepared by Networks Associates, Inc. (the Company) without audit in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X. The unaudited, condensed consolidated financial statements include the accounts of the Company and its majority owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The Company has two reportable segments consisting of computer security and management software, and managed security and availability application services to business users on the Internet (Infrastructure) and consumer PC security and management software on the Internet (McAfee.com).

In the opinion of management, all adjustments, consisting only of normal recurring adjustments considered necessary for a fair presentation, have been included. The results of operations for the three month and six month periods ended June 30, 2001 are not necessarily indicative of the results to be expected for the full year or for any future periods. The accompanying unaudited, condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements contained in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 2, 2001. The balance sheet at December 31, 2000 has been derived from the audited financial statements as of and for the year ended December 31, 2000, but does not include all the information and footnotes required by generally accepted accounting principles for complete financial statements.

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

2. Business Segment Information

In 2000, the Company established a subsidiary, McAfee.com, as a separate business entity. The Company evaluated its product segments in 2001 and concluded that its reportable segments were Infrastructure and McAfee.com. Management measures profitability for its business based on these two segments.

The Infrastructure segment consists of anti-virus, network management, security and help desk software. These products are marketed and sold through a direct sales force to distributors, retailers, and end users world-wide. In addition, the Infrastructure segment includes managed security and availability applications services on the Internet.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000

Infrastructure:				
Net revenues	$181,505	$221,765	$339,028	$425,963
Segment operating income (loss)	(27,321)	24,041	(84,468)	40,438
McAfee.com:				
Net revenues	14,409	11,907	27,225	22,165
Segment operating loss	(639)	(7,894)	(3,357)	(15,824)

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	June 30, 2001	December 31, 2000
Infrastructure:		
Total assets	$1,173,635	$1,286,716
McAfee.com:		
Total assets	100,386	98,132

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

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

In accordance with Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, the Company incurred an initial stock based compensation charge in connection with this repricing. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately $368,000 and $682,000 was expensed in the three months and six months ended June 30, 2001, respectively.

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

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

In addition, variable plan accounting as described above, applied to options issued to employees of McAfee.com and myCIO.com as a replacement for Company options which were subject to the repricing described above. As a result, the Company will record variable charges based on the movements in the fair value of McAfee.com and myCIO.com common stock from July 1, 2000.

During the three months and six months ended June 30, 2001, the Company did not incur charges to earnings related to options subject to variable plan accounting as the Company s stock price was below

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

$20.375. As of June 30, 2001 the Company and McAfee.com had options to purchase 3.8 million and 59,650 shares, respectively, which were outstanding and subject to variable plan accounting. Depending on movements in the market value of the Company s common stock, the accounting treatment may result in significant additional compensation charges in future periods.

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

On January 3, 2001, the Company entered into an employment agreement with George Samenuk to become the Company s chief executive officer (CEO). In accordance with the terms of the agreement, the Company issued 400,000 shares of restricted stock to Mr. Samenuk. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase such shares will lapse as follows: 12.5% on the first four quarterly anniversaries of Mr. Samenuk s employment with the Company with the remaining 50% on the second year anniversary of Mr. Samenuk s employment with the Company. The fair value of the restricted stock was determined to be approximately $1.7 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of the Company s common stock on Mr. Samenuk s employment commencement date. In the three months and six months ended June 30, 2001, the Company recognized $209,000 and $418,000, respectively, related to stock compensation associated with Mr. Samenuk s restricted stock.

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

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

On August 3, 1999, February 16, 2000 and May 31, 2000, the Company sold European style put options for 3.0 million shares of the Company s common stock as part of its stock repurchase plan. The strike prices for these put options were $20.00, $30.00 and $24.07, respectively. The Company received total proceeds of approximately $19.1 million from the sale. In August 2000, put options sold on August 2, 1999 for 1 million shares were exercised in the Company s stock. The strike price for these put options was $20.00. In February 2001, the Company settled the remaining put options which resulted in the purchase of 2.0 million shares of the Company s common stock for approximately $53.8 million.

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

4. Stockholders Equity

Stock Option Plans

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

The Company s board of directors authorized the reservation of an additional 5 million options for the 1997 Stock Incentive Plan. These additional options were approved at the Company s 2001 annual meeting held May 24, 2001.

