McAfee, Inc.
Form 10-Q
May 02, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended March 31, 2006
	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: 001-31216

McAfee, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**77-0316593**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
3965 Freedom Circle Santa Clara, California	**95054**
(Address of principal executive offices)	*(Zip Code)*

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

As of April 28, 2006, 159,524,329 shares of the registrant s common stock, $0.01 par value, were outstanding.

MCAFEE, INC.

FORM 10-Q
March 31, 2006

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2006	December 31, 2005
	(In thousands, except share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 430,512	$ 728,592
Restricted cash		50,489
Short-term marketable securities	412,217	316,298
Accounts receivable, net of allowance for doubtful accounts of $2,164 and $2,389, respectively	123,845	158,680
Prepaid expenses and prepaid taxes	98,220	78,945
Other current assets	25,409	27,846
Deferred income taxes	219,136	206,811
Total current assets	1,309,339	1,567,661
Long-term marketable securities	294,863	212,131
Restricted cash	1,212	939
Property and equipment, net	89,060	85,641
Deferred income taxes	223,557	241,315
Intangible assets, net	74,138	80,782
Goodwill	438,255	438,396
Other assets	15,920	15,759
Total assets	$ 2,446,344	$ 2,642,624
LIABILITIES		
Current liabilities:		
Accounts payable	$ 34,300	$ 34,678
Accrued SEC settlement		50,000
Accrued income taxes	65,372	81,227
Accrued compensation	41,554	50,617
Accrued marketing	21,346	15,172
Other accrued liabilities	66,747	66,839
Deferred revenue	598,602	570,458
Total current liabilities	827,921	868,991
Deferred revenue, less current portion	177,503	175,962
Accrued taxes and other long-term liabilities	144,482	142,638
Total liabilities	1,149,906	1,187,591

Commitments and contingencies (Notes 12 and 13)

STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none in 2006 and 2005		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; Issued: 171,649,364 shares at March 31, 2006 and 170,453,210 shares at December 31, 2005 Outstanding: 159,239,082 shares at March 31, 2006 and 167,688,210 shares at December 31, 2005	1,717	1,705
Treasury stock, at cost: 12,410,282 shares at March 31, 2006 and 2,765,000 shares at December 31, 2005	(298,954)	(68,395)
Additional paid-in capital	1,390,253	1,356,881
Deferred stock-based compensation		(474)
Accumulated other comprehensive income	28,518	31,302
Retained earnings	174,904	134,014
Total stockholders equity	1,296,438	1,455,033
Total liabilities and stockholders equity	$ 2,446,344	$ 2,642,624

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

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
	(In thousands, except per share data) (Unaudited)	
Net revenue:		
Product	$ 31,100	$ 35,537
Subscription	92,726	68,078
Service and support	148,141	132,112
Total net revenue	271,967	235,727
Cost of net revenue:		
Product	15,667	16,923
Subscription	18,944	10,510
Service and support	6,466	7,374
Amortization of purchased technology	3,841	3,850
Total cost of net revenue	44,918	38,657
Operating costs:		
Research and development	51,191	38,230
Marketing and sales	84,866	71,184
General and administrative	37,870	33,621
Amortization of intangibles	2,793	3,528
Restructuring charges	551	2,296
Loss on sale of assets and technology	24	259
(Recovery of) provision for doubtful accounts, net	(451)	159
Reimbursement from transition services agreement		(328)
Total operating costs	176,844	148,949
Income from operations	50,205	48,121
Interest and other income	12,036	4,960
Loss on investments, net	(102)	(648)
Income before provision for income taxes	62,139	52,433
Provision for income taxes	21,249	16,463
Net income	$ 40,890	$ 35,970
Other comprehensive income:		
Unrealized gain (loss) on marketable securities, net of reclassification adjustment for losses recognized on marketable securities during the period and income tax	$ 185	$ (1,419)

Foreign currency translation (loss) gain		(2,969)		335
Comprehensive income	$	38,106	$	34,886
Net income per share Basic	$	0.25	$	0.22
Net income per share Diluted	$	0.25	$	0.21
Shares used in per share calculation Basic		164,940		162,992
Shares used in per share calculation Diluted		166,833		167,339

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

MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2006	2005
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income	$ 40,890	$ 35,970
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,191	16,421
(Recovery of) provision for doubtful accounts, net	(451)	159
Non cash restructuring charge	551	1,554
Interest released from restricted cash	489	
(Discount) premium amortization on marketable securities	(1,393)	654
Loss on sale of assets and technology	24	259
Loss on sale of investments	102	648
Deferred income taxes	4,067	(6,073)
Stock-based compensation charges (benefits)	13,571	(3,292)
Excess tax benefits from stock-based compensation	(3,001)	
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	36,483	40,128
Prepaid expenses, prepaid taxes and other assets	(16,281)	(9,582)
Accounts payable	(2,272)	(2,424)
Accrued taxes and other liabilities	(64,374)	(71)
Deferred revenue	24,778	26,099
Net cash provided by operating activities	48,374	100,450
Cash flows from investing activities:		
Purchase of marketable securities	(323,500)	(253,419)
Proceeds from sale and maturity of marketable securities	146,448	207,196
Decrease (increase) in restricted cash	49,727	(1)
Purchase of property, equipment and leasehold improvements	(10,191)	(9,146)
Net cash used in investing activities	(137,516)	(55,370)
Cash flows from financing activities:		
Proceeds from issuance of common stock from option and stock purchase plans	18,040	24,816
Excess tax benefits from stock-based compensation	3,001	
Repurchase of common stock	(230,559)	(47,351)
Net cash used in financing activities	(209,518)	(22,535)
Effect of exchange rate fluctuations	580	(9,661)

Net (decrease) increase in cash and cash equivalents		(298,080)		12,884
Cash and cash equivalents at beginning of period		728,592		291,155
Cash and cash equivalents at end of period	$	430,512	$	304,039
Non cash investing activities:				
Unrealized gain (loss) on marketable securities, net	$	185	$	(1,419)
Purchase of property, equipment and leasehold improvements	$	(2,974)	$	
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	31,358	$	19,960

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

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

We and our wholly owned subsidiaries are a worldwide supplier of computer security solutions designed to prevent intrusions on networks and secure computer systems and other digital devices from the next generation of blended attacks and threats. We offer two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. Our computer security solutions are offered primarily to large enterprises, governments, small and medium-sized businesses and consumers through a network of qualified partners. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific, excluding Japan; and Latin America.

2. Summary of Significant Accounting Policies and Basis of Presentation

The accompanying condensed consolidated financial statements include our accounts as of March 31, 2006 and December 31, 2005 and for the three months ended March 31, 2006 and March 31, 2005. All significant intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The December 31, 2005 consolidated balance sheet was derived from audited consolidated financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, we believe that all disclosures are adequate to make the information presented not misleading. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

In the opinion of our management, all adjustments (which consist of normal recurring adjustments, except as disclosed herein) necessary to fairly present our financial position as of March 31, 2006, and results of operations and cash flows for the three months ended March 31, 2006 and March 31, 2005 have been included. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

As of January 1, 2006, we changed the presentation of our net revenue and cost of net revenue to include three categories: (i) product, (ii) subscription and (iii) service and support. See Note 3 for further information.

Foreign Currency Translation

We have designated the U.S. dollar as the functional currency of McAfee, Inc. For the majority of our subsidiaries, we consider the local currency to be their functional currency. The assets and liabilities of subsidiaries that are denominated in functional currencies other than the U.S. dollar are translated using the exchange rate on the condensed consolidated balance sheet date. Revenues and expenses are translated at average exchange rates prevailing during the period. Translation adjustments resulting from this process are charged or credited to accumulated other comprehensive income, which is a component of stockholders equity. As of March 31, 2006, our stockholders equity included $3.0 million of net foreign currency translation losses for the three months ended March 31, 2006 and as of

March 31, 2005, stockholders equity includes a $0.3 million gain for the three months ended March 31, 2005.

Occassionally, a subsidiary enters into transactions that are denominated in currencies other than its functional currency. In these cases, the assets and liabilities and revenues and expenses related to the transactions are translated into the functional currency and any resulting gains or losses are recorded in the condensed consolidated statements of income. During the three months ended March 31, 2006 and 2005, we recorded net foreign currency transaction losses of $1.6 million and $1.1 million, respectively, in our condensed consolidated statements of income.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inventory

Inventory, which consists primarily of finished goods, is stated at lower of cost or market and is included in other current assets on our condensed consolidated balance sheet. Cost is computed using standard cost, which approximates actual cost on a first in, first out basis. Inventory balances were $1.2 million at both March 31, 2006 and December 31, 2005.

Stock-Based Compensation

On January 1, 2006, we adopted SFAS No. 123R, *Share-Based Payment,* or SFAS 123R, which is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation,* or SFAS 123, and supersedes APB No. 25, *Accounting for Stock Issues to Employees,* or APB 25. Among other items, SFAS 123R requires companies to record compensation expense for share-based awards issued to employees and directors in exchange for services provided. The amount of the compensation expense is based on the estimated fair value of the awards on their grant dates and is recognized over the required service periods. Our share-based awards include stock options, restricted stock awards, restricted stock units and our Employee Stock Purchase Plan.

Prior to our adoption of SFAS 123R, we applied the intrinsic value method set forth in APB 25 to calculate the compensation expense for share-based awards. Historically, we have generally set the exercise price for our stock options equal to the market value on the grant date. As a result, the options generally had no intrinsic value on their grant dates, and we did not record any compensation expense unless the terms of the options were subsequently modified. In addition, we did not recognize any compensation expense for our Employee Stock Purchase Plan under APB 25. For restricted stock awards and units, the calculation of compensation expense under APB 25 and SFAS 123R is the same.

We adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard to all share-based awards issued on or after January 1, 2006 and any outstanding share-based awards that were issued but not vested as of January 1, 2006. Accordingly, our condensed consolidated financial statements as of March 31, 2005 and for the three months then ended have not been restated to reflect the impact of SFAS 123R. During the three months ended March 31, 2005, we recognized a benefit of approximately $3.7 million under APB 25 related to the exchange of McAfee.com options in 2002 and the re-pricing of options in 1999. This benefit was partially offset by an expense of approximately $0.4 million for restricted stock awards. See Note 4 for additional information.

In the three months ended March 31, 2006, we recognized stock-based compensation expense of $13.6 million in our condensed consolidated financial statements, which included $10.9 million for stock options, $1.9 million for restricted stock awards and units and $0.8 million for our Employee Stock Purchase Plan. These amounts include (i) compensation expense for stock options granted prior to January 1, 2006 but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS 123, (ii) compensation expense for stock options granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R and (iii) compensation expense for restricted stock award and unit grants made both before and after January 1, 2006 that are not yet vested.

The estimated fair value underlying our calculation of compensation expense for stock options is based on the Black-Scholes pricing model. Upon adoption of SFAS 123R, we changed our method of attributing the value of stock-based compensation to the straight-line, single-option method. Compensation expense for all stock options granted prior to January 1, 2006 will continue to be recognized using the accelerated, single-option method. In addition, SFAS 123R requires forfeitures of share-based awards to be estimated at the time of grant and revised, if necessary, in subsequent periods if our estimates change based on the actual amount of forfeitures we have experienced. In the pro-forma information required under SFAS 123 for periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SFAS 123R requires us to calculate the pool of excess tax benefits, or the APIC pool, available as of January 1, 2006 to absorb tax deficiencies recognized in subsequent periods, assuming we had applied the provisions of the standard in prior periods. Pursuant to the provisions of FASB Staff Position 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards,* we adopted the alternative method for determining the tax effects of share-based compensation, which among other things, provides a simplified method for estimating the beginning APIC pool balance.

Accounting for Income Taxes

At the end of each interim period we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year. This effective tax rate is used to determine income taxes on a current year-to-date basis. The effective tax rate may consider, as applicable, tax credits, foreign tax rates, and other available tax planning alternatives. It also includes the effect of any valuation allowance expected to be necessary at the end of the period for deferred tax assets related to originating deductible temporary differences and carryforwards. In arriving at this effective tax rate applied to interim periods no effect is included for the tax related to significant, unusual, or extraordinary items that may be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate is revised, if necessary, as of the end of each successive interim period during the fiscal year to our best current estimate of our expected annual effective tax rate.

The effective tax rate is our best estimate of the tax expense (or benefit) that will be provided for the fiscal year, stated as a percentage of our estimated annual ordinary income (or loss). The tax expense (or benefit) related to ordinary income (or loss) for the interim period is determined using this estimated annual effective tax rate. The tax expense (or benefit) related to other items is individually computed and recognized when the items occur. The estimated tax rate applied to interim ordinary income (or loss) is reliant on our estimates of expected annual operating income (or loss) for the year as well as our projections of the proportion of income (or loss) earned in foreign jurisdictions which may have statutory tax rates significantly lower than tax rates applicable to our earnings in the United States. In each successive interim period, to the extent our operating results year to date and our estimates for the remainder of the fiscal year change from our original expectations regarding the proportion of earnings in various tax jurisdictions we expect that our effective tax rate will change accordingly, affecting tax expense (or benefit) for both that successive interim period as well as year-to-date interim results.

Tax returns are subject to audit by various taxing authorities. Although we believe that adequate accruals have been made each period for unsettled issues, additional benefits or expenses could occur in future years from resolution of outstanding matters. We record additional expenses each period on unsettled issues relating to the expected interest we would be required to pay a tax authority if we do not prevail on an unsettled issue. We continue to assess our potential tax liability included in accrued taxes in the condensed consolidated financial statements, and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. We have classified a portion of our tax liability as non-current in the condensed consolidated balance sheet based on the expected timing of cash payments to settle contingencies with taxing authorities.

Computation of Net Income per Share

Basic net income per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted-average number of common shares and dilutive

potential common shares outstanding during the period.

SFAS No. 128, *Earnings per Share,* requires that employee equity share options, nonvested shares and similar equity instruments granted by us be treated as potential common shares outstanding in computing diluted earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money options which is calculated based on the average share price for each reported period using the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that we have not yet recognized and the amount of tax benefits that would be

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. We calculate tax benefits that will be recorded in additional paid-in capital based on the portion of the fair value of the award that will be recognized in the financial statements, and exclude the portion of the award that was recognized under the SFAS 123 pro-forma disclosures prior to the implementation of SFAS 123R.

Recent Accounting Pronouncements

Electronic Equipment Waste Obligations

In June 2005, the FASB issued SFAS 143-1, *Accounting for Electronic Equipment Waste Obligations,* which provides guidance on the accounting for certain obligations associated with Directive 2002/96/EC on Waste Electrical and Electronic Equipment, or the Directive, which was adopted by the European Union, or EU. Under the Directive, the waste management obligation for historical equipment, defined as products put on the market on or prior to August 13, 2005, remains with the commercial user until the equipment is replaced. SFAS 143-1 is required to be applied to the later of the first fiscal period ending after June 8, 2005 or the date of the Directive s adoption into law by the applicable EU member countries in which we have significant operations. We are currently evaluating the impact of FSP SFAS 143-1 on our financial position and results of operations. The effects will depend on the respective laws adopted by the EU member countries.

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections,* or SFAS 154, a replacement of APB Opinion No. 20, *Accounting Changes,* and SFAS Statement 3, *Reporting Accounting Changes in Interim Financial Statements.* SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS 154 did not have a material effect on our consolidated financial position, results of operations or cash flows.

The Meaning of Other-Than-Temporary Impairment

In November 2005, the FASB issued Staff Position 115-1 *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* or FSP 115-1, that addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary and the measurement of an impairment loss. FSP 115-1 also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 amends SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities* and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* . The final FSP nullifies certain requirements of EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* , and supersedes EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value* . The guidance in FSP 115-1 is effective for reporting periods beginning after December 15, 2005. The adoption of FSP

115-1 did not have a material effect on our consolidated financial position, results of operations or cash flows.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Net Revenue and Cost of Net Revenue

As disclosed in our 2005 Annual Report on Form 10-K, during the three months ended December 31, 2005, we made certain reclassifications from product revenue to service revenue, primarily related to online subscriptions. Total net revenue was not impacted by these reclassifications. The following table presents our 2005 quarterly net revenue, as reclassified in 2005, and cost of net revenue, as disclosed in our respective Quarterly Report on Form 10-Q (in thousands):

	Three Months Ended				Twelve Months Ended
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005	December 31, 2005
Net revenue:					
Product	$ 45,145	$ 43,805	$ 32,578	$ 46,010	$ 167,538
Service and support	190,582	201,577	220,333	207,269	819,761
Total net revenue	$ 235,727	$ 245,382	$ 252,911	$ 253,279	$ 987,299
Cost of net revenue:					
Product	$ 16,646	$ 11,865	$ 10,282	$ 24,479	$ 63,272
Service and support	18,161	21,105	22,873	23,689	85,828
Amortization of purchased technology	3,850	3,886	3,938	3,841	15,515
Total cost of net revenue	$ 38,657	$ 36,856	$ 37,093	$ 52,009	$ 164,615

As of January 1, 2006, we changed the presentation of our net revenue and cost of net revenue to include three categories: (i) product, which includes hardware and perpetual licenses (ii) subscription, which includes subscription-based offerings and (iii) service and support, which includes maintenance, consulting and training. Previously, we chose to allocate our subscription business between product and services and support instead of presenting it as a separate category. We believe this new presentation is consistent with the way we currently manage our business as we grow the subscription component of both our corporate and consumer businesses. In the table below, we have applied the change in presentation retrospectively to the balances previously reported for each period during the year ended December 31, 2005. Total net revenues and cost of net revenues were not affected by the change.

The following table presents our revised 2005 quarterly net revenue and cost of net revenue presentation (in thousands):

	Three Months Ended				Twelve Months Ended
	March 31, 2005	**June 30, 2005**	**September 30, 2005**	**December 31, 2005**	**December 31, 2005**
Net revenue:					
Product	$ 35,537	$ 34,308	$ 20,825	$ 37,185	$ 127,855
Subscription	68,078	77,828	90,891	81,409	318,206
Service and support	132,112	133,246	141,195	134,685	541,238
Total net revenue	$ 235,727	$ 245,382	$ 252,911	$ 253,279	$ 987,299
Cost of net revenue:					
Product	$ 16,923	$ 11,986	$ 10,399	$ 24,636	$ 63,944
Subscription	10,510	13,709	14,909	15,147	54,275
Service and support	7,374	7,275	7,847	8,385	30,881
Amortization of purchased technology	3,850	3,886	3,938	3,841	15,515
Total cost of net revenue	$ 38,657	$ 36,856	$ 37,093	$ 52,009	$ 164,615

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. Employee Stock Benefit Plans

Employee Stock Purchase Plan

In April 2002, our board of directors adopted McAfee s 2002 Employee Stock Purchase Plan, or the Employee Stock Purchase Plan, which reserved 2.0 million shares of our common stock for issuance to our employees. In December 2003 and May 2005, our stockholders approved an additional 2.0 million and 1.0 million shares for issuance, respectively, bringing the total number of shares reserved under the plan to 5.0 million. Generally, individuals who are employed for 30 days and perform at least 20 hours of service per week are eligible to participate in the Employee Stock Purchase Plan.

Prior to August 1, 2005, we offered shares of stock for purchase to eligible employees through a series of two-year offering periods. Each two-year offering period was comprised of four consecutive six-month purchase periods. Beginning August 1, 2005, the term of the offering period was changed to six months. Outstanding offering periods that commenced prior to August 1, 2005 will continue until the end of the two-year offering period.

During an offering period, employees make contributions to the Employee Stock Purchase Plan through payroll deductions. At the end of each purchase period, we use the accumulated contributions to issue shares of our stock to the participating employees. The issue price of those shares is equal to the lesser of (i) 85% of our stock price on the first day of the offering period, or (ii) 85% of our stock price on the purchase date. No participant may be issued more than $25,000 of common stock in any one calendar year and the maximum number of shares a participant may be issued during a single offering period is 10,000 shares. In both the three months ended March 31, 2006 and March 31, 2005, approximately 0.4 million shares were issued under the Employee Stock Purchase Plan at a weighted-average issue price of $17.22 and $13.93, respectively. The total intrinsic value of shares issued under the Employee Stock Purchase Plan during the three months ended March 31, 2006 and March 31, 2005 was $2.4 million and $4.8 million, respectively.