Warrants

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

In April 2001, upon completion of the search for the Company s CFO, the Company issued warrants to a retained executive search firm for services performed. The warrants, if exercised, can be exchanged for 66,667 shares of the Company s common stock. The weighted-average exercise price of the underlying shares is $4.50 per share. The warrants are immediately exercisable and expire in April 2004. The combined fair value of the warrants was determined to be approximately $280,000 and was estimated using the Black-Scholes model with the following assumptions: risk free interest rate of 4.27%; expected life of 3 years; dividend yield of 0%; and expected volatility of 91%. The fair market value of the warrants was included as stock compensation during the three months ended June 30, 2001 and included in general and administrative expenses in the accompanying financial statements.

5. Recent Accounting Pronouncements

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

In July 2001, 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, 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

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

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. We are currently assessing but have not yet determined the impact of SFAS No. 142 on our financial position and results of operations.

In June 2001, the Emerging Issues Task Force (EITF) issued EITF Issue No. 00-25, Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor s Products. 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 income statement 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 income statement. The Company will adopt EITF Issue No. 00-25 effective January 1, 2002. The adoption of EITF Issue No. 00-25 is not expected to have a material impact on the Company s financial statements.

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

6. Net Income (Loss) Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Numerator Basic				
Net income (loss)	$(37,179)	$11,399	$(84,540)	$40,424

Numerator — Diluted

Net income (loss)	$(37,179)	$11,399	$(84,540)	$40,424
Interest on convertible debentures(1)				
	$(37,179)	$11,399	$(84,540)	$40,424

Denominator — Basic

Weighted average shares of common stock outstanding	137,229	138,072	137,360	138,475
Less: Weighted average shares of common stock subject to repurchase	(350)		(350)	
Basic weighted average common shares outstanding	136,879	138,072	137,010	138,475

Denominator — Diluted

Basic weighted average common shares outstanding	136,879	138,072	137,010	138,475
Effective of dilutive securities:				

Common stock options(2)		3,874		4,685
Put Options		292		112
Diluted weighted average shares	136,879	142,238	137,010	143,272
Net income (loss) per share basic	$(0.27)	$0.08	$(0.62)	$0.29
Net income (loss) per share diluted	$(0.27)	$0.08	$(0.62)	$0.28

(1) Convertible debt interest and related as-if converted shares were excluded from the calculation since the effect was anti-dilutive. The total number of shares excluded from the calculation related to as-if converted shares was 7.6 million for the three months and six months ended June 30, 2001 and 2000.

(2) At June 30, 2001 and 2000, 32.7 million and 18.5 million common stock options, respectively, were excluded from the determination of diluted net income per share as the effect of such options is anti-dilutive.

7. Write-down of strategic and other investments

The Company assesses the recoverability of the carrying value of its strategic investments on a regular basis. Factors the Company considers important which could trigger an impairment include, but are not limited to, the likelihood that the related company would have insufficient cash flows to operate for the next twelve months, significant changes in the operating performance or business model, and changes in market conditions. The Company recorded charges related to other than temporary declines in the value of certain strategic investments of $13.1 million and $18.1 million in the three and six months ended June 30, 2001, respectively.

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NETWORKS ASSOCIATES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

8. Litigation

General

From time to time, the Company has been subject to litigation including the pending litigation described below. The Company s current estimated range of liability related to some of the pending litigation below is based on claims for which management can estimate the amount and range of loss. The Company has recorded a liability related to these claims in accordance with generally accepted accounting principles.

Because of the uncertainties related to the amount and range of loss on the remaining pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, the Company will assess its potential liability and revise its estimates as appropriate. Pending or future litigation could be costly, could cause the diversion of management s attention and could have a material adverse effect on the Company s business, results of operations and financial condition.