Company Stock Incentive Plans

Under the terms of our amended 1997 Stock Incentive Plan, or the 1997 Plan, we have reserved a total of 38.5 million shares for issuance to employees, officers, directors, third-party contractors and consultants through awards provided in the form of options, restricted stock awards, restricted stock units, or stock appreciation rights. As of March 31, 2006, we have no share-based issuances outstanding with third-party contractors or consultants.

For options granted to employees and officers under the 1997 Plan, the exercise price is no less than 100% of the fair value of our stock on the grant date. For options granted to all other parties, the exercise price is no less than 85% of the fair value of our common stock on the grant date. Although some of the options may be exercised immediately upon granting, the majority contain gradual vesting provisions, whereby 25% vest one year from the date of grant and thereafter in monthly increments over the remaining three years. All unexercised options expire ten years after the grant date. Restricted stock awards and restricted stock units also vest over a specified period, generally 50% two years from the grant date and 50% three years from the grant date. Restricted stock awards are common stock issued to the recipient that have not vested. Restricted stock units are promises to issue stock in the future.

Under the Stock Option Plan for Outside Directors, we have reserved 1.1 million shares of our common stock for issuance to certain members of our board of directors who are not employees of ours or any of our affiliated entities. The exercise price for these options is equal to the market value of our common stock on the grant date. Initial grants to each outside director generally vest ratably over a three-year period, while any subsequent grants are exercisable three years from the grant date. All unexercised options expire ten years after the grant date.

In connection with our acquisition of Foundstone, Inc. in October 2004, we assumed the obligations of their 2000 Stock Plan and converted their outstanding options into options to purchase 428,696 shares of our common stock. We have reserved 747,144 shares of our common stock for issuance under this plan. The plan provides for an

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

option price no less than 85% of the fair value of our common stock on the date of grant. The options contain gradual vesting provisions, whereby 25% vest one year from the date of grant and thereafter in monthly increments over the remaining three years. All unexercised options expire ten years after grant date.

Plan Activity

A summary of the activity of our employee stock options during the three months ended March 31, 2006 and details regarding the options outstanding and exercisable at March 31, 2006 are provided below (in thousands, except per share data):

	Three Months Ended March 31, 2006			
	Number of Options	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Life (Yrs)	Aggregate Intrinsic Value
Outstanding at beginning of period	16,111	$ 19.79		
Options granted	600	25.88		
Options exercised	(801)	14.03		
Options canceled	(717)	21.12		
Outstanding at end of period	15,193	$ 20.28		
Options outstanding, expected to vest	13,875	$ 19.99	7.7	$ 74,399
Options exercisable	6,176	$ 18.36	6.3	$ 42,530

The total intrinsic value of options exercised during the three months ended March 31, 2006 and March 31, 2005 was $8.7 million and $30.9 million, respectively.

The tax benefit realized from stock option exercises and employee stock purchase rights in the three months ended March 31, 2006 was $4.0 million. We realized no tax benefit in the three months ended March 31, 2005.

A summary of the activity for restricted stock awards and restricted stock units during the three months ended March 31, 2006 is provided below (in thousands except per share data):

	Three Months Ended March 31, 2006		
	Weighted		Weighted

	Restricted Stock Units	Average Grant Date Fair Value	Restricted Stock Awards	Average Grant Date Fair Value
Unvested at beginning of period		$	185	$ 29.79
Grants	3,601	23.77		
Vested			(25)	28.41
Canceled	(15)	23.62		
Unvested at end of period	3,586	$ 23.78	160	$ 30.01

The weighted-average remaining contractual life for unvested restricted stock units and restricted stock awards at March 31, 2006 was 2.5 years and 2.2 years, respectively. The 3.6 million of restricted stock units granted in the three months ended March 31, 2006 under the 1997 Plan were valued at $69.6 million when reduced by estimated forfeitures. The total fair value of restricted stock awards vested during the three months ended March 31, 2006 and March 31, 2005 was $0.7 million and $1.2 million, respectively.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Shares available for future grants to employees under our stock incentive plans totaled 3.9 million at March 31, 2006. Our management currently plans to issue new shares for the vesting of restricted stock awards and restricted stock units and exercises of stock options.

Valuation and Expense Information under SFAS 123R

As indicated in Note 2, we adopted the provisions of SFAS 123R on January 1, 2006. In the three months ended March 31, 2006, we recognized stock-based compensation expense of $13.6 million in our condensed consolidated financial statements, which included $10.9 million for stock options, $1.9 million for restricted stock awards and units and $0.8 million for our Employee Stock Purchase Plan. The following table summarizes the stock-based compensation expense by income statement line item that we recorded in accordance with the provisions of SFAS 123R (in thousands):

		Three Months Ended March 31, 2006
Cost of net revenue product	$	226
Cost of net revenue subscription		91
Cost of net revenue service and support		359
Stock-based compensation expense included in cost of net revenue		676
Research and development		3,917
Sales and marketing		4,691
General and administrative		4,287
Stock-based compensation expense included in operating expenses		12,895
Total stock-based compensation expense related to stock-based equity awards		13,571
Deferred tax benefit		3,925
Total stock-based compensation expense related to stock-based equity awards, net of tax	$	9,646

We had no stock-based compensation costs capitalized as part of the cost of an asset.

The adoption of SFAS 123R on January 1, 2006 decreased our pre-tax income by $13.6 million, decreased net income by $9.6 million, decreased our basic net income per share by $0.06 per share and decreased diluted net income per share by $0.05 per share. Cash provided by operating activities decreased and cash provided by financing activities increased $3.0 million, respectively, related to excess tax benefits from stock-based payment arrangements.

At March 31, 2006, the estimated fair value of all unvested stock options, restricted stock units, restricted stock awards and employee stock purchase rights that have not yet been recognized as compensation expense was

$113.6 million, net of expected forfeitures. We expect to recognize this amount over a weighted-average period of 3.0 years.

As indicated in Note 2, under both SFAS 123R and SFAS 123 we used the Black-Scholes model to estimate the fair value of our option awards and employee stock purchase rights issued under the Employee Stock Purchase Plan.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The key assumptions used in the model during the three months ended March 31, 2006 and 2005 are provided below:

	Three Months Ended March 31,	
	2006	**2005**
Stock option grants:		
Risk free interest rate	4.5%	3.8%
Weighted average expected lives	5.4	4.0
Volatility	38.0%	60.4%
Dividend yield		
ESPP:		
Risk free interest rate	4.6%	2.9%
Weighted average expected lives	0.5	1.3
Volatility	38.0%	40.0%
Dividend yield		

The fair value of the option awards and employee stock purchase rights were:

	Three Months Ended March 31,	
	2006	**2005**
Weighted-average grant date fair value of options granted	$ 10.91	$ 13.17
Weighted-average fair value of employee stock purchase rights	$ 6.11	$ 8.62

We derive the expected term of our options through the use of a lattice model that factors in historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Since January 1, 2006, we have used the implied volatility of options traded on our stock with a term of one year or more to calculate the expected volatility of our option grants. Prior to that time, the expected volatility was based solely on the historical volatility of our stock. We changed our method of estimating volatility to using implied volatility, because we believe that using implied volatility of options traded on our stock is a better measure of volatility than historical volatility. We have not declared any dividends on our stock in the past and do not expect to do so in the foreseeable future.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pro-forma Information under SFAS 123 for Periods Prior to January 1, 2006

As indicated in Note 2, we applied the provisions of APB 25 to determine our stock-based compensation expense for all periods prior to January 1, 2006. The following table illustrates the effect on net income and net income per share if we had applied the fair value recognition provision of SFAS 123 to our stock-based compensation plans during the three months ended March 31, 2005 (in thousands, except per share data):

		Three Months Ended March 31, 2005
Net income, as reported	$	35,970
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of tax		(7,403)
Deduct: Stock-based compensation benefit, net of tax, included in reported net income under APB 25		(2,136)
Pro-forma net income	$	26,431
Basic net income per share, as reported	$	0.22
Diluted net income per share, as reported	$	0.21
Basic net income per share, pro-forma	$	0.16
Diluted net income per share, pro-forma	$	0.16

Stock-based Compensation Recognized Prior to January 1, 2006

In the three months ended March 31, 2005, we recorded a stock-based compensation benefit under APB 25 which consisted of the following items (in thousands):

		Three Months Ended March 31, 2005
Exchange of McAfee.com options	$	(1,976)
Repriced options		(1,699)
New and existing executives and employees		383
Total stock-based compensation benefit		(3,292)
Tax expense		1,156

Total stock-based compensation benefit, after-tax	$	(2,136)

The pre-tax stock-based compensation benefit of $3.3 million in the three months ended March 31, 2005 is included in the following line items in our condensed consolidated statement of income (in thousands):

	Three Months Ended March 31, 2005	
Research and development	$	(2,503)
Marketing and sales		(735)
General and administrative		(54)
Total stock-based compensation benefit	$	(3,292)

Exchange of McAfee.com options. On September 13, 2002, we acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of our common stock plus $8.00 in cash, $11.85 after applying the option exchange ratio, which is paid to the option holder upon exercise of the option and without interest.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of our common stock. The assumed options were subject to variable accounting treatment, which means that the compensation charge was measured initially at the date of the closing of the acquisition and was remeasured each reporting period based on our common stock fair market value at the end of each report period.

During the three months ended March 31, 2005, we recorded a benefit of approximately $2.0 million related to exchanged options subject to variable accounting. The stock-based compensation benefit in the three months ended March 31, 2005 was due to a decline in our stock price from $28.93 at December 31, 2004 to $22.56 as of March 31, 2005. Under SFAS 123R, variable accounting does not apply to the exchanged options.

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 value of the stock. Options to purchase a total of 9.5 million shares were cancelled and the same number of new options was granted. These new options vested at the same rate that they would have vested under previous option plans and were subject to variable accounting. Accordingly, we have remeasured compensation cost for these repriced options until these options were exercised, cancelled, or forfeited without replacement. The first valuation period began July 1, 2000.

The amount of stock-based compensation recorded was 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 common stock on July 1, 2000, which was $20.375.

During the three months ended March 31, 2005, we recorded a benefit of approximately $1.7 million. The stock-based compensation benefit for these options was based on closing stock price as of March 31, 2005 of $22.56. The benefit in the three months ended March 31, 2005 was due to a decline in our stock price from $28.93 at December 31, 2004 to $22.56 as of March 31, 2005. These options were fully vested as of December 31, 2005, therefore, no stock-based compensation expense will be recognized under SFAS 123R.

New and existing executives and employees. In January 2005, our board of directors granted 75,000 shares of restricted stock to our chief financial officer. The price of the underlying shares is $0.01 per share. The shares will vest and our right to repurchase the shares will lapse over three years from the date of grant. The fair value of the restricted stock award was determined to be approximately $2.1 million and was based on the difference between the exercise price of the restricted stock award and the fair value of the common stock on the date of grant. We recorded expense of approximately $0.2 million during the three months ended March 31, 2005, related to the stock-based compensation associated with the chief financial officer s restricted stock award grant.

In connection with the acquisition of Foundstone in October 2004, we exchanged options to purchase shares of our common stock for Foundstone stock options. A portion of the fair value of our stock options was included in the Foundstone purchase price. In accordance with FIN 44, we recorded $2.3 million of deferred stock-based compensation related to the exchange of unvested stock options which are subject to vesting provisions as employment services are provided to us by the former Foundstone employees. The unvested stock options granted to Foundstone employees vest over periods ranging through 2008. We recorded stock-based compensation of approximately $0.2 million in the three months ended March 31, 2005, related to the unvested stock options exchanged in the Foundstone acquisition.

In January 2002, our board of directors approved a grant of 50,000 shares of restricted stock to our chief executive officer. The price of the underlying shares is $0.01 per share. The shares vested and our right to repurchase such shares lapsed as follows: 3,000 vested as of the grant date and 47,000 were restricted until January 15, 2005. The fair value of the restricted stock was determined to be approximately $1.4 million and was determined based on the difference between the exercise price of the restricted stock and the fair value of the common stock on the date of grant. During the three months ended March 31, 2005, we recorded less than $0.1 million related to stock-based compensation associated with the chief executive officer s restricted stock grant.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Business Combinations and Divestitures

Wireless Security Corporation

In June 2005, we acquired 100% of the outstanding shares of Wireless Security Corporation, a provider of home and small business wireless network security products, for approximately $20.0 million in cash and $0.3 million of direct expenses, totaling $20.3 million. We acquired Wireless Security Corporation to continue to develop their patent-pending technology, introduce a new consumer offering and to utilize the technology in our small business managed solutions. The results of operations of Wireless Security Corporation have been included in our results of operations since the date of acquisition.

Our management determined the purchase price allocation based on estimates of the fair values of the tangible and intangible assets acquired and liabilities assumed. These estimates were arrived at utilizing recognized valuation techniques. We recorded $13.2 million of goodwill (none of which is deductible for tax purposes). The following is a summary of the assets acquired and liabilities assumed in the acquisition of Wireless Security Corporation as adjusted during the current period for resolution of ongoing purchase price valuation procedures:

		(In thousands)
Technology	$	1,500
Other intangibles		300
Goodwill		13,247
Cash		129
Other assets		34
Deferred tax assets		1,870
Total assets acquired		17,080
Liabilities		38
Deferred tax liabilities		711
Total liabilities assumed		749
Net assets acquired		16,331
In-process research and development expensed		4,000
Total acquisition cost	$	20,331

We recorded approximately $4.0 million for in-process research and development, which was fully expensed upon purchase because technological feasibility had not been achieved and there was no alternative use for the projects under development. The in-process research and development included the development of the consumer wireless

security product that we introduced in the third quarter of 2005. In addition, the in-process research and development included existing wireless security offers that we plan to integrate in our small business managed solution. At the date of acquisition, we estimated that 60% of the development effort had been completed and that the remaining 40% of the development would take approximately three months to complete and would cost approximately $0.6 million. As of December 31, 2005, we had completed the remaining development efforts. The intangible assets, other than goodwill, are being amortized over their useful lives of 2.0 to 3.5 years or a weighted-average period of 3.2 years. As part of the acquisition, we did not assume any outstanding stock options or warrants. A performance and retention plan, which provides for payment of up to $1.8 million, was established at the close of the acquisition. At March 31, 2006, approximately $0.8 million had been expensed and $0.4 million had been paid related to this performance plan. The results of operations for Wireless Security Corporation prior to the acquisition would not have a material impact on our results of operations.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

McAfee Labs

In April 2005, we completed the sale of our McAfee Labs assets to SPARTA, Inc. for $1.5 million and recognized a gain on the sale of $1.3 million. The carrying value of McAfee Labs assets and liabilities, which were sold in this agreement, were not significant. The operations of McAfee Labs, which are not material to our consolidated results of operations, are included in income from operations for the three months ended March 31, 2005.

Revenues related to McAfee Labs were approximately $1.7 million in the three months ended March 31, 2005.

6. Goodwill and Other Intangible Assets

We account for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets.* Specifically, we perform an impairment review of our goodwill on at least an annual basis and amortize all other intangible assets over their estimated useful lives.

Our goodwill impairment review is conducted as of October 1 of each fiscal year or earlier if indicators of impairment exists. In 2005 and 2004, these analyses have indicated that goodwill was not impaired. The fair value of the reporting units was estimated using the average of the expected present value of future cash flows and of the market multiple value. We will continue to test for impairment on an annual basis and on an interim basis if an event occurs or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying amounts.

Goodwill by geographic region is as follows (in thousands):

	December 31, 2005	Goodwill Acquired	Adjustments	Effects of Foreign Currency Exchange	March 31, 2006
North America	$ 353,534	$	$ (11)	$ (45)	$ 353,478
EMEA	50,024			24	50,048
Japan	17,519				17,519
Asia-Pacific (excluding Japan)	5,957				5,957
Latin America	11,362			(109)	11,253
Total	$ 438,396	$	$ (11)	$ (130)	$ 438,255

The adjustment to goodwill during the first quarter of 2006 related to Foundstone stock compensation and the realization of net deferred tax assets from the Foundstone acquisition.

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

		March 31, 2006			December 31, 2005		
	Weighted Average Useful Life	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization (Including Effects of Foreign Currency Exchange)	Amount Carrying Net
Other intangible assets:							
Purchased technologies	6.0 years	$ 138,255	$ (91,017)	$ 47,238	$ 138,052	$ (86,965)	$ 51,087
Trademarks and patents	5.0 years	28,838	(27,626)	1,212	28,838	(26,986)	1,852
Customer base and other intangibles	6.8 years	62,083	(36,395)	25,688	62,089	(34,246)	27,843
		$ 229,176	$ (155,038)	$ 74,138	$ 228,979	$ (148,197)	$ 80,782

The aggregate amortization expenses for the intangible assets listed above totaled $6.6 million and $7.4 million in the three months ended March 31, 2006 and 2005, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Expected future intangible asset amortization expense as of March 31, 2006 is as follows (in thousands):

Fiscal Years:	
Remainder of 2006	$ 18,631
2007	22,471
2008	16,918
2009	10,724
2010	4,317
Thereafter	1,077
	$ 74,138

7. Restructuring Charges

2005 Restructuring

During 2005, we permanently vacated several leased facilities and recorded a $1.9 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, along with estimated costs associated with subleasing the vacated facility, net of estimated sublease rental income. We also recorded a restructuring charge of $0.2 million related to a reduction in headcount of approximately 14 employees.

The following table summarizes our restructuring accrual established in 2005 and activity through March 31, 2006 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2005	$	$	$	$
Restructuring accrual	1,852	216	4	2,072
Cash payments	(1,127)	(216)	(4)	(1,347)
Effects of foreign currency exchange	(14)			(14)
Accretion	23			23
Balance, December 31, 2005	734			734
Cash payments	(284)			(284)
Effects of foreign currency exchange	(12)			(12)

Accretion	6			6
Balance, March 31, 2006	$ 444	$	$	$ 444

As of March 31, 2006, $0.4 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while less than $0.1 million has been classified as other long-term liabilities, and will be paid through July 2007. Lease termination costs are net of estimated sublease income of $0.1 million at March 31, 2006.

2004 Restructuring

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2004. In the second quarter of 2004, we recorded a restructuring charge of approximately $1.6 million related to the severance of approximately 80 employees in our sales, technical support and general and administrative functions. Approximately $0.6 million of the restructuring charge was related to the EMEA operating segment and the remaining $1.0 million was related to the North America operating segment. In the third quarter of 2004, we recorded a restructuring charge related to ten employees which totaled approximately $0.9 million, all of which related to the North America operating segment. In the fourth quarter of 2004, we recorded a restructuring charge of $1.3 million related to 111 employees, of which $0.7 million, $0.2 million, $0.2 million and $0.2 million related to the Latin America, North America, EMEA and Asia-Pacific (excluding Japan) operating segments, respectively. All employees were terminated at December 31, 2004. The reductions in the second, third and fourth quarters were part of the previously announced cost-savings measures being implemented by us.

In September 2004, we announced the move of our European headquarters to Ireland, which was substantially completed by the end of March 2005. In the third and fourth quarters of 2004, we recorded restructuring charges of $0.2 million and $2.2 million, respectively, related to the severance of approximately 80 employees.

Also in September 2004, we permanently vacated an additional two floors in our Santa Clara headquarters building. We recorded a $7.8 million accrual for the estimated lease related costs associated with the permanently vacated facility, partially offset by a $1.3 million write-off of deferred rent liability. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income along with estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. We also recorded a non-cash charge of approximately $0.8 million related to disposals of certain leasehold improvements.

In the fourth quarter of 2004, we permanently vacated several leased facilities and recorded a $2.2 million accrual for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of remaining lease obligations, along with estimated costs associated with subleasing the vacated facility.

During 2004, we adjusted the restructuring accruals related to severance costs and lease termination costs recorded in 2004. We recorded a $0.3 million adjustment to reduce the EMEA severance accrual for amounts that were no longer necessary after paying out substantially all accrued amounts to the former employees. We also recorded a $0.2 million reduction in lease termination costs due to changes in estimates related to the sublease income to be received over the remaining lease term of our Santa Clara headquarters building.

During 2005, we completed the move of our European headquarters to Ireland and vacated the remaining planned floors. We recorded an additional $1.4 million restructuring charge for estimated lease related costs associated with the permanently vacated facilities and a $1.4 million restructuring charge for severance costs. All of these restructuring charges were related to the EMEA operating segment. During 2005, we also made adjustments to our restructuring accrual totaling $0.8 million due to a change in assumptions related to utility costs and sublease income.

During the three months ended March 31, 2006, we made adjustments to our restructuring accrual totaling $0.3 million attributable to commissions owed on new subleases and a change in assumptions related to commissions on existing subleases.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes our restructuring accruals established in 2004 and activity through March 31, 2006 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2004	$	$	$	$
Restructuring accrual	8,685	7,932	480	17,097
Cash payments	(579)	(4,175)	(63)	(4,817)
Adjustment to liability	(222)	(275)		(497)
Accretion	74			74
Balance, December 31, 2004	7,958	3,482	417	11,857
Restructuring accrual	1,402	1,382	20	2,804
Cash payments	(2,747)	(4,864)	(297)	(7,908)
Adjustment to liability	(819)		(140)	(959)
Effects of foreign currency exchange	(46)			(46)
Accretion	341			341
Balance, December 31, 2005	6,089			6,089
Cash payments	(895)			(895)
Adjustment to liability	301			301
Effects of foreign currency exchange	(21)			(21)
Accretion	70			70
Balance, March 31, 2006	$ 5,544	$	$	$ 5,544

As of March 2006, $1.2 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of $4.3 million has been classified as other long-term liabilities, and will be paid through March 31, 2013. Lease termination costs are net of estimated sublease income of $4.9 million at March 31, 2006.

2003 Restructuring

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

Protection Solutions businesses.

As part of the consolidation of activities into the Plano facility, we relocated employees from the Santa Clara, California headquarters site. As a result of this consolidation, in March 2003, we recorded a $15.6 million accrual for estimated lease related costs associated with the permanently vacated facilities, partially offset by a $1.9 million write off of deferred rent liability. The remaining costs associated with vacating the facility are primarily comprised of the present value of remaining lease obligations, net of estimated sublease income, along with estimated costs associated with subleasing the vacated facility. The remaining costs will generally be paid over the remaining lease term ending in 2013. We also recorded a non-cash charge of approximately $2.1 million related to asset disposals and discontinued use of certain leasehold improvements and furniture and equipment. This restructuring charge was allocated to our North American segment.

During the second and third quarters of 2003, we recorded restructuring charges of $6.8 million and $0.6 million, respectively, which consisted of $6.7 million related to a headcount reduction of 210 employees

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

In 2004, we adjusted the restructuring accrual related to lease termination costs previously recorded in 2003. The adjustments decreased the liability by approximately $0.6 million 2004, due to changes in estimates related to the sublease income to be received over the remaining lease term. Also in 2004, we recorded a $0.1 million adjustment to reduce the restructuring accrual for severance and benefits from our EMEA operating segment that would not be utilized.

During 2005, we made adjustments to our restructuring accrual totaling $1.0 million due to a change in assumptions related to utility costs and sublease income.

During the three months ended March 31, 2006, we made adjustments to our restructuring accrual totaling $0.1 million attributable to commissions owed on new subleases and a change in assumptions related to commissions on existing subleases.

The following table summarizes our restructuring accrual established in 2003 and activity through March 31, 2006 (in thousands):

	Lease Termination Costs	Severance and Other Benefits	Other Costs	Total
Balance, January 1, 2003	$	$	$	$
Restructuring accrual	15,734	6,692	739	23,165
Cash payments	(1,707)	(6,259)	(167)	(8,133)
Adjustment to liability	(273)	(116)	(572)	(961)
Accretion	463			463
Balance, December 31, 2003	14,217	317		14,534
Cash payments	(1,841)	(194)		(2,035)
Adjustment to liability	(623)	(123)		(746)
Accretion	548			548
Balance, December 31, 2004	12,301			12,301
Cash payments	(1,279)			(1,279)
Adjustment to liability	(1,048)			(1,048)

Accretion	498			498
Balance, December 31, 2005	10,472			10,472
Cash payments	(478)			(478)
Adjustment to liability	68			68
Accretion	106			106
Balance, March 31, 2006	$ 10,168	$	$	$ 10,168

As of March 31, 2006, $1.8 million of the restructuring accrual is due within 12 months and has been classified as current accrued liabilities, while the remaining balance of $8.4 million has been classified as other long-term liabilities and will be paid through March 31, 2013. Lease termination costs are net of estimated sublease income of $8.0 million at March 31, 2006.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our estimate of the excess facilities charges recorded during 2005, 2004 and 2003 may vary significantly depending, in part, on factors which may be beyond our control, such as our success in negotiating with our lessor, the time periods required to locate and contract suitable subleases and the market rates at the time of such subleases. Adjustments to the facilities accrual will be made if actual lease exit costs or sublease income differ from amounts currently expected. The facility restructuring charges in 2005 were primarily allocated to the EMEA and Japan operating segments, and the facility restructuring charges in 2004 and 2003 were primarily allocated to the North America operating segment.

8. Line of Credit

We have a $17.0 million credit facility with a bank. The credit facility is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between us and the bank at the time of each specific transaction. The credit facility is intended to be used for short-term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time. No balances were outstanding as of March 31, 2006 and December 31, 2005.

9. Net Income Per Share

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

	Three Months Ended March 31,	
	2006	**2005**
Numerator Basic net income	$ 40,890	$ 35,970
Numerator Diluted net income	$ 40,890	$ 35,970
Denominator Basic		
Basic weighted average common stock outstanding	164,940	162,992
Denominator Diluted		
Basic weighted average common stock outstanding	164,940	162,992
Effect of dilutive securities:		
Common stock options, Employee Stock Purchase Plan shares and shares subject to repurchase(1)	1,893	4,347
Diluted weighted average shares	166,833	167,339
Net income per share Basic	$ 0.25	$ 0.22

Net income per share Diluted	$	0.25	$	0.21

(1) At March 31, 2006 and 2005, approximately 7.1 million and 3.0 million options to purchase common stock, respectively, were excluded from the calculation since the effect was anti-dilutive.

10. Income Taxes

Our consolidated provision for income taxes for the three months ended March 31, 2006 and 2005 was $21.2 million and $16.5 million, respectively, reflecting an effective tax rate of 34% and 31%, respectively. The effective tax rate differs from the statutory rate primarily due to the impact of foreign tax credits and lower effective rates in some overseas jurisdictions. In each successive interim period, to the extent our operating results year to

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

date and our estimates for the remainder of the fiscal year change from our original expectations regarding the proportion of earnings in various tax jurisdictions we expect that our effective tax rate will change accordingly, affecting tax expense (or benefit) for both that successive interim period as well as year-to-date interim results.

Although we reported an effective tax rate of 34% for the three months ended March 31, 2006, our total tax expense of $21.2 million is comprised of tax expense of $19.0 million on year to date ordinary income at an estimated 31% annual effective tax rate in addition to a net tax expense of $2.2 million from discrete items individually computed and recognized when the items occurred. The discrete tax expense of $2.2 million primarily related to increases in foreign valuation allowances.

11. Business Segment Information

We have concluded that we have one business and operate in one industry, developing, marketing, distributing and supporting computer security solutions for large enterprises, small and medium-sized business and consumer users, as well as resellers and distributors. Management measures operations based on our five geographic segments: North America; Europe, Middle East and Africa, or EMEA; Japan; Asia-Pacific, excluding Japan; and Latin America. The corporate business activities include the following expenses for the three months ended March 31, 2006: general and administrative expenses of $32.2 million, stock-based compensation expense of $13.6 million, corporate marketing expenses of $12.6 million, amortization of purchased technology and other intangibles of $6.6 million, acquisition bonuses of $0.9 million, restructuring charges of $0.6 million and SEC compliance costs of $0.4 million. In the three months ended March 31, 2005, corporate activities included general and administrative expenses of $32.0 million, corporate marketing expenses of $8.3 million, amortization of purchased technology and other intangibles of $7.4 million, restructuring charges of $2.3 million, acquisition bonuses of $1.5 million, divestiture costs of $0.6 million, loss on sale of assets of $0.2 million, stock-based compensation benefit of $3.3 million, and reimbursement related to transition services of $0.3 million. These corporate expenses are not considered attributable to any specific geographic region.

We market and sell anti-virus and security software, hardware and services through our geographic regions. These products and services are marketed and sold worldwide primarily through resellers, distributors, systems integrators, retailers, original equipment manufacturers, internet service providers and directly by us. In addition, we offer web sites, which provide suites of on-line products and services personalized for the user based on the users personal computer, or PC, configuration, attached peripherals and resident software. We also offer managed security and availability applications to corporations and governments on the internet.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Summarized financial information concerning our net revenue and operating income by geographic region is as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Net revenue by region:		
North America	$ 150,662	$ 141,433
EMEA	82,127	62,818
Japan	21,258	16,840
Asia-Pacific, excluding Japan	9,840	8,647
Latin America	8,080	5,989
Net revenue	$ 271,967	$ 235,727
Operating income by region:		
North America	$ 55,666	$ 55,097
Europe	43,961	25,805
Japan	11,956	10,811
Asia-Pacific, excluding Japan	679	1,908
Latin America	4,813	3,222
Corporate	(66,870)	(48,722)
Operating income	$ 50,205	$ 48,121

The difference between operating income and income before taxes is reflected on the face of our condensed consolidated statements of income.

12. Litigation

General

From time to time, we have been subject to litigation including the pending litigation described below. Our current estimated range of liability related to some of the pending litigation below is based on claims for which our management can estimate the amount and range of loss. Where there is a range of loss, we have recorded the minimum estimated liability related to those claims. Because of the uncertainties related to the range of loss on the remaining pending litigation, our 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 our potential liability and revise our estimates. Pending or future litigation could be costly, could cause the diversion of our management s attention and could upon resolution have a material adverse effect on the business, results of operations, financial

condition and cash flow.

In addition, we are engaged in certain legal and administrative proceedings incidental to our normal business activities and believe that these matters will not have a material adverse effect on our financial position, results of operations or cash flows, except for the $50.0 million settlement with the SEC related to the Formal Order of Private Investigation into our accounting practices.

Securities Cases

In September 2003, we entered into a settlement agreement with the plaintiffs in the *In re Network Associates, Inc. II Securities Litigation*, which was originally filed in December 2000. Under the settlement agreement we paid $70.0 million, which was recorded as litigation settlement in the consolidated statement of income for 2002. The

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

settlement was approved by the court in February 2004, and the case was dismissed with prejudice to all parties and claims. In 2004, we received approximately $25.0 million from our insurance carriers related to this litigation.

Certain investment bank underwriters, our company, and certain of our directors and officers have been named in a putative class action for violation of the federal securities laws in the United States District Court for the Southern District of New York, captioned *In re McAfee.com Corp. Initial Public Offering Securities Litigation*, 01 Civ. 7034 (SAS). This is one of a number of cases challenging underwriting practices in the initial public offerings, or IPOs, of more than 300 companies. These cases have been coordinated for pretrial proceedings as *In re Initial Public Offering Securities Litigation*, 21 MC 92 (SAS). Plaintiffs generally allege that certain underwriters engaged in undisclosed and improper underwriting activities, namely the receipt of excessive brokerage commissions and customer agreements regarding post-offering purchases of stock in exchange for allocations of IPO shares. Plaintiffs also allege that various investment bank securities analysts issued false and misleading analyst reports. The complaint against us claims that the purported improper underwriting activities were not disclosed in the registration statements for McAfee.com s IPO and seeks unspecified damages on behalf of a purported class of persons who purchased our securities or sold put options during the time period from December 1, 1999 to December 6, 2000. On February 19, 2003 the Court issued an Opinion and Order dismissing certain of the claims against us with leave to amend. We accepted a settlement proposal on July 15, 2003.

In June 2004, a stipulation for the settlement and release of claims against the issuer defendants, including us, was submitted to the Court for approval. The terms of the settlement, if approved, would dismiss and release all claims against participating defendants, including us. In exchange for this dismissal, insurance carriers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least $1.0 billion, and the issuer defendants would agree to an assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. On August 31, 2005, the Court confirmed preliminary approval of the settlement. The settlement remains subject to a number of conditions, including final court approval.

Other Matters

On June 6, 2002, Paul Cozza filed a Complaint in the United States District Court, District of Massachusetts, alleging breach of contract, fraud and bad faith arising out of a dispute concerning the licensing of certain technology used in the Virex 6.1 product. The Complaint seeks treble damages, attorneys fees and costs for the alleged unauthorized sale of products Cozza claims contain or contained his technology from and after January 1, 2002, and an injunction against the alleged further use of Cozza s technology. McAfee filed papers in opposition to the Complaint and asserted various defenses. A motion by McAfee to compel arbitration and a motion for partial summary judgment on liability (but not damages) issues relating to whether the contract claims extended beyond the Virex 6.1 product, have both been denied by the Court. In its order denying the McAfee motion for partial summary judgment, the Court also granted a motion for partial summary judgment filed by Cozza in which Cozza sought a declaration that the language of an agreement is unambiguous and enforceable against any McAfee product which might be proved to contain that same technology referenced in a 1993 License Agreement. Discovery has closed in anticipation of trial commencing during 2006, although no trial date has been set.

On March 22, 2002, the SEC notified us that it had commenced a Formal Order of Private Investigation into our accounting practices. On September 29, 2005, we announced we had reserved $50.0 million in connection with the proposed settlement with the SEC and we had deposited $50.0 million in an escrow account with the SEC as the designated beneficiary. On February 9, 2006, the SEC entered the final judgment for the settlement with us. We also

agreed to release $50.0 million to the SEC for the civil penalty on February 13, 2006 and certain other conditions, such as engaging independent consultants to examine and recommend improvements to our internal controls to ensure compliance with federal securities laws.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. Warranty Provision and Guarantees

We offer warranty on our hardware and software products and record a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and our estimate of the level of future costs. A reconciliation of the change in our warranty obligation as of March 31, 2006 and December 31, 2005 follows (in thousands):

	Warranty Provision
Balance, January 1, 2005	$ 1,818
Additional accruals	3,514
Costs incurred during the period	(4,249)
Balance, December 31, 2005	1,083
Additional accruals	1,524
Costs incurred during the period	(1,342)
Balance, March 31, 2006	$ 1,265

In November 2002, the FASB issued Interpretation No. 45, or FIN 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee or indemnification. FIN 45 also requires additional disclosure by a guarantor in its interim and annual consolidated financial statements about its obligations under certain guarantees and indemnifications. The following is a summary of the agreements that the we have determined are within the scope of FIN 45 as of March 31, 2006:

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

Under the terms of certain vendor agreements, in particular, vendors used as part of our managed services, we have agreed that in the event the service provided to the customer by the vendor on behalf of us infringes upon any patent, copyright, trademark, or any other proprietary right of a third-party, we will indemnify our vendor,

against any loss, expense, or liability from any damages that may be awarded against our customer. No maximum liability is stipulated in these vendor agreements. We have recorded no liability associated with this indemnification, as we are not aware of any pending or threatened infringement actions or claims that are probable losses. We believe the estimated fair value of these indemnification clauses is minimal.

We have agreed to indemnify members of the board of directors, as well as our officers, if they are made a party or are threatened to be made a party to any proceeding (other than an action by or in the right of us) by reason of the fact that they are an agent of us, or by reason of anything done or not done by them in any such capacity. The indemnity is for any and all expenses and liabilities of any type whatsoever (including judgments, fines and amounts paid in settlement) actually and reasonably incurred by the directors or officers in connection with the investigation, defense, settlement or appeal of such proceeding, provided they

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

acted in good faith. We maintain insurance coverage for directors and officers liability, or D&O insurance. No maximum liability is stipulated in these agreements that include indemnifications of members of our board of directors and officers. We have recorded no liability associated with these indemnifications as we are not aware of any pending or threatened actions or claims against our members of the board of directors or officers that are probable losses in excess of amounts covered by our D&O insurance. As a result of the insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal.

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

Under the terms of our agreement to sell Sniffer in July 2004, we agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is $200.0 million. To date, we have paid no amounts under the representations and warranties indemnification. We have not recorded any accruals related to these agreements.

Under the terms of our agreement to sell McAfee Labs assets in December 2004, we agreed to indemnify the purchaser for any breach of representations or warranties in the agreement as well as for any liabilities related to the assets prior to sale that are not included in the purchaser assumed liabilities (undiscovered liabilities). Subject to limited exceptions, the maximum potential loss related to the indemnification is $1.5 million. We have not recorded any accruals related to these agreements.

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

14. Subsequent Events

On April 3, 2006, we acquired 100% of the outstanding capital shares of SiteAdvisor Inc., a web safety consumer software company that tests and rates internet sites on an ongoing basis. We believe the technology and business model that SiteAdvisor has developed is not currently available in the marketplace and it will allow us to enhance our existing product offerings and add value to the McAfee brand. The purchase price of the acquisition included approximately $60.8 million of cash payments made to the former SiteAdvisor shareholders and approximately $0.3 million of direct acquisition costs. We have also agreed to make $9.3 million of cash payments to certain SiteAdvisor employees and advisors over the next two years that will be contingent upon their fulfillment of future service obligations. These payments will be recorded as an expense during the periods in which they are earned. The financial results of SiteAdvisor will be included in our results of operations from the date of acquisition. We have not received a final independent appraisal of the acquired assets and liabilities. Accordingly, we cannot provide the purchase price allocation or the valuation of acquired intangible assets at this time.

In April 2006, our board of directors authorized the repurchase of an additional $250.0 million of our common stock in the open market from time to time until October 2007, depending upon market conditions, share price and other factors.

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

Forward-Looking Statements; Trademarks

This Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. These statements include, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Report on Form 10-Q are based on information available to us on the date hereof. These statements involve known and unknown risks, uncertainties and other factors, 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, could, expects, plans, anticip believes, estimates, predicts, potential, targets, goals, projects, continue, or variations of such words, si expressions, or the negative of these terms or other comparable terminology. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Neither we nor any other person can assume responsibility for the accuracy and completeness of forward-looking statements. Important factors that may cause actual results to differ from expectations include, but are not limited to, those discussed in Risk Factors . We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

This report includes registered trademarks and trade names of McAfee and other corporations. Trademarks or trade names owned by McAfee and/or our affiliates include: McAfee, Network Associates, McAfee Security, ePO, ePo Orchestrator, SpamKiller, VirusScan, AVERT, IntruShield, Entercept, and Foundstone.

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.

Overview and Executive Summary

We are a worldwide supplier of computer security solutions designed to proactively prevent intrusions on networks and secure computer systems and other digital devices from a large variety of known and unknown threats and attacks. We apply business discipline and a pragmatic approach to security that is based on four principles of security risk management (identify and prioritize assets; determine acceptable risk; protect against intrusions; enforce and measure compliance). We have one business and operate in one industry, developing, marketing, distributing and supporting computer security solutions for large enterprises, governments, small and medium-sized business and consumers through a network of qualified partners. We operate our business in five geographic regions: North America; Europe, Middle East and Africa, collectively referred to as EMEA; Japan; Asia-Pacific, excluding Japan; and Latin America. See Note 11 to our condensed consolidated financial statements for a description of revenues and operating income by geographic region.

We derive our revenue and generate cash from customers from primarily three sources (i) product revenue, which includes hardware and perpetual licenses revenue, (ii) subscription revenue, which includes revenue from subscription-based offerings and (iii) services and support revenue, which includes maintenance, training and consulting revenue. In the three months ended March 31, 2006 and 2005, our net revenue was $272.0 million and $235.7 million, respectively, and our net income was $40.9 million and $36.0 million, respectively. Our net revenue is impacted by corporate IT, government and consumer spending levels. In addition to total net revenue and net income, in evaluating our business, management considers, among many other factors, the following:

Net Revenues by Geography

During the three months ended March 31, 2006 and 2005, 45% and 40% of our total net revenue, respectively, was generated outside of North America, with North America and EMEA collectively accounting for approximately 85% and 87% of our total net revenue in the three months ended March 31, 2006 and 2005, respectively.

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Net Revenues by Product and Customer Category

McAfee. Our McAfee products include our corporate products and consumer products. Our corporate products include (i) our small and medium-sized business, or SMB, products and (ii) our enterprise products, which include our IntruShield intrusion protection products, our Entercept host-based intrusion protection products, our Foundstone risk management products that were acquired in connection with the Foundstone acquisition in October 2004, our anti-virus products and our system security management products. Revenues from our corporate products increased $19.5 million, or 14%, to $160.3 million in the three months ended March 31, 2006 from $140.8 million in the three months ended March 31, 2005 due to increased corporate spending on McAfee security products.