Securities Cases

In Re Network Associates, Inc. Securities Litigation. On April 7, 1999, a putative securities class action, captioned *Knisley v. Network Associates, Inc., et al.,* Civil Action No. C-99-1729-SBA, was filed against the Company and several of its officers in the United States District Court for the Northern District of California. The complaint alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and sought unspecified damages on behalf of a purported class of purchasers of common stock between January 20, 1998 and April 19, 1999. Twenty-five similar actions asserting virtually identical allegations were filed by other plaintiffs. The Court consolidated these cases and an amended complaint was filed. Defendants filed a motion to dismiss on June 6, 2000. The Court granted in part and dismissed in part the motion to dismiss. The Court allowed only plaintiffs claims related to In-Process Research and Development to go forward and shortened the class period to April 6, 1999. Plaintiffs filed a First Amended Consolidated Complaint, and defendants filed an answer. In February 2001, the Company settled the class action. The amount of the settlement is $30 million and is being funded principally by the Company s Directors and Officers insurance carriers. On May 21, 2001, the Court issued a Final Judgment approving the settlement agreement and dismissing with prejudice all claims asserted by the class. On June 19, 2001, a member of the class filed a Notice of Appeal in the District Court for Northern District of California, notifying the parties that he would appeal to the Ninth Circuit Court of Appeals to overturn the Court s Final Judgment.

On October 26, 2000, a new action, captioned *The State Board of Administration of Florida v. Network Associates, Inc. et. al.*, Civil Action No. C-00-3981-WHA, naming the same defendants as the class-action, was filed in the Northern District of California by an opt-out plaintiff. The action had been coordinated with the class action for pretrial and trial proceedings. The parties have stipulated to dismissal of the action without prejudice and have entered into a tolling agreement with respect to the claims asserted by the State Board of Administration of Florida. In May 2001, the Company settled these claims.

In Re Network Associates, Inc. Derivative Litigation. On May 12, 1999, a purported derivative action, captioned *Dow Jones Investment Club v. Network Associates, Inc. et al.,* Civil Action No. CV-781854, was filed against nominal defendant the Company and certain of its officers and directors in the Superior Court of California, County of Santa Clara. The complaint alleges violations of Sections 25402 and 1507 of the California Corporations Code, breach of fiduciary duty, insider trading, gross negligence, and unjust enrichment. The complaint seeks unspecified damages. Two similar derivative actions have been filed by other plaintiffs in the Superior Court of California, County of Santa Clara, including *Leighton v. Network Associates, Inc. et al.,* Civil Action No. CV-781947, and *Katz v. Network Associates, Inc., et al.,* Civil Action No. CV-782194. The court ordered these three actions consolidated for pretrial and trial proceedings and

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deemed the complaint filed in the *Leighton* action the operative complaint. Defendants demurrer to the operative complaint was sustained with leave to amend. A First Amended Complaint was filed by the plaintiffs. The Company and the individual defendants demurred to the First Amended Complaint. The demurrer was overruled, except with respect to the Sixth Cause of Action, which was sustained without leave to amend. The parties signed a Memorandum of Understanding settling the action and on June 18, 2001, the Court issued a Final Judgment approving the settlement agreement and dismissing with prejudice all claims asserted in the action.

Gage v. Network Associates. A similar case, captioned *Gage v. Network Associates, Inc., et al.,* Civil Action No. B C211552, has been filed in the Superior Court of California, County of Los Angeles. Plaintiffs allege violations of Sections 25400 et seq. of the California Corporations Code, Section 17200 of the California Business and Professions Code, and breach of fiduciary duty. The parties stipulated to transfer the action to Santa Clara County Superior Court where it is now pending under Civil Action No. CV-785715. The complaint was dismissed without prejudice. Gage filed a First Amended Complaint asserting claims in his individual capacity, which was dismissed without prejudice. Gage then filed a Second Amended Complaint. The individual defendants and the Company s demurrer to the Second Amended Complaint was overruled in part, sustained in part with prejudice, and sustained in part without prejudice. Gage then filed a Third Amended Complaint. The individual defendants and the Company s motion to Strike certain allegations of the Third Amended Complaint was granted. Gage has filed a Fourth Amended Complaint which defendants have answered. Discovery is currently ongoing. On June 7, 2001, all proceedings in the Gage action were stayed pending Gage s Appeal of the Final Judgment in the federal class action to the Ninth Circuit Court of Appeals.