We continued to experience growth in the consumer market. Our consumer market is comprised of our McAfee consumer on-line subscription service and retail-boxed product sales. In the three months ended March 31, 2006, we added approximately 2.0 million net new on-line consumer subscribers. Net revenue from our consumer security market increased $18.4 million, or 20%, to $111.7 million in the three months ended March 31, 2006 from $93.3 million in the same prior period. At March 31, 2006, we had a total on-line subscriber base of approximately 19.0 million consumer customers, compared to approximately 11.0 million at March 31, 2005. The main driver of this subscriber growth was our continued strategic relationships with strategic channel partners, such as AOL, Comcast and Dell.

McAfee Labs. We sold our McAfee Labs assets to SPARTA, Inc. for $1.5 million in April 2005. Net revenue related to McAfee Labs was $1.7 million in the three months ended March 31, 2005.

Deferred Revenue

Our deferred revenue balance at March 31, 2006 was $776.1 million compared to $746.4 million at December 31, 2005, an increase of 4%. The increase was attributable to an increase in bookings of subscription and support contracts.

Stock-compensation Expense

On January 1, 2006, we adopted SFAS 123R on a modified prospective basis, which requires the application of the accounting standard to all share-based awards issued on or after January 1, 2006 and any outstanding share-based awards that were issued in prior years but not vested as of January 1, 2006.

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Including stock-based compensation expense related to equity-based awards under SFAS 123 in the prior-year, the change in our year-over-year net income per share for the periods covered in the following table is positive. The following table provides a comparison of net income and basic and diluted net income per share, if the effect of pro-forma stock-based compensation expense as disclosed in the notes to the condensed consolidated financial statements prior to January 1, 2006 were included for prior periods (in thousands, except per-share data):

	Three Months Ended March 31,	
	2006	2005
Net income as reported	$ 40,890	$ 35,970
Deduct: Total stock-based compensation expense determined under fair value based method for all awards		(11,408)
Tax benefit		4,005
Total fair value-based stock-based compensation expense, net of tax		(7,403)
Deduct: Stock-based compensation benefit included in reported net income under APB 25		(3,292)
Tax expense		1,156
Total stock-based compensation benefit included in net income, net of tax		(2,136)
Net-income, including the effect of stock-based compensation expense	$ 40,890	$ 26,431
Net income per share:		
Basic as reported	$ 0.25	$ 0.22
Diluted as reported	$ 0.25	$ 0.21
Basic pro-forma	N/A	$ 0.16
Diluted pro-forma	N/A	$ 0.16

Cash, Cash Equivalents and Marketable Securities

The balance of cash, cash equivalents and marketable securities at March 31, 2006 was $1,137.6 million compared to $1,257.0 million at December 31, 2005. The decrease was primarily attributable to the repurchase of 9.6 million shares of common stock for approximately $230.6 million, including commissions, offset by (i) net cash provided by operating activities of $48.4 million, (ii) a $50.7 million release of restricted cash to cash and cash equivalents and (iii) cash received from the exercise of stock options and stock purchases under the stock purchase plans of $18.0 million. See the Liquidity and Capital Resources section below.

In 2006, our management remains focused on, among other things, (i) sustaining momentum in the consumer online market, (ii) increasing revenue in both the corporate and consumer market, (iii) continuing to streamline our business to make it easier for strategic channel partners to do business with us, (iv) delivering new products to our customers, (v) generating cash to re-invest in our business and for potential acquisitions and (vi) improving operational efficiencies and financial systems.

Our McAfee Protection-in-Depth Strategy is designed to provide a complete set of system and network protection solutions differentiated by intrusion prevention technology that can detect and block known and unknown attacks. To

more effectively market our products in our various geographic sales regions, as more fully described below, we have combined complementary products into separate product groups as follows:

McAfee System Protection Solutions, which delivers a comprehensive range of anti-virus, anti-spyware, anti-spam, desktop firewall, host intrusion prevention, network access control and other security products and services designed to protect systems such as desktops and servers managed from a single integrated management console, and

McAfee Network Protection Solutions, which offer products designed to maximize the performance and security of networks and network intrusion prevention with McAfee IntruShield and McAfee Foundstone.

The majority of our net revenue has historically been derived from our McAfee Security anti-virus products and, until the sale of the Sniffer product line in July 2004, our Sniffer Technologies network fault identification and application performance management products. We have also focused our efforts on building a full line of complementary network and system protection solutions. In the system protection area, we strengthened our anti-virus lineup by adding complementary products in the anti-spam and host intrusion prevention categories, and through our June 2005 Wireless Security Corporation acquisition, we have strengthened our solution portfolio in our consumer and small business segments. On the network protection side, we have added products in the network intrusion prevention and detection category, and through our October 2004 Foundstone acquisition, vulnerability management products and services.

McAfee System Protection Solutions

McAfee system protection solutions help large enterprises, small and medium-sized businesses, consumers, government agencies and educational organizations assure the availability and security of their computer desktops, digital devices, application servers and web service platforms. The McAfee system protection solutions portfolio features a range of products and services including anti-virus, anti-spyware, managed services, desktop firewalls and host intrusion prevention. Each is backed by McAfee AVERT Labs, a leading threat research organization. A substantial majority of our net revenue has historically been derived from our McAfee System Protection Solutions.

Our flagship business offering for system protection is McAfee Total Protection Solutions, which was introduced in April 2006. A single solution with a single management console, McAfee Total Protection reduces the complexity of managing enterprise security. Delivering comprehensive threat prevention, centralized management and scalable network access control, this integrated approach enables organizations to proactively block known and unknown attacks and ensures business continuity by controlling non-compliant endpoints. McAfee Total Protection Solutions come as a licensed offering or in a software-as-a-service model.

McAfee system protection solutions also include McAfee consumer security products, offering both traditional retail products and on-line subscription services. Consumer retail and on-line subscription applications allow users to protect their personal computers, or PCs, from malicious code and other attacks, repair PCs from damage caused by viruses and spyware and block spam and other undesirable content. Our retail products are sold through retail outlets, including Best Buy, CompUSA, Costco, Dixons, Fry s, Office Depot, Office Max, Staples, Wal-Mart and Yamada to single users and small home offices in the form of traditional boxed product. These products include for-fee software updates and technical support services. On-line subscription services are delivered through the use of an internet browser at our McAfee Consumer Online web site, through multiple on-line service providers, such as AOL and Comcast, and through original equipment manufacturers, or OEMs, such as Dell, Gateway/eMachines, NEC and Toshiba, North America.

Our McAfee system protection solutions previously included our Magic Service Solutions product line, offering management and visibility of desktop and server systems. In January 2004, we sold our Magic Solutions product line to BMC Software.

McAfee Network Protection Solutions

McAfee network protection solutions help enterprises, small businesses, government agencies, educational organizations and service providers maximize the availability, performance and security of their network infrastructure. The McAfee network protection solutions portfolio features a range of products including IntruShield for network intrusion detection, Secure Content Management solutions for complete e-mail and web security and prevention, and Foundstone for intrusion detection and prevention and vulnerability management.

We acquired Foundstone on October 1, 2004. We continue to integrate Foundstone s products with our intrusion prevention technologies and systems management capabilities to deliver enhanced risk management of prioritized assets, automated shielding and risk remediation, and automated policy enforcement and compliance.

Our McAfee network protection solutions previously included our Sniffer Technologies product line, offering network fault identification and application performance management products. In July 2004, we sold our Sniffer Technologies product line to Network General Corporation.

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Policy Management

Policy management tools keep threat-protection systems up-to-date and enforce security policies. Policy management includes live threat information and identifying and dealing with rogue systems, and is a key element of complete security protection.

Expert Services and Technical Support

We have established Professional Services and McAfee Technical Support to provide professional assistance in the design, installation, configuration and support of our customers networks and acquired products. We offer a range of consulting and educational services under both the McAfee and Foundstone banners.

McAfee Consulting Services provide product design and deployment with an array of standardized and custom offerings. This business is organized around our major product groupings and also offers a range of classroom education courses designed to enable customers and partners to successfully deploy and operate McAfee s security products. Services are also available to help customers deal with security outbreaks and plan for the upgrade or replacement of key parts of the security infrastructure.

Foundstone Consulting Services include (i) threat modeling services that identify detrimental software security problems, (ii) network assessments and (iii) education. Foundstone Consulting Services assist clients in the early assessment and design of their security and risk architectures. Through research and innovation, the Foundstone Security Practice is able to advise government and commercial organizations on the most effective counter measures required to meet business and legislative targets for security and privacy. Foundstone Consulting Services are augmented by a range of classroom-based training courses including the Ultimate Hacking Series.

The McAfee Technical Support program provides our customers on-line and telephone-based technical support in an effort to ensure that our products are installed and working properly. During the first quarter of 2005, we reorganized our technical support offerings to better meet our customers varying needs. McAfee Technical Support offers a choice of Gold or Platinum support for our customers. In addition, for our legacy support customers only, we offer the on-line ServicePortal or the telephone-based Connect. The services in these offerings have been incorporated into the current Gold and Platinum Technical Support offerings. All Technical Support programs include software updates and upgrades. Technical Support is available to all customers worldwide from various regional support centers.

McAfee Technical Support ServicePortal Consists of a searchable knowledge base of technical solutions and links to a variety of technical documents such as product FAQs and technical notes and the ability to submit and track support cases online.

McAfee Gold Technical Support Provides unlimited, toll-free (where available) telephone access to technical support 24 hours a day, 7 days a week and access to the McAfee Technical Support ServicePortal.

McAfee Platinum Technical Support Offers proactive, personalized service and includes an assigned Technical Account Manager, or TAM. Customers receive proactive support contact (telephone or e-mail) with customer-defined frequency, election of five designated customer contacts, access to all the services in McAfee Gold Technical Support and the McAfee Technical Support ServicePortal.

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

Research and Development

We are committed to malicious code and vulnerability research through our McAfee AVERT Labs organization. McAfee AVERT Labs conducts research in the areas of host intrusion prevention, network intrusion prevention, wireless intrusion prevention, malicious code defense, security policy and management, high-performance assurance and forensics and threats, attacks, vulnerabilities and architectures.

In April 2005, we sold the assets of McAfee Labs, our research and development organization focused on performing research for government agencies, to SPARTA, Inc. McAfee remained as the general contractor on

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certain of its government contracts until government approval was obtained for SPARTA to be the general contractor in the first quarter of 2006.

Strategic Alliances

From time to time, we enter into strategic alliances with third parties to support our future growth plans. These relationships may include joint technology development and integration, research cooperation, co-marketing activities and sell-through arrangements. Strategic alliance partners include AOL, Cable and Wireless, Comcast, Dell, Gateway, Postini, Telecom Italia, Telefonica and Wanadoo, among others. As part of our NTT DoCoMo alliance, we have jointly developed technology to provide integrated malware protection against mobile threats to owners of 3G FOMA handsets.

Product Licensing Model

We typically license our products to corporate and government customers on a perpetual basis. Most of our licenses are sold with maintenance contracts, and typically these are sold on an annual basis. As the maintenance contracts near expiration, we contact customers to renew their contracts, as applicable. We typically sell perpetual licenses in connection with sales of our hardware-based products in which software is bundled with the hardware platform.

For our largest customers (over 2,000 nodes) and government agencies, we from time-to-time offer two-year term-based licenses. Our two-year term licensing model also creates the opportunity for recurring revenue through the renewal of existing licenses. By offering two-year licenses, as opposed to traditional perpetual licenses, we are also able to meet a lower initial cost threshold for customers with annual budgetary constraints. We also offer one-year licensing arrangements in Japan. The renewal process provides an opportunity to cross-sell new products and product lines to existing customers. Term-based licenses for our customers with over 2,000 nodes accounts for less than 2% of our total revenues in the three months ended March 31, 2006.

On-Line Subscription Services and Managed Applications

For our on-line subscription services, customers essentially rent the use of our security services for a defined period of time. Because our on-line subscription services are version-less, or self-updating, customers subscribing to these services are capable of using the most recent version of the software application without the need to purchase product updates or upgrades. Our on-line subscription consumer products and services are found at our www.mcafee.com website where consumers download our anti-virus application using their internet browser which allows the application to detect and eliminate viruses on their PCs, repair their PCs from damage caused by viruses, optimize their hard drives and update their PCs virus protection systems with current software updates and upgrades. Our website also offers customers access to McAfee Personal Firewall Plus, McAfee SpamKiller and McAfee Privacy Service, as well as combinations of these services. Our on-line subscription services are also available to customers and small business through various relationships with internet service providers, or ISPs, such as AOL and Comcast, and available through PC OEMs, such as Dell and Gateway. Our business model allows for ISPs to make McAfee subscription services available as either a premium service or as a feature included in the ISP s service. At March 31, 2006, we had approximately 19.0 million McAfee consumer on-line subscribers, which includes on-line customers obtained through our alliances with ISPs and OEMs.

Similarly, our small and medium-sized business on-line subscription products and services, or our McAfee Total Protection for small business, provide these customers the most up-to-date anti-virus software. Our McAfee Total Protection for small business provides anti-virus protection for both desktops and file servers. In addition, McAfee Managed Mail Protection screens emails to detect and quarantine viruses and infected attachments, and spam. Our McAfee Desktop Firewall blocks unauthorized network access and stops known network threats.

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

Critical Accounting Policies

Critical Accounting Policies and Estimates

In preparing our consolidated financial statements, we make estimates, assumptions and judgments that can have a significant impact on our net revenue, operating income and net income, as well as the value of certain assets and liabilities on our consolidated balance sheet. The application of our critical accounting policies requires an evaluation of a number of complex criteria and significant accounting judgments by us. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. We evaluate our estimates on a regular basis and make changes accordingly. Senior management has discussed the development, selection and disclosure of these estimates with the audit committee of our board of directors. Actual results may materially differ from these estimates under different assumptions or conditions. If actual results were to differ from these estimates materially, the resulting changes could have a material adverse effect on the consolidated financial statements.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. Management believes the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of the consolidated financial statements.

Our critical accounting policies are as follows:

- revenue recognition;
- estimating valuation allowances and accrued liabilities, specifically sales returns and other incentives, the allowance for doubtful accounts, our facility restructuring accrual; and the assessment of the probability of the outcome of litigation against us;
- stock-based compensation expense;
- accounting for income taxes; and
- valuation of goodwill, finite-lived intangibles and long-lived assets.

Revenue Recognition

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. These estimates affect the deferred revenue line item on our consolidated balance sheet and the net revenue line item on our consolidated statement of income. Estimates regarding revenue affect all of our operating geographies.

Our revenue is derived from primarily three sources (i) product revenue, which includes hardware and perpetual licenses revenue, (ii) subscription revenue, which includes revenue from subscription-based offerings and (iii) services and support revenue, which includes maintenance, training and consulting revenue.

We apply the provisions of Statement of Position 97-2, *Software Revenue Recognition,* or SOP 97-2, and related interpretations to all transactions involving the sale of software products and hardware products that include software. For hardware products where software is incidental, we do not separate the license fee and we do not apply separate accounting guidance to the hardware and software elements. For hardware transactions where no software is involved or software is not incidental, we apply the provisions of Staff Accounting Bulletin 104 *Revenue Recognition* , or SAB 104.

We market and distribute our software products both as standalone software products and as comprehensive security solutions. We recognize revenue from the sale of software licenses when all of the following is met:

- persuasive evidence of an arrangement exists,
- the product or service has been delivered,

the fee is fixed or determinable, and

collection of the resulting receivable is reasonably assured.

Persuasive evidence is generally a binding purchase order or license agreement. Delivery generally occurs when product is delivered to a common carrier or upon delivery of a grant letter and license key, if applicable. If a significant portion of a fee is due after our normal payment terms of typically 30 90 days, we recognize revenue as the fees become due. If we determine that collection of a fee is not reasonably assured, we defer the fees and recognize revenue upon cash receipt, provided all other revenue recognition criteria are met.

We enter into perpetual and subscription software license agreements through direct sales to customers and indirect sales with partners, distributors and resellers. We recognize revenue from the indirect sales channel upon sell-through by the partner or distributor. The license agreements generally include service and support agreements, for which the related revenue is deferred and recognized ratably over the performance period. All revenue derived from our online subscription products is deferred and recognized ratably over the performance period. Professional services revenue is generally recognized as services are performed or if required, upon customer acceptance.

For arrangements with multiple elements, including software licenses, maintenance and/or services, we allocate and defer revenue equivalent to the vendor-specific objective evidence, or VSOE, of fair value for the undelivered elements and recognize the difference between the total arrangement fee and the amount deferred for the undelivered elements as product revenue. VSOE of fair value is based upon the price for which the undelivered element is sold separately or upon substantive renewal rates stated in a contract. We determine fair value of the undelivered elements based on historical evidence of stand-alone sales of these elements to our customers. When VSOE does not exist for undelivered elements such as maintenance and support, the entire arrangement fee is recognized ratably over the performance period generally as services and support revenue.

Sales Incentives and Sales Returns. We reduce revenue for estimates of sales incentives and sales returns. We offer sales incentives, including channel rebates, marketing funds and end-user rebates for products in our corporate and consumer product lines. Additionally, end-users may return our products, subject to varying limitations, through distributors and resellers or to us directly for a refund within a reasonably short period from the date of purchase. We estimate and record reserves for sales incentives and sales returns based on our historical experience. In each accounting period, we must make judgments and estimates of sales incentives and potential future sales returns related to current period revenue. These estimates affect our net revenue line item on our statement of income and affect our net accounts receivable, deferred revenue or accrued liabilities line items on our consolidated balance sheet. These estimates affect all of our operating geographies.

At March 31, 2006, our allowance for sales returns and incentives was $42.0 million compared to $32.6 million at December 31, 2005. If our allowance for sales returns and incentives were to increase by 10%, or $4.2 million, our net revenue would decrease by approximately $1.3 million and our deferred revenue would decrease by approximately $2.9 million in the three months ended March 31, 2006.

Deferred Costs of Revenue. Deferred costs of revenue, which consist primarily of costs related to revenue-sharing arrangements and costs of inventory sold into our channel which have not been sold through to the end-user, are included in other current assets on our consolidated balance sheet. We only defer direct and incremental costs related to revenue-sharing arrangements and recognize such deferred costs proportionate to the related revenue recognized. At March 31, 2006, our deferred costs were $40.6 million compared to $31.1 million at December 31, 2005.

Allowance for Doubtful Accounts

We also make estimates of the uncollectibility of our accounts receivables. Management specifically analyzes accounts receivable balances, current and historical bad debt trends, 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. We specifically reserve for any account receivable for which there are identified collection issues. Bad debts have historically been approximately 2% of our average accounts receivable. These estimates affect the provision for doubtful accounts line item on our statement of income and the net accounts

receivable line item on the consolidated balance sheet. The estimation of uncollectible accounts affects all of our operating geographies.

At March 31, 2006, our allowance for doubtful accounts was $2.2 million compared to $2.4 million at December 31, 2005. If an additional 1% of our gross accounts receivable were deemed to be uncollectible at March 31, 2006, our allowance for doubtful accounts and provision for bad debt expense would increase by approximately $1.6 million.

Estimation of Restructuring Accrual and Litigation

Restructuring Accrual. During 2005, we permanently vacated several leased facilities and recorded a $1.9 million accrual for estimated lease related costs associated with the permanently vacated facilities. During 2004, we permanently vacated several leased facilities, including an additional two floors in our Santa Clara headquarters building and recorded an $8.7 million restructuring accrual. In 2003, as part of a consolidation of activities into our Plano, Texas facility from our headquarters in Santa Clara, California, we recorded a restructuring charge of $15.8 million. We recorded these facility restructuring charges in accordance with Statement of Financial Accounting Standard No. 146, *Accounting for Exit Costs Associated With Exit or Disposal Activities* , or SFAS 146. In order to determine our restructuring charges and the corresponding liabilities, SFAS 146 required us to make a number of assumptions. These assumptions included estimated sublease income over the remaining lease period, estimated term of subleases, estimated utility and real estate broker fees, as well as estimated discount rates for use in calculating the present value of our liability. We developed these assumptions based on our understanding of the current real estate market in the respective locations as well as current market interest rates. The assumptions used are our management s best estimate at the time of the accrual, and adjustments are made on a periodic basis if better information is obtained. If, at March 31, 2006, our estimated sublease income were to decrease 10%, the restructuring reserve and related expense would have increased by approximately $1.3 million.

The estimates regarding our restructuring accruals affect our current liabilities and other long-term liabilities line items in our consolidated balance sheet, since these liabilities will be settled each year through 2013. These estimates affect our statement of income in the restructuring line item. At March 31, 2006, our North American operating segment was affected by these estimates.

Litigation. Management s current estimated range of liability related to litigation that is brought against us from time to time is based on claims for which our management can estimate the amount and range of loss. We recorded the minimum estimated liability related to those claims, where there is a range of loss as there is no better point of estimate. Because of the uncertainties related to an unfavorable outcome of litigation, and the amount and range of loss on pending litigation, management is often unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As litigation progresses, we continue to assess our potential liability and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. Estimates of litigation liability affect our accrued liability line item on our consolidated balance sheet and our general and administrative expense line item on our statement of income.

Stock-based Compensation Expense

On January 1, 2006, we adopted SFAS No. 123R, *Share-Based Payment* , or SFAS 123R, which is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation* , or SFAS 123, and supersedes APB No. 25, *Accounting for Stock Issues to Employees* , or APB 25. SFAS 123R requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors based on the estimated fair values of the awards on their grant dates. Our share-based awards include stock options, restricted stock awards, restricted stock units and our Employee Stock Purchase Plan.

In the three months ended March 31, 2006, we recognized stock compensation expense of $13.6 million. Prior to our adoption of SFAS 123R, we applied the intrinsic value method set forth in APB 25 to calculate the compensation expense for share-based awards. Historically, our general policy was to set the exercise price for our stock options equal to the market value on the grant date. As a result, the options had no intrinsic value on their grant dates, and we did not record any compensation expense unless the terms of the options were subsequently modified. During the three months ended March 31, 2005, we recognized a benefit of approximately $3.7 million under

APB 25 related to the exchange of McAfee.com options in 2002 and re-pricing of options in 1999. This benefit was partially offset by an expense of approximately $0.4 million for restricted stock awards. See Note 4 to the consolidated financial statements for additional information.

We use the Black-Scholes model to estimate the fair value of our option awards and employee stock purchase rights issued under the Employee Stock Purchase Plan. The Black-Scholes model requires estimates of the expected term of the option, as well as future volatility and the risk-free interest rate.

For options issued during the three months ended March 31, 2006, we estimated the weighted-average fair value to be $10.91. For employee stock purchase rights issued during the three months ended March 31, 2006, we estimated the weighted-average fair value to be $6.11. The key assumptions that we used to calculate this value are provided below:

	Three Months Ended March 31,	
	2006	2005
Stock option grants:		
Risk free interest rate	4.5%	3.8%
Weighted average expected lives	5.4	4.0
Volatility	38.0%	60.4%
Dividend yield		
ESPP:		
Risk free interest rate	4.6%	2.9%
Weighted average expected lives	0.5	1.3
Volatility	38.0%	40.0%
Dividend yield		

We derive the expected term of our options through a lattice model that factors in historical data on employee exercise and post-vesting employment termination behavior. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Since January 1, 2006, we have used the implied volatility of options traded on our stock with a term of one year or more to calculate the expected volatility of our option grants. Prior to that time, the expected volatility was based solely on the historical volatility of our stock. We have not declared any dividends on our stock in the past and do not expect to do so in the foreseeable future.

The assumptions that we have made represent our management s best estimate, but they are highly subjective and inherently uncertain. If management had made different assumptions, our calculation of the options fair value and the resulting stock-based compensation expense could differ, perhaps materially, from the amounts recognized in our financial statements. For example, if we increased the assumption regarding our stock s volatility for options granted during the three months ended March 31, 2006 by 10%, our stock-based compensation expense would increase by $0.7 million, net of expected forfeitures, amortized over 4.0 years. Likewise, if we increased our assumption of the options expected lives by one year, our stock-based compensation expense would increase by $0.4 million, net of expected forfeitures, amortized over 4.0 years.

In addition to the assumptions used to calculate the fair value of our options, we are required to estimate the expected forfeiture rate of all share-based awards and only recognize expense for those awards we expect to vest. The stock-based compensation expense recognized in our condensed consolidated statement of operations for the three months ended March 31, 2006 has been reduced for estimated forfeitures. If we were to change our estimate of forfeiture rates, the amount of share-based compensation could differ, perhaps materially, from the amount recognized

in our financial statements. For example, if we had decreased our estimate of expected forfeitures by 50%, our stock-based compensation expense for the three months ended March 31, 2006 net of expected forfeitures would have increased by approximately $0.7 million. This decrease in our estimate of expected forfeitures would increase our estimated fair value of all unvested stock options, restricted stock units, restricted stock awards and

employee stock purchase rights that have not yet been recognized as compensation expense by $11.1 million, net of expected forfeitures, amortized over a weighted-average period of 3.0 years.

Accounting for Income Taxes

At the end of each interim period we make our best estimate of the effective tax rate expected to be applicable for the full fiscal year. This effective tax rate is used to determine income taxes on a current year-to-date basis. The effective tax rate may consider, as applicable, tax credits, foreign tax rates, and other available tax planning alternatives. It also includes the effect of any valuation allowance expected to be necessary at the end of the period for deferred tax assets related to originating deductible temporary differences and carry-forwards. In arriving at this effective tax rate applied to interim periods no effect is included for the tax related to significant, unusual, or extraordinary items that may be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate is revised, if necessary, as of the end of each successive interim period during the fiscal year to our best current estimate of our expected annual effective tax rate.

The effective tax rate is our best estimate of the tax expense (or benefit) that will be provided for the fiscal year, stated as a percentage of our estimated annual ordinary income (or loss). The tax expense (or benefit) related to ordinary income (or loss) for the interim period is determined using this estimated annual effective tax rate. The tax expense (or benefit) related to other items is individually computed and recognized when the items occur. The estimated tax rate applied to interim ordinary income (or loss) is reliant on our estimates of expected annual operating income (or loss) for the year as well as our projections of the proportion of income (or loss) earned in foreign jurisdictions which may have statutory tax rates significantly lower than tax rates applicable to our earnings in the United States. In each successive interim period, to the extent our operating results year to date and our estimates for the remainder of the fiscal year change from our original expectations regarding the proportion of earnings in various tax jurisdictions we expect that our effective tax rate will change accordingly, affecting tax expense (or benefit) for both that successive interim period as well as year-to-date interim results.

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 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 and make significant estimates regarding 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 income. Estimates related to income taxes affect the deferred tax asset and liability line items and accrued liabilities in our consolidated balance sheet and our income tax expense (or benefit) line item in our statement of income.

The net deferred tax asset as of March 31, 2006 is $442.7 million, net of a valuation allowance of $51.4 million. The valuation allowance is recorded due to the uncertainty of our ability to utilize some of the deferred tax assets related to foreign tax credits and net operating losses of acquired companies. The valuation allowance is based on our historical experience and 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.

Tax returns are subject to audit by various taxing authorities. Although we believe that adequate accruals have been made each period for unsettled issues, additional benefits or expenses could occur in future years from resolution of outstanding matters. We record additional expenses each period on unsettled issues relating to the expected interest we

would be required to pay a tax authority if we do not prevail on an unsettled issue. We continue to assess our potential tax liability included in accrued taxes in the consolidated financial statements, and revise our estimates. Such revisions in our estimates could materially impact our results of operations and financial position. We have classified a portion of our tax liability as non-current in the consolidated balance sheet based on the expected timing of cash payments to settle contingencies with taxing authorities.

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Valuation of Goodwill, Intangibles, and Long-lived Assets

We account for goodwill and other indefinite-lived intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* , or SFAS 142. SFAS 142 requires, among other things, the discontinuance of amortization for goodwill and indefinite-lived intangibles and at least an annual test for impairment. An impairment review may be performed more frequently in the event circumstances indicate that the carrying value may not be recoverable.

We are required to make estimates regarding the fair value of our reporting units when testing for potential impairment. We estimate the fair value of our reporting units using a combination of the income approach and the market approach. Under the income approach, we calculate the fair value of a reporting unit based on the present value of estimated future cash flows. Under the market approach, we estimate the fair value based on market multiples of revenues or earnings for comparable companies. We estimate cash flows for these purposes using internal budgets based on recent and historical trends. We base these estimates on assumptions we believe to be reasonable, but which are unpredictable and inherently uncertain. We also make certain judgments about the selection of comparable companies used in the market approach in valuing our reporting units, as well as certain assumptions to allocate shared assets and liabilities to calculate the carrying value for each of our reporting units. If an impairment were present, these estimates would affect an impairment line item on our consolidated statement of income and would affect the goodwill in our consolidated balance sheet. As goodwill is allocated to all of our reporting units, any impairment could potentially affect each operating geography.

Based on our most recent impairment test, there would have to be a significant change in assumptions used in such calculation in order for an impairment to occur as of March 31, 2006.

We account for finite-lived intangibles and long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Under this standard we will record an impairment charge on finite-lived intangibles or long-lived assets to be held and used when we determine that the carrying value of intangibles and long-lived assets may not be recoverable.

Based upon the existence of one or more indicators of impairment, we measure any impairment of intangibles or long-lived assets 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. Our estimates of cash flows require significant judgment based on our historical results and anticipated results and are subject to many of the factors, noted below as triggering factors, which may change in the near term.

Factors considered important, which could trigger an impairment review include, but are not limited to:

- significant under performance 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 declines in our stock price for a sustained period; and
- our market capitalization relative to net book value.

Goodwill amounted to $438.3 million and $438.4 million as of March 31, 2006 and December 31, 2005, respectively. We did not hold any other indefinite-lived intangibles as of March 31, 2006 and December 31, 2005. Net finite-lived intangible assets and long-lived assets amounted to $163.2 million and $166.4 million as of March 31, 2006 and

December 31, 2005, respectively.

Results of Operations

Reclassification of Net Revenue and Cost of Net Revenue

As disclosed in our 2005 Annual Report on Form 10-K, during the three months ended December 31, 2005, we made certain reclassifications from product revenue to service revenue, primarily related to online subscriptions. Total net revenue was not impacted by these reclassifications. The following table presents our 2005 quarterly net revenue, as reclassified in 2005, and cost of net revenue, as disclosed in our respective Quarterly Report on Form 10-Q (in thousands):

	Three Months Ended				Twelve Months Ended
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005	December 31, 2005
Net revenue:					
Product	$ 45,145	$ 43,805	$ 32,578	$ 46,010	$ 167,538
Service and support	190,582	201,577	220,333	207,269	819,761
Total net revenue	$ 235,727	$ 245,382	$ 252,911	$ 253,279	$ 987,299
Cost of net revenue:					
Product	$ 16,646	$ 11,865	$ 10,282	$ 24,479	$ 63,272
Service and support	18,161	21,105	22,873	23,689	85,828
Amortization of purchased technology	3,850	3,886	3,938	3,841	15,515
Total cost of net revenue	$ 38,657	$ 36,856	$ 37,093	$ 52,009	$ 164,615

As of January 1, 2006, we changed the presentation of our net revenue and cost of net revenue to include three categories: (i) product, which includes hardware and perpetual licenses (ii) subscription, which includes subscription-based offerings and (iii) service and support, which includes maintenance, consulting and training. Previously, we chose to allocate our subscription business between product and services and support instead of presenting it as a separate category. We believe this new presentation is consistent with the way we currently manage our business as we grow the subscription component of both our corporate and consumer businesses. In the table below, we have applied the change in presentation retrospectively to the balances previously reported for each period during the year ended December 31, 2005. Total net revenues and cost of net revenues were not affected by the change.

The following table presents our revised 2005 quarterly net revenue and cost of net revenue presentation (in thousands):

	Three Months Ended				Twelve Months Ended
	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005	December 31, 2005

Net revenue:					
Product	$ 35,537	$ 34,308	$ 20,825	$ 37,185	$ 127,855
Subscription	68,078	77,828	90,891	81,409	318,206
Service and support	132,112	133,246	141,195	134,685	541,238
Total net revenue	$ 235,727	$ 245,382	$ 252,911	$ 253,279	$ 987,299
Cost of net revenue:					
Product	$ 16,923	$ 11,986	$ 10,399	$ 24,636	$ 63,944
Subscription	10,510	13,709	14,909	15,147	54,275
Service and support	7,374	7,275	7,847	8,385	30,881
Amortization of purchased technology	3,850	3,886	3,938	3,841	15,515
Total cost of net revenue	$ 38,657	$ 36,856	$ 37,093	$ 52,009	$ 164,615

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Net Revenue

The following table sets forth, for the periods indicated, a year-over-year comparison of the key components of our net revenue:

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Net revenue:				
Product	$ 31,100	$ 35,537	$ (4,437)	(12)%
Subscriptions	92,726	68,078	24,648	36
Services and support	148,141	132,112	16,029	12
Total net revenue	$ 271,967	$ 235,727	$ 36,240	15%
Percentage of total net revenue:				
Product	11%	15%		
Subscriptions	34	29		
Services and support	55	56		
Total net revenue	100%	100%		

The increase in net revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 reflected (i) a $18.4 million increase in our consumer business and (ii) a $19.5 million increase in our corporate business due to increased corporate spending on McAfee security products. These increases were partially offset by (i) a $1.7 million decrease attributable to McAfee Labs, which was sold in April 2005. Net revenues from our consumer market increased during the three months ended March 31, 2006 primarily due to (i) on-line subscriber growth from approximately 11.0 million on-line subscribers at March 31, 2005 to approximately 19.0 million subscribers at March 31, 2006 due to our stronger strategic channel partner relationships and (ii) increased online renewal subscriptions.

Net Revenue by Geography

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

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Net revenue:				
North America	$ 150,662	$ 141,433	$ 9,229	7%
EMEA	82,127	62,818	19,309	31

Japan	21,258	16,840	4,418	26
Asia-Pacific, excluding Japan	9,840	8,647	1,193	14
Latin America	8,080	5,989	2,091	35
Total net revenue	$ 271,967	$ 235,727	$ 36,240	15%
Percentage of total net revenue:				
North America	55%	60%		
EMEA	30	27		
Japan	8	7		
Asia-Pacific, excluding Japan	4	4		
Latin America	3	2		
Total net revenue	100%	100%		

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Net revenue outside of North America, consisting of U.S. and Canada, accounted for approximately 45% and 40% of net revenue in the three months ended March 31, 2006 and 2005, respectively. Net revenue from North America and EMEA has historically comprised between 85% and 91% of our business. During the three months ended March 31, 2006, the U.S. Dollar strengthened year-over-year against many currencies, especially the Euro. As a result of the stronger U.S. Dollar, we experienced negative impacts on our net revenue in the EMEA region.

The increase in total net revenue in North America during the three months ended March 31, 2006 primarily related to (i) a $1.3 million increase in consumer revenue in North America due to stronger strategic channel partner relationships and (ii) a $9.6 million increase in corporate revenue in North America partially offset by a $1.7 million decrease in McAfee Labs revenue in North America due to the sale of McAfee Labs in April 2005.

The increase in total net revenue in EMEA during the three months ended March 31, 2006 was attributable to (i) a $16.7 million increase in consumer revenue due to stronger strategic channel partner relationships and (ii) a $2.6 million increase in corporate revenue. Although total net revenue from EMEA increased $19.3 million, the weakening Euro against the U.S. Dollar did result in an approximate $7.5 million negative impact to EMEA net revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005.

Net revenues from our consumer market in both North America and in EMEA increased during the three months ended March 31, 2006 primarily due to (i) on-line subscriber growth due to stronger strategic channel partner relationships and (ii) increased on-line renewal subscriptions.

Our Japan, Latin America and Asia-Pacific operations combined have historically comprised less than 20% of our total net revenue and we expect this trend to continue.

Risks inherent in international revenue include the impact of longer payment cycles, greater difficulty in accounts receivable collection, unexpected changes in regulatory requirements, seasonality, political instability, tariffs and other trade barriers, currency fluctuations, a high incidence of software piracy in some countries, product localization, international labor laws and our relationship with our employees and regional work councils and difficulties staffing and managing foreign operations. These factors may have a material adverse effect on our future international revenue.

Product Revenue

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

	Three Months Ended March 31,		2006 vs. 2005	
	2006	**2005**	**$**	**%**
	(Dollars in thousands)			
Net product revenue:				
Licenses	$ 20,157	$ 20,380	$ (223)	(1)%
Hardware	10,679	6,697	3,982	59
Retail and other	264	8,460	(8,196)	(97)
Total product revenue	$ 31,100	$ 35,537	$ (4,437)	(12)%

Percentage of product revenue:		
Licenses	65%	57%
Hardware	34	19
Retail and other	1	24
Total product revenue	100%	100%

Product revenue includes revenue from software licenses, hardware and retail product. The decrease in product revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was attributable to (i) a decrease in licenses revenue in the three months ended March 31, 2006 due to our continued shift in focus from retail-boxed products to our on-line subscription model for consumers, (ii) increased incentive rebates

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and marketing development funds with our partners which are recorded as an offset to revenue and included in retail and other revenue in the table above, partially offset by (iii) increased Foundstone hardware revenue and increased demand for Intrushield. In April 2005 we increased our support pricing on selected consumer products, including VirusScan and McAfee Internet Security, which resulted in a decrease in product revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 due to allocating more revenue related to service and support and recognizing this deferred revenue ratably over the service and support period.

Our customers license our software on a perpetual subscription basis. Our perpetual licenses became a larger percentage of our license revenue in all quarters following the implementation of our perpetual-plus licensing model worldwide, which has significantly higher support pricing. Thus, revenue has been shifting out of product revenue and into services and support revenue. We expect the remaining mix of product revenue to stabilize as a percentage of revenue.

Subscription Revenues

The following table sets forth, for the periods indicated, the change in subscription revenue from March 31, 2005 to March 31, 2006:

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Total Subscription Revenue	$ 92,726	$ 68,078	$ 24,648	36%

Subscription revenues include revenue from subscription arrangements. The increase in subscriptions revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was attributable to (i) an increase in our on-line subscription arrangements due to an increase in our on-line customer base to approximately 19.0 million subscribers at March 31, 2006 from approximately 11.0 million subscribers at March 31, 2005, (ii) an increase in our McAfee Managed VirusScan on-line service for small and medium-sized businesses and (iii) increased royalties from strategic channel partners. The main driver of this subscriber growth was our continued relationships with strategic channel partners, such as AOL, Comcast and Dell.

Service and Support Revenues

The following table sets forth, for the periods indicated, the two categories of our service and support revenue as a percent of total service and support revenue.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Net service and support revenue:				
Support and maintenance	$ 144,969	$ 125,611	$ 19,358	15%
Consulting and training	3,172	6,501	(3,329)	(51)

Total service and support revenue	$ 148,141	$ 132,112	$ 16,029	12%
Percentage of service and support revenue:				
Support and maintenance	98%	95%		
Consulting and training	2	5		
Total service and support revenue	100%	100%		

Service and support revenues include revenues from software support and maintenance contracts, training and consulting revenue. The increase in service and support revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was attributable to an increase in support and maintenance primarily due to amortization of revenue from support arrangements and increased sales of support renewals offset slightly by a decrease in consulting and training revenue. In addition, in April 2005 we increased our support pricing

on selected consumer products, including VirusScan and McAfee Internet Security, which contributed to the increase in service and support revenue in the three months ended March 31, 2006.

Our future profitability and rate of growth, if any, will be directly affected by our revenue-sharing arrangements with our partners, increased price competition and the size of our revenue base. Our growth rate and net revenue depend significantly on renewals of support arrangements 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. Additionally, support pricing under the perpetual-plus model is significantly higher than the previous subscription model. In the event customers choose not to renew their support arrangements or renew such arrangements at other than the contractual rates, revenue recognition under the perpetual-plus model could be negatively impacted.

Cost of Net Revenue; Gross Margin.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	**2005**	**$**	**%**
	(Dollars in thousands)			
Cost of net revenue:				
Product	$ 15,667	$ 16,923	$ (1,256)	(7)%
Subscription	18,944	10,510	8,434	80
Service and support	6,466	7,374	(908)	(12)
Amortization of purchased technology	3,841	3,850	(9)	
Total cost of net revenue	$ 44,918	$ 38,657	$ 6,261	16%
Percentage of total cost of net revenue:				
Product	35%	44%		
Subscription	42	27		
Service and support	14	19		
Amortization of purchased technology	9	10		
Total cost of net revenue	100%	100%		
Gross margin	$ 227,049	$ 197,070		
Gross margin percentage	83%	84%		

Cost of Product Revenue

Cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels, and, with respect to hardware-based anti-virus and security products, computer platforms and other hardware components. The decrease in cost of product revenue in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was primarily attributable to a decrease in product revenue. We anticipate that cost of product revenue will increase in absolute dollars primarily due to the recognition of stock compensation expense and may fluctuate as a percentage of cost of net revenue in future periods depending on mix of

products sold and various other factors.