Securities Lawsuits. Between December 29, 2000 and February 7, 2001, the Company and certain of its current and former officers and directors were named in securities class action lawsuits filed in the United States District Court for the Northern District of California. With one exception, the complaints assert claims against the Company, William Larson and Prabhat Goyal on behalf of a putative class of persons who purchased the Company s stock between July 19 and December 26, 2000; a single complaint asserts claims against the Company, William Larson, Prabhat Goyal, Leslie Denend, Virginia Gemmell, Edwin Harper and Enzo Torresi on behalf of a putative class of persons who purchased and/or acquired the Company s stock between October 16 and December 26, 2000. All of the complaints assert causes of action (and seek unspecified damages) for alleged violations of Exchange Act Section 10(b)/ SEC Rule 10b-5 and Exchange Act Section 20(a). In particular, the complaints allege that defendants made false and misleading statements about the Company s anticipated financial results for the fourth fiscal quarter of 2000, and that the Company s class period financial statements failed to comply with GAAP. Motions for appointment of lead plaintiff and for appointment of lead plaintiff s counsel were filed on February 27, 2001. A motion for consolidation was also filed on that date. A hearing was held on May 8, 2001. A hearing was held on May 8, 2001. By Order dated June 5, 2001, the Court appointed Louisiana Teachers Retirement System of Louisiana (Louisiana Teachers) as lead plaintiff and approved Louisiana Teachers choice of lead counsel. The cases have all been consolidated and a consolidated amended complaint is scheduled to be filed on September 17, 2001.

Derivative Lawsuit. On February 5, 2001, the Company was nominally sued in a derivative lawsuit filed in the Superior Court in Santa Clara County. The lawsuit, encaptioned *Mean Ann Krim v. William L. Larson, et al.,* Case No. CV795734, asserts claims against William Larson, Peter Watkins, Prabhat Goyal, Leslie Denend, Virginia Gemmell, Edwin Harper, Enzo Torresi, and others for breach of fiduciary duty, unjust enrichment and professional negligence against the accountants. In particular, the complaints allege that the defendants engaged in a course of conduct by which they improperly accounted for revenue from software license sales, and that, as a result of their actions, certain of the Company s financial statements were false and misleading and not in compliance with GAAP. The complaint seeks an unspecified amount of damages. Nominal defendant the Company filed a demurrer to the complaint on May 21, 2001. A hearing on the

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demurrer was held on June 29, 2001. To date, there has been no ruling from the Court on the demurrer. The Individual Defendants filed a Motion for Protective Order with respect to document discovery served by Plaintiff on June 21, 2001. The Company expects that a hearing will be held sometime in July 2001.

Other Litigation

Hilgraeve v. Network Associates. On September 15, 1997, the Company was named as a defendant in a patent infringement action filed by Hilgraeve Corporation (Hilgraeve) in the United States District Court, Eastern District of Michigan. Hilgraeve alleges that the Company s VirusScan product infringes a Hilgraeve patent which was issued on June 7, 1994. Hilgraeve s action seeks injunctive relief and unspecified money damages. The District Court granted the Company s motion for summary judgment of non-infringement on May 20, 1999 and entered judgment in favor of the Company on July 7, 1999. On August 2, 2000, the United States Court of Appeal for the Federal Circuit vacated in part, affirmed in part, and remanded the case to the District Court for further proceedings. In an order dated on or about June 19, 2001, the Court denied the Company s further summary judgment motion. The Court has set a trial date of January 3, 2002.

Hilgraeve, Inc. and Hilgraeve Associates v. Network Associates. On October 10, 2000, Hilgraeve filed another complaint against the Company, also in the United States District Court, Eastern District of Michigan. Hilgraeve alleges that the Company s Webshield Proxy product infringes the same Hilgraeve patent in the first suit. Hilgraeve s action seeks injunctive relief and unspecified money damages. The Court has stayed this action until at least June 12, 2001, pending the hearing on the Company s summary judgment in the related matter that day, the parties have agreed that the stay will remain in effect at least until the trial of the related matter in January 2002 (see above).

Foremost Systems v. Network Associates, No. CV 777301 (Santa Clara County). A former agent of the Company in India, Foremost Systems Pvt. Ltd., filed this action on October 14, 1998, in California State court and filed a Second Amended Complaint on February 18, 2000. The Company removed the action to the United States District Court, Northern District of California, San Jose Division. The Second Amended Complaint alleges that the Company wrongly terminated Foremost Systems in breach of their agency agreement and, in addition, contains counts for breach of oral contract, promissory estoppel, intentional and negligent misrepresentation, breach of fiduciary duty, tortious interference with contractual relations, unfair competition, and racketeering in violation of 18 U.S.C 1962 *et seq.* The parties held a preliminary mediation session in this matter on April 5, 2000 and attended a full session for March 12, 2001. A Case Management Conference in this matter is set to take place on October 1, 2001, and the parties are engaging in limited discovery.

eSniff. On June 5, 2001, eSniff, Inc. (eSniff) filed a complaint in U.S. District Court for the District of Colorado, Case No. 01-D-1024, seeking a declaratory judgment that its use of the ESNIFF trade name and trademark does not infringe the Company s to enter its SNIFFER mark. eSniff also requested that the court cancel the federal trademark registration for SNIFFER. However, eSniff incorrectly identified the proper parties to the action. On July 2, 2001, eSniff filed an amended complaint that names the Company and its wholly owned subsidiary, Networks Associates Technology, Inc. (NATI), as defendants. Neither the Company nor NATI has yet been served in this action.

On June 13, 2001, the Company and NATI filed a complaint in U.S. District Court in the Northern District of California, Case No. 01-20537 PVT, against eSniff for trademark infringement, trademark dilution, and unfair competition under federal and California state law related to the use of the ESNIFF name and mark. The complaints seeks damages and injunctive relief against eSniff. On June 27, 2001, eSniff filed a motion to dismiss or, in the alternative, to stay or transfer the case in light of the pending Colorado action. The Company intends to oppose this motion.

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Homenexus Inc. f/k/a HomeRun Network, Inc. v. DirectWeb, Inc., et al., No. 99-CV-2316 (CRW) (E.D. Pa.). In this action, filed in federal court in the Eastern District of Pennsylvania on May 5, 1999, plaintiff Homenexus alleges that DirectWeb successfully conspired with all defendants, including the Company and William Larson, to wrongly misappropriate plaintiff s purported proprietary business plan and to deliberately infringe plaintiff s purported trade dress in its alleged web-site. The complaint further alleges that all defendants conspired to commit, and did commit, the torts of conversion and unfair competition. Plaintiff filed an amended complaint on June 21, 2000, adding a new defendant, Riaz Karamali.

Simple.com v. McAfee.com, Civil Action No. CV-00-20816 RMW, United States District Court, Northern District of California, San Jose Division. On August 1, 2000, Simple.com (Simple) filed a complaint against McAfee.com, alleging that McAfee.com misappropriated Simple s trade secrets and infringed Simple s copyrights in certain software code. The parties have entered into a settlement agreement and a stipulation of dismissal with prejudice has been filed.

9. Other Comprehensive Income (Loss), Net

Other comprehensive income (loss), net comprises the following: (in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	**2000**	**2001**	**2000**
Gross change in unrealized gain (loss) on investments	$(330)	$(2,196)	$(4,467)	$31,860
Write down of available-for-sale strategic investments	8,638		8,638	
Realized (gain)/loss on investments		16	(3,876)	141
Gain on sale of Goto.com investment				(28,551)
	8,308	(2,180)	295	3,450
Foreign currency translation gain (loss)	397	(5,370)	81	(7,335)
	$8,705	$(7,550)	$376	$(3,885)

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MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

This Report on Form 10-Q contains forward-looking statements, including but not limited to those specifically identified as such, that involve risks and uncertainties. The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act, including without limitation statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including, but not limited to, those set forth in Risk Factors and elsewhere in this Report on Form 10-Q.

Overview

We are a leading supplier of network security and network management solutions. The majority of our revenue has historically been derived from our McAfee anti-virus product group and our Sniffer network availability and performance management product group. These two flagship product groups form the base from which the balance of our product groups have developed.

In recent years, 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 line by adding products in the help desk, asset management, network monitoring, and network reporting categories. We continuously seek to expand our product lines. In order to more effectively market our products, we have combined complementary products into separate product groups, as follows:

McAfee, which primarily markets the McAfee Active Virus Defense product group;

Sniffer Technologies, which primarily markets the Sniffer Total Network Visibility product group;

PGP Security, which primarily markets the PGP Total Network Security product group; and

Magic Solutions, which primarily markets the Magic Total Support Desk product group.