Cost of Subscription Revenue

Cost of subscription revenue consists primarily of costs related to the sale of on-line subscription arrangements, the majority of which are revenue-sharing arrangements and royalties paid to our strategic channel partners. The increase in subscription costs in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was primarily attributed to an increase in revenue-sharing arrangements and royalties paid to our on-line strategic channel partners. Our margins on cost of subscription have decreased due to higher percentages paid for royalties. We anticipate that cost of subscription revenue will increase in absolute dollars due to the

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recognition of stock compensation expense and may fluctuate as a percentage of cost of net revenue in future periods depending on the mix of products sold, revenue-share arrangements and various other factors.

Cost of Service and Support Revenue

Cost of services and support revenue consists principally of salaries, stock compensation and benefits related to employees providing customer support and consulting services. The cost of services and support revenue as a percentage of service and support net revenue in the three months ended March 31, 2006 was consistent with the three months ended March 31, 2005. The decrease in absolute dollars in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 is due to a decrease in professional services. We anticipate that cost of service and support revenue will increase in absolute dollars due to the recognition of stock compensation expense and may fluctuate as percentage of cost of net revenue in future periods depending on the mix of products sold and various other factors.

Amortization of Purchased Technology

Amortization of purchased technology in the three months ended March 31, 2006 remained relatively consistent compared to the three months ended March 31, 2005. The purchased technology is being amortized over estimated useful lives of up to seven years. Amortization of purchased technology is expected to be $11.5 million for the remainder of 2006.

Gross Margins

Our gross margins were stable for the three months ended March 31, 2006 compared to the three months ended March 31, 2005. Gross margins may fluctuate in the future due to various factors, including the mix of products sold, sales discounts, contra-spend such as rebates and marketing development funds, revenue-sharing agreements, material and labor costs and warranty costs.

Stock-based Compensation Expense

On January 1, 2006, we adopted SFAS 123R, which requires the measurement and recognition of compensation expense for all share-based awards made to our employees and directors based on the estimated fair values. In the three months ended March 31, 2006, we recognized stock-based compensation expense of $13.6 million in our condensed consolidated financial statements, which included $10.9 million for stock options, $1.9 million for restricted stock awards and units and $0.8 million for our Employee Stock Purchase Plan. The following table summarizes stock-based compensation expense recorded by income statement line item in the three months ended March 31, 2006 (in thousands):

		Three Months Ended March 31, 2006
Cost of net revenue product	$	226
Cost of net revenue subscription		91
Cost of net revenue service and support		359
Stock-based compensation expense included in cost of net revenue		676
Research and development		3,917
Sales and marketing		4,691

General and administrative		4,287
Stock-based compensation expense included in operating expenses		12,895
Total stock-based compensation expense related to stock-based equity awards		13,571
Deferred tax benefit		3,925
Total stock-based compensation expense related to stock-based equity awards, net of tax	$	9,646

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Prior to our adoption of SFAS 123R, we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Historically, our general policy was to set the exercise price for our stock options equal to the market value on the grant date. As a result, the options had no intrinsic value on their grant dates, and we did not record any compensation expense unless the terms of the options were subsequently modified. During the three months ended March 31, 2005, we recognized a benefit of approximately of $3.3 million under APB 25 related to the exchange of McAfee.com options in 2002 and re-pricing of options in 1999, partially offset by expense related to restricted stock awards.

The following table summaries the stock-based compensation benefit recorded in the three months ended March 31, 2005 (in thousands):

	Three Months Ended March 31, 2005	
Research and development	$	(2,503)
Marketing and sales		(735)
General and administrative		(54)
Total stock-based compensation benefit	$	(3,292)

See Note 4 in the condensed consolidated financial statements for additional information regarding the benefit recorded.

During the three months ended March 31, 2006, we changed our equity compensation program for existing employees by granting restricted stock units that vest over a specified period of time instead of awarding stock options. For new employees, we continue to grant stock options. Going forward, our management will consider utilizing all types of equity compensation to reward top-performing employees.

As of March 31, 2006, total compensation cost related to unvested stock options, restricted stock units, restricted stock awards and employee stock purchase rights not yet recognized and reduced by estimated forfeitures was $113.6 million. This amount is expected to be recognized over a weighted-average period of approximately 3.0 years.

Operating Costs

Research and Development

The following table sets forth, for the periods indicated, a comparison of our research and development expenses.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	**2005**	**$**	**%**
	(Dollars in thousands)			
Research and development expenses(1)	$ 51,191	$ 38,230	$ 12,961	34%
Percentage of net revenues	19%	16%		

(1) Includes stock-based compensation charges (benefits) of $3,917 and ($2,503) in the three months ended March 31, 2006 and 2005, respectively.

Research and development expenses consist primarily of salary, benefits, stock compensation for our development and technical support staff, contractors fees and other costs associated with the enhancements of existing products and services and development of new products and services. The increase in research and development expenses in the three months ended March 31, 2006 was primarily attributable to (i) the recognition of $3.9 million of stock compensation expense in the three months ended March 31, 2006 due to the implementation of SFAS 123R on January 1, 2006 compared to the recognition of a $2.5 million stock compensation benefit under APB 25 in the three months ended March 31, 2005, (ii) a $2.7 million increase in salary expense for individuals performing research and development activities primarily attributable to an increase in average headcount and (iii) a $0.9 million increase in discretionary spending specifically due to an increase in events and travel for certain

research and development personnel, partially offset by a $0.5 million decrease due to weakening foreign currencies against the U.S. Dollar in EMEA and Japan.

We believe that continued investment in product development is critical to attaining our strategic objectives. We expect research and development expenses will increase in absolute dollars primarily due to the recognition of stock compensation expense and may fluctuate as a percentage of net revenue compared to the same prior year periods for the remainder of 2006.

Marketing and Sales

The following table sets forth, for the periods indicated, a comparison of our marketing and sales expenses.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Marketing and sales expenses(1)	$ 84,866	$ 71,184	$ 13,682	19%
Percentage of net revenues	31%	30%		

(1) Includes stock-based compensation charges (benefits) of $4,691 and ($735) in the three months ended March 31, 2006 and 2005, respectively.

Marketing and sales expenses consist primarily of salary, commissions, stock compensation and benefits for marketing and sales personnel and costs associated with advertising and promotions. The increase in marketing and sales expenses during the three months ended March 31, 2006 compared to the three months ended March 31, 2005 reflected (i) the recognition of $4.7 million of stock compensation expense in the three months ended March 31, 2006 due to the implementation of SFAS 123R on January 1, 2006 compared to the recognition of a $0.7 million stock compensation benefit under APB 25 in the three months ended March 31, 2005, (ii) a $2.1 million increase in salary expense for individuals performing marketing and sales activities primarily attributable to an increase in average headcount and (iii) increased spending on sales and marketing programs, offset slightly by a $1.7 million decrease due to weakening foreign currencies against the U.S. Dollar in EMEA and Japan in the three months ended March 31, 2006 compared to the same prior-year period.

We anticipate that marketing and sales expenses will increase in absolute dollars and as a percentage of net revenue compared to the same prior year periods for the remainder of 2006, primarily due to the recognition of stock compensation expense beginning January 1, 2006.

General and Administrative

The following table sets forth, for the periods indicated, a comparison of our general and administrative expenses.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			

General and administrative expenses(1)	$ 37,870	$ 33,621	$ 4,249	13%
Percentage of net revenues	14%	14%		

(1) Includes stock-based compensation charges (benefits) of $4,287 and ($54) in the three months ended March 31, 2006 and 2005, respectively.

General and administrative expenses consist principally of salary, stock compensation and benefit costs for executive and administrative personnel, professional services and other general corporate activities. The increase in general and administrative expenses during the three months ended March 31, 2006 compared to the three months ended March 31, 2005 reflected (i) the recognition of $4.3 million of stock compensation expense in the three months ended March 31, 2006 due to the implementation of SFAS 123R on January 1, 2006 compared to the recognition of a $0.1 million stock compensation benefit under APB 25 in the three months ended March 31, 2005,

(ii) a $0.6 million increase in salary expense for individuals performing general and administrative activities primarily attributable to an increase in average headcount, (iii) a $1.5 million increase in legal fees and (iv) $0.4 million related to independent consultants engaged to examine and recommend improvements to our internal controls to ensure compliance with federal securities laws as required by our settlement with the SEC, partially offset by (i) a $0.9 million decrease in costs incurred to comply with Section 404 of the Sarbanes-Oxley Act and (ii) a $0.6 million decrease due to weakening foreign currencies against the U.S. Dollar in EMEA and Japan.

In the three months ended March 31, 2006 and 2005, we recognized acquisition-related compensation expense of $0.9 million and $1.5 million, respectively, which represents amounts paid to Entercept, IntruVert, Foundstone and Wireless Security Corporation employees currently providing services to us.

We anticipate that general and administrative expenses will increase in absolute dollars primarily due to the recognition of stock compensation expense and may fluctuate as a percentage of net revenue compared to the same prior year periods for the remainder of 2006.

Amortization of Intangibles

The following table sets forth, for the periods indicated, a comparison of the amortization of intangibles.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Amortization of intangibles	$ 2,793	$ 3,528	$ (735)	(21)%
Percentage of net revenues	1%	2%		

Intangibles consist of identifiable intangible assets. The decrease in amortization of intangibles in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 was attributable to older intangibles becoming fully amortized in 2006 and 2005.

Restructuring Charges

The following table sets forth, for the periods indicated, a comparison of our restructuring charges.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Restructuring charges	$ 551	$ 2,296	$ (1,745)	(76)%
Percentage of net revenues		1%		

During 2005, 2004 and 2003 we permanently vacated several leased facilities and recorded accruals for estimated lease related costs associated with the permanently vacated facilities. The remaining costs associated with vacating the facilities are primarily comprised of the present value of the remaining lease obligations, along with estimated costs

associated with subleasing the vacated facility, net of estimated sublease rental income. The 2006 restructuring charge consists of accretion totaling $0.2 million and an adjustment to the accrual totaling $0.4 million attributable to a change in assumptions associated with commissions on existing subleases. The 2005 restructuring charge consists of a charge totaling $0.8 million for permanently vacated leased facilities, a charge totaling $1.3 million for severance costs being recognized over the required service period related to the move of our European headquarters to Ireland and accretion of $0.2 million. See Note 7 for further information related to restructuring charges.

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Loss on Sale of Assets and Technology

The following table sets forth, for the periods indicated, a comparison of the loss on sale of assets and technology.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Loss on sale of assets and technology	$ 24	$ 259	$ (235)	(91)%
Percentage of net revenues				

We recognized losses of less than $0.1 million and approximately $0.3 million in the three months ended March 31, 2006 and 2005, respectively related to the write-off of property and equipment.

(Recovery from) Provision for Doubtful Accounts, Net

The following table sets forth, for the periods indicated, a comparison of our provision for (recovery from) doubtful accounts, net.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
(Recovery from) provision for doubtful accounts, net	$ (451)	$ 159	$ (610)	(384)%
Percentage of net revenues				

Provision for doubtful accounts consists of our estimates for the uncollectibility of receivables, net of recoveries of amounts previously written off. During the three months ended March 31, 2006, we recognized a recovery from doubtful accounts of $0.5 million related to the receipt of several customer accounts primarily in North America and EMEA that had previously been written-off.

Reimbursement from Transition Services Agreement

The following table sets forth, for the periods indicated, a comparison of our reimbursement from transition services agreement.

Three Months Ended March 31,		2006 vs. 2005	
2006	2005	$	%
(Dollars in thousands)			

Reimbursement from transition services agreement	$	$ (328)	$ 328	100%
Percentage of net revenues				

In conjunction with the Sniffer sale, we entered into a transition services agreement with Network General. Under this agreement, we provided certain back-office services to Network General for a period of time through June 2005. We completed our requirements under the transition services agreement in July 2005.

Interest and Other Income

The following table sets forth, for the periods indicated, a comparison of our interest and other income.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	**2005**	**$**	**%**
	(Dollars in thousands)			
Interest and other income	$ 12,036	$ 4,960	$ 7,076	143%
Percentage of net revenues	4%	2%		

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Interest and other income includes interest earned on investments, partially offset by net foreign currency transaction losses. The increase in interest and other income is partially due to an increase in average cash and marketable securities in the three months ended March 31, 2006 compared to the three months ended March 31, 2005 of approximately $244.9 million. In addition, our average rate of annualized return on our investments has also increased from 2% in the three months ended March 31, 2005 to 4% in the three months ended March 31, 2006. During the three months ended March 31, 2006 and 2005, we recorded net foreign currency transaction losses of $1.6 million and $1.1 million, respectively, in our condensed consolidated statements of income.

Provision for Income Taxes

The following table sets forth, for the periods indicated, a comparison of our provision for income taxes.

	Three Months Ended March 31,		2006 vs. 2005	
	2006	2005	$	%
	(Dollars in thousands)			
Provision for income taxes	$ 21,249	$ 16,463	$ 4,786	29%
Effective tax rate	34%	31%		

The effective tax rate differs from the statutory rate primarily due to the impact of foreign tax credits and lower effective rates in some overseas jurisdictions. In each successive interim period, to the extent our operating results year to date and our estimates for the remainder of the fiscal year change from our original expectations regarding the proportion of earnings in various tax jurisdictions we expect that our effective tax rate will change accordingly, affecting tax expense (or benefit) for both that successive interim period as well as year-to-date interim results.

Although we reported an effective tax rate of 34% for the three months ended March 31, 2006, our total tax expense of $21.2 million was comprised of tax expense of $19.0 million on year to date ordinary income at an estimated 31% annual effective tax rate in addition to a net tax expense of $2.2 million from discrete items individually computed and recognized when the items occurred. The discrete tax expense of $2.2 million primarily relates to increases in foreign valuation allowances.

The earnings from our foreign operations in India are subject to a tax holiday from a grant effective through 2010. The tax holiday provides for zero percent taxation on certain classes of income and requires certain conditions to be met. We are in compliance with these conditions as of March 31, 2006.

Recent Accounting Pronouncements

See Note 2 to the condensed consolidated financial statements.

Liquidity and Capital Resources

	Three Months Ended March 31,	
	2006	2005
Net cash provided by operating activities	$ 48,374	$ 100,450

Net cash used in investing activities	(137,516)	(55,370)
Net cash used in financing activities	(209,518)	(22,535)

Overview

At March 31, 2006, we had cash and cash equivalents totaling $430.5 million, as compared to $728.6 million at December 31, 2005. In the three months ended March 31, 2006, we generated positive operating cash flows of $48.4 million, our restricted cash decreased $49.7 million and we received cash of $18.0 million related to our employee stock purchase plan and option exercises under our employee stock option plans. Uses of cash during the quarter included the repurchase of common stock of approximately $230.6 million, including commissions, net purchases of marketable securities of $177.1 million, payment of the $50.0 million penalty to the SEC and

purchases of property and equipment of $10.2 million. A more detailed discussion of changes in our liquidity follows.

Operating Activities

Net cash provided by operating activities in the three months ended March 31, 2006 and 2005 was primarily the result of our net income of $40.9 million and $36.0 million, respectively. Net income for the three months ended March 31, 2006 was adjusted for non-cash items such as depreciation and amortization of $15.2 million, stock compensation charges of $13.6 million, changes in deferred income taxes of $4.1 million and changes in various assets and liabilities such as accrued taxes and other liabilities, accounts receivable, deferred revenue and prepaid expenses, prepaid taxes and other assets.

Historically, our primary source of operating cash flow is the collection of accounts receivable from our customers and the timing of payments to our vendors and service providers. One measure of the effectiveness of our collection efforts is average accounts receivable days sales outstanding, or DSO. DSOs were 41 days and 36 days at March 31, 2006 and 2005, respectively. We calculate accounts receivable DSO on a net basis by dividing the net accounts receivable balance at the end of the quarter by the amount of net revenue recognized for the quarter multiplied by 90 days. We expect DSOs to vary from period to period because of changes in quarterly revenue and the effectiveness of our collection efforts. In 2006 and 2005, we did not make any significant changes to our payment terms for our customers, which are generally net 30.

The decrease in cash related to accounts payable, accrued taxes and other liabilities was $66.6 million, which reflected the payment of the $50.0 million penalty to the SEC. Our operating cash flows, including changes in accounts payable and accrued liabilities, are impacted by the timing of payments to our vendors for accounts payable and taxing authorities. We typically pay our vendors and service providers in accordance with invoice terms and conditions, and take advantage of invoice discounts when available. The timing of cash payments in future periods will be impacted by the nature of accounts payable arrangements. In the three months ended March 31, 2006 and 2005, we did not make any significant changes to our payment timing to our vendors.

Our cash and marketable securities balances are held in numerous locations throughout the world, including substantial amounts held outside the United States. As of March 31, 2006, approximately $221.2 million was held outside the United States. We utilize a variety of operational planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed. We have provided for U.S. federal income taxes on these amounts for consolidated financial statement purposes, except for foreign earnings that are considered indefinitely reinvested outside the United States. The American Jobs Creations Act of 2004 provided for a deduction of 85% of certain foreign earnings that are repatriated in stipulated periods, including our year ending December 31, 2005. As a result, a $350.0 million distribution was repatriated in the fourth quarter of 2005.

Our working capital, defined as current assets minus current liabilities, was $481.4 million and $698.7 million at March 31, 2006 and December 31, 2005, respectively. The decrease in working capital of approximately $217.3 million from December 31, 2005 to March 31, 2006 was primarily attributable to a $202.2 million decrease in cash and short-term marketable securities balances to repurchase common stock.

In the third quarter of 2005, we placed $50.0 million in escrow for a proposed settlement with the SEC relating to the Formal Order of Private Investigation into our accounting practices that commenced on March 22, 2002 (see Note 12 to our condensed consolidated financial statements). On February 9, 2006, the SEC entered the final judgment for settlement with us. The $50.0 million escrow was released and transferred to the SEC on February 13, 2006. The transfer to the SEC is reflected as cash provided by investing activities of $50.0 million and cash used in operating activities of $50.0 million. The interest earned on the amount in escrow was released to us when the transfer was made to the SEC and is reflected as a positive adjustment to reconcile net income to net cash provided by operating

activities on our condensed consolidated statement of cash flows for the three months ended March 31, 2006.

We expect to meet our obligations as they become due through available cash and internally generated funds. We expect to continue generating positive working capital through our operations. However, we cannot predict whether current trends and conditions will continue or what the effect on our business might be from the competitive

environment in which we operate. We believe the working capital available to us will be sufficient to meet our cash requirements for at least the next 12 months.

Investing Activities

Our investing activities for the three months ended March 31, 2006 and 2005 are as follows (in thousands).

	Three Months Ended March 31,	
	2006	**2005**
Net purchases of marketable securities	$ (177,052)	$ (46,223)
Decrease (increase) in restricted cash	49,727	(1)
Purchase of property and equipment and leasehold improvements, net	(10,191)	(9,146)
Net cash provided used in investing activities	$ (137,516)	$ (55,370)

Investments

We have classified our investment portfolio as available-for-sale, and our investments are made with a policy of capital preservation and liquidity as the primary objectives. We generally hold investments in money market, U.S. government fixed income and U.S. government agency securities to maturity; however, we may sell an investment at any time if the quality rating of the investment declines, the yield on the investment is no longer attractive or we are in need of cash. Because we invest only in investment securities that are highly liquid with a ready market, we believe that the purchase, maturity or sale of our investments has no material impact on our overall liquidity.

Restricted Cash

The current restricted cash balance of $50.5 million at December 31, 2005 reflected the $50.0 million we placed in escrow for the SEC settlement and the interest earned on the escrow which was restricted until released by the SEC. On February 9, 2006, the SEC entered the final judgment for settlement with us. On our consolidated statement of cash flow, the $50.0 million released from escrow for payment to the SEC was reflected as cash provided by investing activities and cash used in operating activities. The interest earned on the escrow was released to cash upon payment to the SEC.

The non-current restricted cash balance of $1.2 million at March 31, 2006 and $0.9 million at December 31, 2005 consisted primarily of cash collateral related to the Foundstone facility lease, the Entercept facility lease and a facility lease in India, as well as workers compensation insurance coverage.

Property and Equipment

The $10.2 million and $9.1 million of property and equipment purchased during the three months ended March 31, 2006 and 2005, respectively, was primarily for upgrades of our existing accounting system and purchases of computers, equipment and software.

We anticipate that we will continue to purchase property and equipment necessary in the normal course of our business. The amount and timing of these purchases and the related cash outflows in future periods is difficult to

predict and is dependent on a number of factors including our hiring of employees, the rate of change in computer hardware/software used in our business and our business outlook.

Acquisitions

Our available cash and equity securities may be used to acquire or invest in complementary companies, products and technologies.

Financing Activities

Our financing activities for the three months ended March 31, 2006 and 2005 are as follows (in thousands):

	Three Months Ended March 31,	
	2006	2005
Proceeds from issuance of common stock under stock option and stock purchase plans	$ 18,040	$ 24,816
Excess tax benefits from stock-based compensation	3,001	
Repurchase of common stock	(230,559)	(47,351)
Net cash used in financing activities	$ (209,518)	$ (22,535)

Stock Option and Stock Purchase Plans

Historically, our recurring cash flows provided by financing activities have been from the receipt of cash from the issuance of common stock under stock option and employee stock purchase plans. We received cash proceeds from these plans in the amount of $18.0 million and $24.8 million in three months ended March 31, 2006 and 2005, respectively. While we expect to continue to receive these proceeds in future periods, the timing and amount of such proceeds are difficult to predict and are contingent on a number of factors including the price of our common stock, the number of employees participating in the plans and general market conditions. In the three months ended March 31, 2006, we changed our equity compensation program for existing employees by granting restricted stock units instead of awarding stock options. We continued to grant stock options to new employees. Although management has not determined what type of equity compensation we will use to reward top-performing employees going forward, if management decides to grant only restricted stock units, which provide no proceeds to us, going forward, our proceeds from issuance of common stock will decrease significantly.

As our stock price rises, more participants are in the money in their options, and thus, more likely to exercise their options, which results in cash to us. As our stock price decreases, more of our employees are out of the money or under water in regards to their options, and therefore, choose not to exercise options, which results in no cash received by us.

Excess Tax Benefits from Stock-Based Compensation

The excess tax benefit reflected as a financing cash inflow in the three months ended March 31, 2006 represents excess tax benefits realized relating to share-based payments to our employees, in accordance with SFAS 123R. There is a corresponding cash outflow included in cash flows from operating activities.

Repurchase of Common Stock

In April 2005, our board of directors authorized the repurchase of an additional $175.0 million of our common stock in the open market from time to time until August 2006, depending upon market conditions, share price and other factors. Prior to this additional authorization, in November 2003 our board of directors had authorized the repurchase of up to $150.0 million of our common stock in the open market through November 2005, and in August 2004, our board of directors had authorized the repurchase of up to an additional $200.0 million of our common stock in the

open market through August 2006. During the three months ended March 31, 2006, we used $230.6 million to repurchase 9.6 million shares of our common stock in the open market, including commissions paid on these transactions. During the three months ended March 31, 2005, we used $47.4 million to repurchase 2.0 million shares of our common stock in the open market.

In April 2006, our board of directors authorized the repurchase of an additional $250.0 million of our common stock in the open market from time to time until October 2007, depending upon market conditions, share price and other factors.

Credit Facility

We have a $17.0 million credit facility with a bank. The credit facility is available on an offering basis, meaning that transactions under the credit facility will be on such terms and conditions, including interest rate, maturity, representations, covenants and events of default, as mutually agreed between us and the bank at the time of each specific transaction. The credit facility is intended to be used for short-term credit requirements, with terms of one year or less. The credit facility can be cancelled at any time. No balances are outstanding as of March 31, 2006.

Off-Balance Sheet Arrangements

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

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Our market risks at March 31, 2006, have not changed significantly from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission.

Item 4. *Controls and Procedures*

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report on Form 10-Q.

A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within the company have been detected. These inherent limitations include the reality that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. The design of any control system is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Based upon the material weakness described in Item 9A of our Annual Report on Form 10-K filed on March 3, 2006, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, and internal controls over financial reporting, were ineffective as of March 31, 2006. Although our controls over the financial close and reporting process were sufficient to prevent a material misstatement of our financial statements during the first quarter of 2006, they have not yet operated consistently for an extended period of time to remediate the material weakness that existed at December 31, 2005. In accordance with the remediation plan set forth in our Annual Report on Form 10-K, we took the following steps during the first quarter of 2006 to ensure the continued

effectiveness of our controls in subsequent periods:

(1) Hired additional personnel for key finance and accounting functions, including a controller of our North American and Latin American operations and a senior manager of technical accounting to ensure the consistency of our accounting policies and procedures worldwide.

(2) Reduced our reliance on external consultants.

(3) Continued with our plans to automate and re-engineer certain business process.

PART II: OTHER INFORMATION

Item 1. *Legal Proceedings*

Information with respect to this item is incorporated by reference to Note 12 of the notes to the condensed consolidated financial statements included in this Report on Form 10-Q.

Item 1A. *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, Making It Difficult for Us to Accurately Estimate Operating Results.

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

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

- introduction of new products, product upgrades or updates by us or our competitors;
- revenue recognition which may be influenced by volume, size, timing and contractual terms of new licenses and renewals of existing licenses;
- the mix of products we sell and services we offer and whether (i) our products are sold directly by us or indirectly through distributors, resellers, ISPs such as AOL, OEMs such as Dell, and others, (ii) the product is hardware or software based and (iii) in the case of software licenses, the licenses are perpetual licenses or time-based subscription licenses;
- changes in our supply chains and product delivery channels, which may result in product fulfillment delays;
- personnel limitations, which may adversely impact our ability to process the large number of orders that typically occur near the end of a fiscal quarter;
- costs or charges related to our acquisitions or dispositions, including our acquisitions of Site Advisor, Inc. in April 2006 and Wireless Security Corporation in June 2005 and the dispositions of our McAfee Labs assets;

the components of our revenue that are deferred, including our on-line subscriptions and that portion of our software licenses attributable to support and maintenance;

stock-based compensation expense, which we began recognizing for our stock-based compensation plans in the first quarter of 2006;

costs and charges related to certain events, including Sarbanes-Oxley compliance efforts, litigation, relocation of personnel and previous financial restatements;

changes in generally accepted accounting principles;

our ability to effectively manage our operating expense levels; and

factors that lead to substantial declines in estimated values of long-lived assets below their carrying value.

Although a significant portion of our revenue in any quarter comes from previously deferred revenue, a meaningful part of our revenue in any quarter depends on contracts entered into or orders booked and shipped in that quarter. Historically, we have experienced 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. Any failure or delay in the closing of new orders in a given quarter could have a material adverse effect on our quarterly operating results. For example, during the fourth quarter of 2005, we failed to meet our previously issued revenue and earnings guidance due in part to incorrect assumptions regarding in-period realization of fourth quarter bookings, a higher proportion of sales involving ratable revenue or multi-year support and more large, multi-product, multi-year enterprise transactions that resulted in lower recognition of up-front revenue. In addition, a significant portion of our revenue is derived from product sales through our distributors. 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 accurately gather sales information on a timely basis 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. We may be required to expend time and money to ensure that interfaces between our systems and our distributors systems are up to date and effective. As our reliance upon interdependent automated computer systems continues to increase, a disruption in any one of these systems could interrupt the distribution of our products and impact our ability to accurately and timely recognize and report revenue. Further, as we increasingly rely upon third-party manufacturers to manufacture our hardware-based products, our reliance on their ability to provide us with timely and accurate product cost information exposes us to risk. A failure of our third-party manufacturers to provide us with timely and accurate product cost information may impact our costs of goods sold and negatively impact our ability to accurately and timely report revenue.

Because we expect these trends to continue, it is difficult for us to accurately estimate operating results prior to the end of a quarter.

We Face Risks in Connection With the Material Weakness Resulting From Our Sarbanes-Oxley Section 404 Management Report and Any Related Remedial Measures That We Undertake.

In conjunction with (i) our ongoing reporting obligations as a public company and (ii) the requirements of Section 404 of the Sarbanes-Oxley Act that management report as of December 31, 2005 on the effectiveness of our internal control over financial reporting and identify any material weaknesses in our internal control over financial reporting, we engaged in a process to document, evaluate and test our internal controls and procedures, including corrections to existing controls and additional controls and procedures that we may implement. As a result of this evaluation and testing process, our management identified a material weakness in our internal control over financial reporting relating to the financial close process. See Item 9A in the Annual Report on Form 10-K for the year ended December 31, 2005 for additional disclosure about the material weakness. In response to the material weakness in our internal control over financial reporting, we have implemented and will continue to implement, additional controls and procedures, including automating many of our controls and financial reporting processes, re-engineering our close process, standardizing our worldwide policies and procedures and continuing to hire accounting and finance personnel where appropriate. In addition, in connection with the settlement of the SEC s formal investigation into our accounting practices, we are required to appoint an independent consultant to conduct a one-time, comprehensive review of our internal accounting and financial reporting controls, among other matters. These efforts could result in increased cost and could divert management attention away from operating our business. As a result of the identified material weakness, even though our management believes that our efforts to remediate and re-test our internal control

deficiencies have resulted in the improved operation of our internal control over financial reporting, we cannot be certain that the measures we have taken or we are planning to take will sufficiently and satisfactorily remediate the identified material weakness in full.

In future periods, if the process required by Section 404 of the Sarbanes-Oxley Act reveals further material weaknesses or significant deficiencies, the correction of any such material weakness or significant deficiency could

require additional remedial measures which could be costly and time-consuming. In addition, the discovery of further material weaknesses could also require the restatement of prior period operating results. If a material weakness exists as of a future period year-end (including a material weakness identified prior to year-end for which there is an insufficient period of time to evaluate and confirm the effectiveness of the corrections or related new procedures), our management will be unable to report favorably as of such future period year-end to the effectiveness of our control over financial reporting. If we are unable to assert that our internal control over financial reporting is effective in any future period (or if our independent auditors are unable to express an opinion on the effectiveness of our internal controls), or if we continue to experience material weaknesses in our internal control over financial reporting, we could lose investor confidence in the accuracy and completeness of our financial reports, which would have an adverse effect on our stock price and potentially subject us to litigation.

If We Fail to Effectively Upgrade Our Information Technology System, We May Not Be Able to Accurately Report Our Financial Results or Prevent Fraud.

As part of our efforts to continue improving our internal control over financial reporting, we plan to upgrade our existing SAP information technology system during 2006 in order to automate certain controls that are currently performed manually. We may experience difficulties in transitioning to new or upgraded systems, including loss of data and decreases in productivity as personnel become familiar with new systems. In addition, our management information systems will require modification and refinement as we grow and as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems and respond to changes in our business needs, our operating results could be harmed or we may fail to meet our reporting obligations. In addition, as a result of the automation of these manual processes, the data produced may cause us to question the accuracy of previously reported financial results.

We Are Subject to Intense Competition in the System and Network Protection Markets, and We Expect to Face Increased Competition in the Future.

The markets for our products are intensely competitive and we expect both product and pricing competition to increase. As competition increases, we expect increases in our product-related expenses, including increased product rebates, marketing development funds and strategic channel partner revenue-sharing agreements. Some of our competitors have longer operating histories, have more extensive international operations, greater name recognition, larger technical staffs, established relationships with hardware vendors and/or greater financial, technical and marketing resources. We face competition in specific product markets. Principal competitors include:

- in the system protection market, which includes our anti-virus and risk assessment and vulnerability management solutions, Symantec Corp., CA, Inc. and Microsoft Corp. Trend Micro Inc. remains the strongest competitor in the Asian anti-virus market and has recently entered the U.S. market. F-Secure Corporation, Dr. Ahn s Anti-Virus Lab, Panda Software and Sophos are also showing growth in their respective markets; and

- in the network protection market, which includes our other intrusion detection and protection products, Cisco Systems Inc., CA, Inc., Internet Security Systems Inc., Juniper Networks, Inc., Symantec Corp. and 3Com Corporation. Qualys and Internet Security Systems Inc. are the strongest competitors for our Foundstone products and solutions.

Other competitors for our various products could include large technology companies. We also face competition from numerous smaller companies and shareware authors that may develop competing products.

A significant portion of our revenue comes from our consumer business. We will continue to focus on growth in this segment both directly and through relationships with ISPs such as AOL and Comcast, and PC OEMs, such as Dell and Gateway. As competition in this market increases, we may experience pricing pressures from both our competitors and partners which may have a negative effect on our ability to sustain our revenue and market share growth. In addition, as our consumer business becomes more dependent upon the ISP model, our direct on-line

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revenue may suffer and our retail box business may also continue to decline. Furthermore, as penetration of the consumer anti-virus market through the ISP model increases, this market may become saturated.

Increasingly, our competitors are large vendors of hardware or operating system software. These competitors are continuously developing or incorporating system and network protection functionality into their products. For example, in the first quarter of 2006 Microsoft announced that it intends to release its consumer security solution in June 2006 and continues to execute on its announced plans to boost the security functionality of its Windows platform through its acquisition of managed service provider FrontBridge Technologies, anti-virus provider Sybari Software, Inc. and anti-spyware provider GIANT Company Software. Through its acquisitions of Okena, Inc., Riverhead Networks and NetSolv, Cisco Systems Inc. may incorporate functionality that competes with our content filtering and anti-virus products. In addition, Juniper Networks, Inc. acquired Netscreen Technologies.

The widespread inclusion of products that perform the same or similar functions as our products within computer hardware or other companies software products could reduce the perceived need for our products or render our products obsolete and unmarketable. Furthermore, even if these competitors incorporated products are inferior or more limited than our products, customers may elect to accept the incorporated products rather than purchase our products. Or, if our competitors products are offered at significant discounts to our prices or for free, we may be unable to respond competitively, or may have to significantly reduce our prices which would negatively impact our revenue. In addition, the software industry is currently undergoing consolidation as firms seek to offer more extensive suites and broader arrays of software products, as well as integrated software and hardware solutions. This consolidation may negatively impact our competitive position.

We Face Risks Related to Our International Operations.

During the three months ended March 31, 2006, net revenue in our operating regions outside of North America represented approximately 45% of our net revenue. We intend to continue our focus on international growth and expect international revenue to remain a significant percentage of our net revenue.

Risks related to international operations include:

- longer payment cycles and greater difficulty in collecting accounts receivable;
- increased costs and management difficulties related to the growth and operation of our international sales and support organization;
- our ability to successfully establish, manage and staff shared service centers for worldwide sales finance and accounting operations centralized from locations in the U.S. and Europe;
- our ability to adapt to sales and marketing practices and customer requirements in different cultures;
- our ability to successfully localize software products for a significant number of international markets;
- compliance with more stringent consumer protection and privacy laws;
- currency fluctuations, including weakness of the U.S. dollar relative to other currencies, or the strengthening of the U.S. dollar that may have an adverse impact on revenues, financial results and cash flows and risks related to hedging strategies;

enactment of additional regulations or restrictions on the use, import or export of encryption technologies, which would delay or prevent the acceptance and use of encryption products and public networks for secure communication;

political instability in both established and emerging markets;

tariffs, trade barriers and export restrictions;

a high incidence of software piracy in some countries; and

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

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

We rely on a combination of contractual rights, trademarks, trade secrets, patents and copyrights to establish and protect proprietary rights in our software. However, the steps taken by us to protect our proprietary software may not deter its misuse, theft or misappropriation. Competitors may independently develop technologies or products that are substantially equivalent or superior to our products or that inappropriately incorporate our proprietary technology. We are aware that a substantial number of users of our anti-virus products have not paid any registration or license fees to us. Certain jurisdictions may not provide adequate legal infrastructure for effective protection of our intellectual property rights. Changing legal interpretations of liability for unauthorized use of our software or lessened sensitivity by corporate, government or institutional users to avoiding infringement of intellectual property could also harm our business.

We Face Risks Related to Our Strategic Alliances.

Through our strategic alliances we may from time to time license technology from third parties to integrate or bundle with our products or we may license out our technology for others to integrate or bundle with their products. We may not realize the desired benefits from our strategic alliances on a timely basis or at all. We face a number of risks relating to our strategic alliances, including the following:

Strategic alliances require significant coordination between the parties involved. To be successful, our alliances may require the integration of other companies products with our products, which may involve significant time and expenditure by our technical staff and the technical staff of our strategic allies.

Our agreements with our strategic alliances are terminable without cause with no or minimal notice or penalties. We may expend significant time, money and resources to further relationships with our strategic alliances that are thereafter terminated.

The integration of products from different companies may be more difficult than we anticipate, and the risk of integration difficulties, incompatible products and undetected programming errors or bugs may be higher than that normally associated with new products.

Our sales force and our marketing and professional services personnel may require additional training to market products that result from our strategic alliances. The marketing of these products may require additional sales force efforts and may be more complex than the marketing of our own products.

We may be required to share ownership in technology developed as part of our strategic alliances

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

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

offer a broad range of network and system protection products;

enhance existing products and expand product offerings;

extend security technologies to additional digital devices such as mobile phones and personal digital assistants;

respond promptly to new customer requirements and industry standards;

provide frequent, low cost upgrades and updates for our products;

maintain quality; and

remain compatible with popular operating systems such as Linux, Windows XP, and Windows NT, and develop products that are compatible with new or otherwise emerging operating systems such as Microsoft s Vista Operating System.

We may experience delays in product development as we have at times in the past. Complex products like ours may contain undetected errors or version compatibility problems, particularly when first released, which could delay or harm market acceptance. The widespread inclusion of products that perform the same or similar functions as our products within the Windows platform could reduce the perceived need for our products. For example, in the first quarter of 2006 Microsoft announced that it intends to release its consumer security solution in June 2006 and continues to execute on its announced plans to boost the security functionality of its Windows platform. 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. The occurrence of these events could negatively impact our revenue.

We Face Risks Associated with Past and Future Acquisitions.

We may buy or make investments in complementary companies, products and technologies. For example, in October 2004 we acquired Foundstone to bolster our risk assessment and vulnerability management capabilities and in June 2005 we acquired Wireless Security Corporation to continue to develop their patent-pending technology, to introduce a new consumer wireless security offering, and to integrate the technology into our small business managed solution. In addition, we acquired SiteAdvisor in April 2006. We may not realize the anticipated benefits from the Foundstone, Wireless Security Corporation or SiteAdvisor acquisitions.

Integration

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

- integrate and retain key management, sales, research and development and other personnel;
- integrate the acquired products into our product offerings both from an engineering and sales and marketing perspective;
- integrate and support preexisting supplier, distribution and customer relationships;
- coordinate research and development efforts; and
- consolidate duplicate facilities and functions and integrate back-office accounting, order processing and support functions.

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

Internal Controls, Policies and Procedures

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

Open Source Software

Products or technologies acquired by us may include so-called open source software. Open source software is typically licensed for use at no initial charge, but imposes on the user of the open source software certain requirements to license to others both the open source software as well as the software that relates to, or interacts with, the open source software. Our ability to commercialize products or technologies incorporating open source

software or otherwise fully realize the anticipated benefits of any such acquisition may be restricted because, among other reasons:

- open source license terms may be ambiguous and may result in unanticipated obligations regarding our products;
- competitors will have improved access to information that may help them develop competitive products;
- open source software cannot be protected under trade secret law;
- it may be difficult for us to accurately determine the developers of the open source code and whether the acquired software infringes third-party intellectual property rights; and
- open source software potentially increases customer support costs because licensees can modify the software and potentially introduce errors.

Use of Cash and Securities

Our available cash and securities may be used to acquire or invest in companies or products, possibly resulting in significant acquisition-related charges to earnings and dilution to our stockholders. For example, in April 2006 we used approximately $60.8 million to acquire SiteAdvisor, Inc. and in June 2005 we used approximately $20.2 million to acquire Wireless Security Corporation. Moreover, if we acquire a company, we may have to incur or assume that company s liabilities, including liabilities that may not be fully known at the time of acquisition.

We Face Manufacturing, Supply, Inventory, Licensing and Obsolescence Risks Relating to Our Products.

Third-Party Manufacturing

We rely on a small number of third parties to manufacture some of our hardware-based network protection and system protection products. We expect the number of our hardware-based products and our reliance on third-party manufacturers to increase as we continue to expand our portfolio of hardware-based network protection and system protection products. Reliance on third-party manufacturers, including software replicators, involves a number of risks, including the lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. If any of our third-party manufacturers cannot or will not manufacture our products in required volumes on a cost-effective basis, in a timely manner, at a sufficient level of quality, 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. Furthermore, supply disruptions or cost increases could increase our costs of goods sold and negatively impact our financial performance. For example, if the price to us of our hardware-based products increased and we were unable to offset the price increase, then the increased cost to us of selling the product could reduce our overall profitability.