The four product groups represent our Infrastructure segment. Organization around our product groups is designed to allow us to, among other things, react faster to customers changing needs and better specialize our sales forces. Organization around product groups was completed in the first half of 2001. For the three months and six months ended June 30, 2001, our infrastructure segment accounted for approximately $181.5 million and $339.0 million in net revenue and a net operating loss of $27.3 million and $84.5 million, respectively.

In addition to our product groups, we also have one publicly traded subsidiary, McAfee.com. McAfee.com is an applications service provider, or ASP, targeted at consumers and small to medium-sized businesses. For the three months and six months ended June 30, 2001, McAfee.com, which constitutes our second business segment, accounted for approximately $14.4 million and $27.2 million in net revenue and a net operating loss of approximately $639,000 and $3.4 million, respectively.

McAfee

McAfee s products and services provide solutions designed to enforce anti-virus policies and measure the performance of anti-virus activities. The McAfee product group consists of products and services that provide multi-layer anti-virus protection, management and reporting for desktops, servers, GroupWare, Internet technologies, and wireless technologies. McAfee s services are provided by McAfee s Anti-Virus Emergency

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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

Sniffer Technologies products and services provide customers with network and application management solutions designed to maximize network availability and performance. Sniffer Technologies products capture data, monitor network traffic and collect key network statistics for computer networks. Sniffer Technologies products are also designed to optimize network and application performance and increase network reliability by uncovering and analyzing network problems 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.

PGP Security

PGP Security s products help organizations worldwide secure their networks using firewall, encryption, intrusion detection, risk assessment and Virtual Private Network or VPN technologies. PGP Security s products include E-Business Server, Gauntlet Firewall, CyberCop Scanner and E-ppliance. E-Business Server provides an encryption and data authentication solution designed to protect the integrity and security of the customers data. Gauntlet Firewall delivers integrated anti-virus protection, a built-in standards-based VPN server, and spam and content filtering. CyberCop Scanning tools deliver risk assessment solutions that continually scan networks for weak spots, enabling network administrators to prevent security breaches before they occur. PGP s E-ppliance, a web-based configuration tool, is designed to deploy the latest firewall technologies and continually administers anti-virus protection. PGP Security s services are offered by its vulnerability research team known as COVERT. COVERT s mission is to identify and resolve serious customer vulnerabilities before attackers are able to exploit them. PGP Security s customers include individuals, government agencies, financial institutions and corporations, including e-businesses.

Magic Solutions

Magic Solutions products provide customers with a 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

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. We recently 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 new 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 June 30, 2001, we owned 36,000,000 shares of McAfee.com Class B common stock, entitled to three votes per share and representing approximately 80% of McAfee.com s outstanding common stock and 93% of its total voting power.

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.

We entered into amended distribution arrangements under which we permit our distributors to purchase software licenses at the time they fill customer orders and to pay for hardware and retail products only when these products are sold to the distributors customers. In addition, we permit our distributors to make hardware and retail product returns at any time prior to the time they sell the products to their customers. This right of return is unconditional. After sale by the distributor to its customer, the distributor has no right to return products to us unless we approve the return from the final customer to the distributor. Under our new business model, we recognize revenue on products when products are sold through by the distributor to their customers.

Results of Operations

The following table sets forth, for the periods indicated, the percentage of net revenues represented by certain items in our statements of operations for the three months ended June 30, 2001 and 2000.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Net revenue:				
Product	69.3%	74.6%	66.3%	75.7%
Services and support	30.7	25.4	33.7	24.3
Total net revenue	100.0	100.0	100.0	100.0
Cost of net revenue:				
Product	13.0	12.5	13.3	11.8
Services and support	6.7	3.8	6.4	3.9