Sourcing

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

Third-Party Licenses

Some of our products incorporate software licensed from third parties. We must be able to obtain reasonably priced licenses and successfully integrate this software with our hardware. In addition, some of our products may include "open source" software. Our ability to commercialize products or technologies incorporating open source software may be restricted because, among other reasons, open source license terms may be ambiguous and may result in unanticipated obligations regarding our products.

Obsolescence

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

Product Fulfillment

We typically fulfill delivery of our hardware-based products from centralized distribution centers. We have in the past and may in the future make changes in our product delivery network. Changes in our product delivery network may disrupt our ability to timely and efficiently meet our product delivery commitments, particularly at the end of a quarter. As a result, we may experience increased costs in the short term as temporary delivery solutions are implemented to address unanticipated delays in product delivery. In addition, product delivery delays may negatively impact our ability to recognize revenue if shipments are delayed at the end of a quarter.

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

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

We Face a Number of Risks Related to Our Product Sales Through Intermediaries.

We sell a significant amount of our products through intermediaries such as distributors, PC OEMs, ISPs and other strategic channel partners, referred to collectively as distributors. Our top ten distributors typically represent approximately 46% to 65% of our net sales in any quarter. We expect this percentage to increase as we continue to focus our sales efforts through the channel and other partners. Our two largest distributors, Ingram Micro Inc. and Tech Data Corp., together accounted for approximately 25% of our net revenue in the three months ended March 31, 2006.

Sale of Competing Products

Our distributors may sell other vendors products that are complementary to, or compete with, our products. While we have instituted programs designed to motivate our distributors to focus on our products, these distributors may give greater priority to products of other suppliers, including competitors. Our ability to meaningfully increase the amount of our products sold through our distributors depend on our ability to adequately and efficiently support these distributors with, among other things, appropriate financial incentives to encourage pre-sales investment and sales tools, such as online sales and technical training as product collateral needed to support their customers and prospects. Any failure to properly and efficiently support our distributors may result in our distributors focusing more on our competitors products rather than our products and thus in lost sales opportunities.

Loss of a Distributor

The agreements with our distributors, such as Dell, Ingram Micro Inc., Tech Data Corp. and AOL, are generally terminable by either party without cause with no or minimal notice or penalties. We may expend significant time, money and resources to further relationships with our distributors that are thereafter terminated. If one of our

significant distributors terminates its agreement with us, we could experience a significant interruption in the distribution of our products. In addition, our business interests and those of our distributors may diverge over time, which might result in conflict, termination or a reduction in collaboration. For example, our relationship with Internet Security Systems Inc. was terminated following the announcement of our acquisitions in 2003 of Entercept and IntruVert.

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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 $2.2 million as of March 31, 2006. We regularly review the collectibility and credit-worthiness of our distributors to determine an appropriate allowance for doubtful accounts. Our uncollectible accounts could exceed our current or future allowances.

We Face Risks Related to Customer Outsourcing to System Integrators.

Some of our customers have outsourced the management of their information technology departments to large system integrators. If this trend continues, our established customer relationships could be disrupted and our products could be displaced by alternative system and network protection solutions offered by system integrators. Significant product displacements could impact our revenue and have a material adverse effect on our business.

Critical Personnel May Be Difficult to Attract, Assimilate and Retain.

Our success depends in large part on our ability to attract and retain senior management personnel, as well as technically qualified and highly-skilled sales, consulting, technical, finance and marketing personnel. Other than executive management who have at will employment agreements, our employees are not typically subject to an employment agreement or non-competition agreement. For example, in January 2006, Gene Hodges, our former president, resigned to pursue other opportunities. In the past we have experienced significant turnover in our finance organization worldwide and replacing these personnel remains difficult given the competitive market for these skill sets.

It could be difficult, time consuming and expensive to replace any key management member or other critical personnel. Integrating new management and other key personnel also may be difficult and costly. Changes in management or other critical personnel may be disruptive to our business and might also result in our loss of unique skills and the departure of existing employees and/or customers. It may take significant time to locate, retain and integrate qualified management personnel.

Other personnel related issues that we may encounter include:

Competition for Personnel; Need for Competitive Pay Packages

Competition for qualified individuals in our industry is intense. To attract and retain critical personnel, we believe that we must maintain an open and collaborative work environment. We also believe we need to provide a competitive compensation package, including stock options and restricted stock. Increases in shares available for issuance under our stock option plans require stockholder approval. Institutional stockholders, or our other stockholders, may not approve future requests for option pool increases. For example, at our 2003 annual meeting held in December 2003, our stockholders did not approve a proposed increase in shares available for grant under our employee stock option plans. Additionally, as of January 2006 we are required to include compensation expense in our consolidated statement of income and comprehensive income relating to the issuance of employee stock options. We are currently evaluating our compensation programs and in particular our equity compensation philosophy. In the future, we may decide to issue fewer stock options, possibly impairing our ability to attract and retain necessary personnel. Conversely, issuing a comparable number of stock options could adversely impact our results of operations when compared with periods prior to the effectiveness of these new rules.

Reduced Productivity of New Hires; Senior Management Additions

Notwithstanding our ongoing efforts to reduce our general personnel levels, we continue to hire in key areas and have added a number of new employees in connection with our acquisitions. We have also increased our hiring in Bangalore, India in connection with the relocation of a significant portion of our research and development operations to India.

Several members of our senior management were only added in the last year, and we may add new members to senior management. In July 2005 we hired Richard Decker as our new senior vice president and chief information officer and in the second quarter of 2005, we promoted William Kerrigan to the position of executive vice president

of consumer brands. Also, in March 2006 we promoted Kevin Weiss to the position of president of McAfee, Inc. and Eric Brown to the position of chief operating officer and chief financial officer of McAfee, Inc.

For new employees or management additions, there may be reduced levels of productivity as recent additions or hires are trained or otherwise assimilate and adapt to our organization and culture.

Product Liability and Related Claims May Be Asserted Against Us.

Our products are used to protect and manage computer systems and networks that may be critical to organizations. Because of the complexity of the environments in which our products operate, an error, or a false positive, failure or bug in our products, including a security vulnerability, could disrupt or cause damage to the networks of our customers, including disruption of legitimate network traffic by our products. For example, in March 2006 we released a data file update that contained a defect causing certain of our products to generate false positives. Failure of our products to perform to specifications (including the failure of our products to identify or block a virus), disruption of our customers network traffic or damages to our customers networks caused by our products could result in product liability damage claims by our customers. Our license agreements with our customers typically contain provisions designed to limit our exposure to potential product liability claims. It is possible, however, that the limitation of liability provisions may not be effective under the laws of certain jurisdictions, particularly in circumstances involving unsigned licenses.

Intellectual Property Litigation in the Network and System Security Market Is Common and Can Be Expensive.

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

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

- result in the loss of our proprietary rights;
- subject us to significant liabilities, including monetary liabilities;
- require us to seek licenses from third parties; or
- prevent us from manufacturing or selling our products.

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

If we acquire a portion of software included in our products from third parties, our exposure to infringement actions may increase because we must rely upon these third parties as to the origin and ownership of any software being acquired. Similarly, notwithstanding measures taken by our competitors or us to protect our competitors intellectual property, exposure to infringement claims increases if we employ or hire software engineers previously employed by competitors. Further, to the extent we utilize open source software we face risks. For example, the scope and requirements of the most common open source software license, the GNU General Public License, or GPL, have not been interpreted in a court of law. Use of GPL software could subject certain portions of our proprietary software to the GPL requirements. Other forms of open source software licensing present license compliance risks, which could result in litigation or loss of the right to use this software.

Computer Hackers May Damage Our Products, Services and Systems.

Due to our high profile in the network and system protection market, we have been a target of computer hackers who have, among other things, created viruses to sabotage or otherwise attack our products and services, including our various websites. For example, we have seen the spread of viruses, or worms, that intentionally delete anti-virus and firewall software. Similarly, hackers may attempt to penetrate our network security and misappropriate proprietary information or cause interruptions of our internal systems and services. Also, a number of websites have been subject to denial of service attacks, where a website is bombarded with information requests

eventually causing the website to overload, resulting in a delay or disruption of service. If successful, any of these events could damage users or our computer systems. In addition, since we do not control compact disk, or CD, duplication by distributors or our independent agents, CDs containing our software may be infected with viruses.

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 other litigation. Where we can make a reasonable estimate of the liability relating to pending litigation and determine that it is probable, we record a related liability. As additional information becomes available, we assess the potential liability and revise estimates as appropriate. However, because of uncertainties relating to litigation, the amount of our estimates could be wrong. In addition to the related cost and use of cash, pending or future litigation could cause the diversion of management s attention and resources.

We Face Risks Related to the Settlement Agreement with the Securities and Exchange Commission.

On February 9, 2006, the United States District Court for the Northern District of California entered a final judgment permanently enjoining us and our officers and agents from future violations of the securities laws. This final judgment resolved the charges filed against us in connection with the SEC s investigation of our financial results. As a result of the judgment, we will forfeit for three years the ability to invoke the safe harbor for forward-looking statements provision of the Private Securities Litigation Reform Act or the Reform Act. This safe harbor provided us enhanced protection from liability related to forward-looking statements if the forward-looking statements were either accompanied by meaningful cautionary statements or were made without actual knowledge that they were false or misleading. While we may still rely on the bespeaks caution doctrine that existed prior to the Reform Act for defenses against securities lawsuits, without the statutory safe harbor, it may be more difficult for us to defend against any such claims. In addition, due to the permanent restraint and injunction against violating applicable securities laws, any future violation of the securities laws would be a violation of a federal court order and potentially subject us to a contempt order. For instance, if, at some point in the future, we were to discover a fact that caused us to restate our financial statements similar to the restatements that were the subject of the SEC action, we could be found to have violated the final judgment. Further, any collateral criminal or civil investigation, proceeding or litigation related to any future violation of the judgment, such as the compliance actions mandated by the judgment, could result in the distraction of management from our day-to-day business and may materially and adversely affect our reputation and results of operations.

We Face Risks Related to Our Anti-Spam and Anti-Spyware Software Products.

Our anti-spam and anti-spyware products may falsely identify emails or programs as unwanted spam or potentially unwanted programs, fail to properly identify unwanted emails or programs, particularly as spam emails or spyware are often designed to circumvent anti-spam or spyware products, or, in the case of our anti-spam products, incorrectly identify legitimate businesses as users of phishing technology. Parties whose emails or programs are blocked by our products, or whose websites are incorrectly identified as utilizing phishing techniques, may seek redress against us for labeling them as spammers or spyware, or for interfering with their business. In addition, false identification of emails or programs as unwanted spam or potentially unwanted programs may reduce the adoption of these products.

Cryptography Contained in Our Technology is Subject to Export Restrictions.

Some of our computer security solutions, particularly those incorporating encryption, may be subject to export restrictions. As a result, some products may not be exported to international customers without prior U.S. government approval. The list of products and end users for which export approval is required, and the 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 Tax Strategy May Expose Us to Risk.

We are generally required to account for taxes in each jurisdiction in which we operate. This process may require us to make assumptions, interpretations and judgments with respect to the meaning and application of promulgated tax laws and related administrative and judicial interpretations thereof of the jurisdictions in which we operate. The positions that we take and our interpretations of the tax laws may differ from the positions and interpretations of the tax authorities in the jurisdictions in which we operate. An audit by a tax authority that results in a contrary decision could have a significant negative impact on our cash position and net income.

Business Interruptions May Impede Our Operations and the Operations of Our Customers.

We are continually updating or modifying our accounting systems. Modifications of these types of systems are often disruptive to business and may cause us to incur higher costs than we anticipate. Failure to properly manage this process could materially harm our business operations.

In addition, we and our customers face a number of potential business interruption risks that are beyond our respective control. Natural disasters or other events could interrupt our business or the business of our customers, and each of us is reliant on external infrastructure that may be antiquated. Our corporate headquarters are located near a major earthquake fault. The potential impact of a major earthquake on our facilities, infrastructure and overall operations is not known. Despite safety precautions that have been implemented, there is no guarantee that an earthquake would not seriously disturb our entire business process. We are largely uninsured for losses and business disruptions caused by an earthquake and other natural disasters.

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

During 2005, our stock price was highly volatile ranging from a per share high of $33.24 to a low of $20.35. On March 31, 2006, our stock s closing price per share price was $24.33. Announcements, business developments, such as a material acquisition or disposition, litigation developments and our ability to meet the expectations of investors with respect to our operating and financial results, may contribute to current and future stock price volatility. In addition, third-party announcements such as those made by our partners and competitors may contribute to current and future stock price volatility. For example, future announcements by Microsoft Corp. related to its consumer security solution may contribute to future volatility in our stock price. Certain types of investors may choose not to invest in stocks with this level of stock price volatility.

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

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

Our Charter Documents and Delaware Law and Our Rights Plan May Impede or Discourage a Takeover, Which Could Lower Our Stock Price.

Our Charter Documents and Delaware Law

Pursuant to our charter, our board of directors has the authority to issue up to 5.0 million shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by our stockholders. The issuance of preferred stock could have the effect of making it more difficult for a third-party to acquire a majority of our outstanding voting stock.

Our classified board and other provisions of Delaware law and our certificate of incorporation and bylaws, could also delay or make a merger, tender offer or proxy contest involving us more difficult. For example, any stockholder wishing to make a stockholder proposal (including director nominations) at our 2006 annual meeting,

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

Our Rights Plan

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

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

Stock Repurchases

The table below sets forth all repurchases by us of our common stock during the quarter ended March 31, 2006, all of which were pursuant to a publicly announced plan or program:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Repurchase Program	Approximate Dollar Value of Shares That May Yet be Purchased Under Our Stock Repurchase Program
	(In thousands, except price per share)			
January 1, 2006 through January 31, 2006	7	$ 27.10		$ 230,217
February 1, 2006 through February 28, 2006	4,088	23.79	4,088	132,944
March 1, 2006 through March 31, 2006	5,550	23.95	5,550	36
Total	9,645	$ 23.88	9,638	

In April 2005, our board of directors authorized the repurchase of an additional $175.0 million of our common stock in the open market from time to time until August 2006. In 2005, we repurchased approximately 2.8 million shares for a total of $68.4 million. As of December 31, 2005, we had authorization from our board of directors to repurchase an additional $230.2 million of our common stock. In February 2006, we repurchased approximately 4.1 million shares in open market transactions for a total of $97.3 million. In March 2006, we repurchased approximately 5.6 million shares in open market transactions for a total of $132.9 million. In January 2006, the shares of common stock repurchased were in connection with our obligation to a holder of restricted stock to withhold the number of shares required to satisfy such holder s tax liability in connection with the vesting of such shares. These shares were not part

of the publicly announced repurchase program.

In April 2006, our board of directors authorized the repurchase of an additional $250.0 million of our common stock in the open market from time to time until October 2007, depending upon market conditions, share price and other factors.

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

None.

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

None.

Item 5. ***Other Information***

None.

Item 6. ***Exhibits***

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

SIGNATURES

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

McAfee Inc.

/s/ Eric F. Brown
Eric F. Brown
Executive Vice President, Chief Financial Officer and
Chief Operating Officer

May 2, 2006

EXHIBIT INDEX

Exhibit Number	Description
3.1	Second Restated Certificate of Incorporation of the Registrant, as amended on December 1, 1997.(2)
3.2	Certificate of Ownership and Merger between Registrant and McAfee, Inc.(1)
3.3	Amended and Restated Bylaws of the Registrant.(1)
3.4	Certificate of Designation of Series A Preferred Stock of the Registrant.(4)
3.5	Certificate of Designation of Series B Participating Preferred Stock of the Registrant.(5)
4.3	Indenture dated as of August 17, 2001 between the Registrant and State Street Bank and Trust Company of California.(6)
10.1	Lease Assignment dated November 17, 1997 for facility at 3965 Freedom Circle, Santa Clara, California by and between Informix Corporation and McAfee Associates, Inc.(7)
10.2	Consent to Assignment Agreement dated December 19, 1997 by and among Birk S. McCandless, LLC, Guaranty Federal Bank, F.S.B., Informix Corporation and the Registrant.(7)
10.3	Subordination, Nondisturbance and Attornment Agreement dated December 18, 1997, between Guaranty Federal Bank, F.S.B., the Registrant and Birk S. McCandless, LLC.(7)
10.4	Lease dated November 22, 1996 by and between Birk S. McCandless, LLC and Informix Corporation for facility at 3965 Freedom Circle, Santa Clara, California.(7)
10.5*	2002 Employee Stock Purchase Plan, as amended.(8)
10.6*	1997 Stock Incentive Plan, as amended.(8)
10.7*	Amended and Restated 1993 Stock Option Plan for Outside Directors.(3)
10.8*	2000 Nonstatutory Stock Option Plan.(9)
10.9*	Amended and Restated Employment Agreement between George Samenuk and the Registrant, dated October 9, 2001.(10)
10.11	1st Amendment to Lease dated March 20, 1998 between Birk S. McCandless, LLC and the Registrant.(12)
10.12	Confirmation, Amendment and Notice of Security Agreement dated March 20, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(12)
10.13	Second Amendment to Lease dated September 1, 1998 among Informix Corporation, Birk S. McCandless, LLC and the Registrant.(12)
10.14	Subordination, Nondisturbance and Attornment Agreement dated June 21, 2000, among Column Financial, Inc., Informix Corporation, Birk S. McCandless, LLC, and the Registrant.(12)
10.16*	Employment Agreement between Kent H. Roberts and the Registrant, dated October 9, 2001.(13)
10.18*	Employment Agreement between Kevin M. Weiss and the Registrant Dated October 15, 2002. (16)
10.19	Form of Indemnification Agreement between the Registrant and its Executive Officers(16)
10.20*	Summary of Pay for Performance Plan.(3)
10.21*	Network Associates, Inc. Tax Deferred Savings Plan.(15)
10.22	Umbrella Credit Facility of Registrant dated April 15, 2004.(17)
10.23	Fifth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(17)
10.24*	Amendment to Employment Agreement of George Samenuk effective as of January 20, 2004.(17)
10.26	Sixth Amendment to Network Associates, Inc. Tax Deferred Savings Plan.(18)
10.27*	Employment Agreement between Registrant and Eric F. Brown dated December 10, 2004. (20)
10.28*	2005 Independent Director Cash Compensation Plan. (21)
10.29*	Executive Officer Annual Compensation for Fiscal Year Ending December 31, 2006. (24)

10.30*	Second Amendment to Amended and Restated Employment Agreement between Registrant and George Samenuk dated May 21, 2005. (23)
10.31*	First Amendment to Employment Agreement between Registrant and Eric F. Brown dated May 26, 2005. (23)

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Exhibit Number	Description
10.32*	First Amendment to Employment Agreement between Registrant and Kevin M. Weiss dated May 21, 2005. (23)
10.33*	First Amendment to Employment Agreement between Registrant and Kent H. Roberts dated May 21, 2005. (23)
10.34*	Letter Agreement Amendment to Employment Agreement between the Registrant and Eric F. Brown dated January 31, 2006. (26)
10.35*	Employment Agreement between William Kerrigan and the Registrant, dated October 1, 2004, as amended by First Amendment to Employment Agreement dated May 24, 2005. (26)
10.36*	Chief Executive Officer Annual Compensation for Fiscal Year Ending December 31, 2006. (25)
21.1	Subsidiaries of the Registrant. (26)
31.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference from the Registrant s Report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.

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

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

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

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

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

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

(8) Incorporated by reference from the Registrant s Registration Statement on Form S-8 filed with the Commission on July 27, 2005.

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

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

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

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

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

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

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

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

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

(18) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended June 30, 2004, filed with the Commission on August 9, 2004.

(19) Incorporated by reference from the Registrant s report on Form 10-Q for the quarter ended September 30, 2004, filed with the Commission on November 8, 2004.

(20) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on December 14, 2004.

(21) Incorporated by reference from the Registrant s report on Form 10-K/A for the year ended December 31, 2004, filed with the Commission on May 24, 2005.

(22) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on April 22, 2005.

(23) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on April 26, 2005.

(24) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on March 13, 2006.

(25) Incorporated by reference from the Registrant s report on Form 8-K filed with the Commission on March 28, 2006.

(26) Incorporated by reference from the Registrant s report on Form 10-K for the year ended December 31, 2005, filed with the Commission on March 1, 2006.

* Management contracts or compensatory plans or arrangements covering executive officers or directors of McAfee, Inc.