Total cost of net revenue	19.7	16.3	19.7	15.7
Operating costs and expenses:				
Research and development	17.8	18.4	20.4	18.9
Marketing and sales	54.6	42.6	59.3	43.8
General and administrative	13.7	9.4	15.6	9.6
Amortization of intangibles	8.5	6.5	8.9	6.6
Total operating costs and expenses	94.6	76.9	104.2	78.9
Income (loss) from operations	(14.3)	6.8	(24.0)	5.4
Interest and other income and expense, net	1.6	2.6	2.6	2.4
Gain (loss) on investments, net			9.0	
Write-down of strategic and other investments	(6.7)		(5.0)	
Income (loss) before provision for income taxes	(19.4)	9.4	(26.3)	16.8
Provision for income taxes (income tax benefit)	(0.4)	5.1	(3.0)	8.4
Income (loss) before minority interest	(19.0)	4.3	(23.3)	8.4

Minority interest in consolidated subsidiaries loss	0.0	0.5	0.2	0.5
Net income (loss)	(19.0)%	4.8%	(23.1)%	8.9%

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Net Revenue. Net revenue decreased 16.2% to $195.9 million from $233.7 million for the three months ended June 30, 2001 and 2000, respectively. Net revenue decreased 18.3% to $366.3 million from $448.1 million for the six months ended June 30, 2001 and 2000, respectively. The decrease in net revenue for the three and six months ended June 30, 2001 is primarily due to the relative increase in the amount of services, such as MSP and ASP, sold versus products, the former being recognized ratably over the period of the service contracts as compared to product sales which are generally recognized at the time of delivery.

Product revenue includes revenue from product licenses and hardware. Product revenue decreased 22.2% to $135.7 million from $174.3 million for the three months ended June 30, 2001 and 2000, respectively. Product revenue decreased 28.4% to $243.0 million from $339.4 million for the six months ended June 30, 2001 and 2000, respectively. The decrease in product revenue is primarily attributable to a change in our product and services mix, as discussed above.

Services and support revenues include revenues from software support and maintenance contracts, and education and consulting services, which are deferred and recognized over the related service period. Service revenues increased 1.4% to $60.2 million from $59.3 million for the three months ended June 30, 2001 and 2000, respectively. Service revenues increased 13.4% to $123.3 million from $108.7 million for the six months ended June 30, 2001 and 2000, respectively. The increase in services and support revenues resulted from growth in all categories of service revenues, principally due to the growth of our installed customer base and the resulting renewal of support and maintenance contracts. In addition, we experienced growth in our MSP and ASP service offerings, including those offered by McAfee.com, during the fourth quarter of 2000 and the first two quarters of 2001.

Our future profitability and rate of growth, if any, will be directly affected by increased price competition, a maturing anti-virus market 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 expanding our customer base. If our renewal of existing orders or our pace of new customer orders slows, our net revenues and operating results would be adversely affected.

International revenues were approximately $69.1 million and $92.9 million in the three months ended June 30, 2001 and 2000, respectively, and approximately $125.4 million and $177.0 million for the six months ended June 30, 2001 and 2000, respectively. On a percentage of net revenue basis, international revenue accounted for approximately 35% and 40%, of net revenue for the three months ended June 30, 2001 and 2000, respectively and approximately 34% and 40% for the six months ended June 30, 2001 and 2000, respectively. The decrease in international net revenue as a percentage of net revenue for the three and six months ended June 30, 2001 compared to the same periods in 2000 was due to the reorganization of our European sales force around our product groups, under performance in sales operations, changes in sales management, a slow down due to softening market conditions, and continued weakness of the Euro. We have recently renewed our emphasis on the international markets as evidenced by European sales force reorganization and continued key management additions. In future periods, we expect international revenues to grow in nominal dollars and as a percentage of net revenue.*

To minimize the impact of foreign currency fluctuations, we use non-leveraged forward currency contracts. However, our future results of operations may be adversely affected by currency fluctuations or by costs associated with currency risk management strategies. Other 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, uncertainties relative to regional economic circumstance, political instability in emerging markets and difficulties staffing and managing foreign operations. These factors may have a material adverse effect on our future international revenue. Further, in countries with a high incidence of software piracy, we may experience a higher rate of piracy of our products.

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* This statement is a forward looking statement reflecting current expectations. There can be no assurance that our actual performance will meet our current expectations. See Risk Factors on page 25 for discussion of certain factors that could affect future performance.

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Cost of Net Revenue. Cost of net revenue increased 1.2% to $38.5 million from $38.1 million for the three months ended June 30, 2001 and 2000, respectively. Cost of net revenue increased 3.0% to $72