McAfee, Inc.
Form 10-Q
December 21, 2007

Table of Contents

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 June 30, 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 *(State or other jurisdiction of incorporation or organization)*	**77-0316593** *(I.R.S. Employer Identification Number)*
3965 Freedom Circle **Santa Clara, California** *(Address of principal executive offices)*	**95054** *(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 o No þ

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 December 7, 2007, 159,908,615 shares of the registrant s common stock, $0.01 par value, were outstanding.

MCAFEE, INC.

FORM 10-Q
June 30, 2006

CONTENTS

EXPLANATORY NOTE REGARDING RESTATEMENT

In this quarterly report on Form 10-Q, we are restating our condensed consolidated balance sheet as of December 31, 2005, our condensed consolidated statements of income and comprehensive income for the three and six months ended June 30, 2005 and the related condensed consolidated statement of cash flows for the six months ended June 30, 2005, as a result of an independent stock option investigation conducted by a special committee of our board of directors. This restatement is more fully described in Note 3, *Restatement of Condensed Consolidated Financial Statements and Special Committee and Company Findings,* to our condensed consolidated financial statements, in Part I, Item 2, *Management s Discussion and Analysis of Financial Condition and Results of Operations* and in Part II, Item 1 *Legal Proceedings* in this quarterly report on Form 10-Q and in our *Explanatory Note Regarding Restatement* preceding Part I of our annual report on Form 10-K for the year ended December 31, 2006 (the 2006 Form 10-K). In our 2006 Form 10-K to be filed with the Securities and Exchange Commission (SEC) simultaneously with the filing of this Form 10-Q, we are restating (i) our audited consolidated financial statements as of December 31, 2005 and for each of the two years in the period ended December 31, 2004; (ii) our selected financial data as of and for the years ended December 31, 2005, 2004, 2003 and 2002; and (iii) our unaudited quarterly financial data for the first quarter in the year ended December 31, 2006 and for all quarters in the year ended December 31, 2005.

Financial information included in our reports on Form 10-K and Form 10-Q filed prior to July 27, 2006, and the related opinions of our independent registered public accounting firms, all earnings press releases and similar communications and all financial information included in our reports on Form 8-K issued by us prior to December 21, 2007, should not be relied upon and are superseded in their entirety by this quarterly report on Form 10-Q and other reports on Form 10-K, Form 10-Q and Form 8-K filed by us with the SEC on or after December 21, 2007.

Table of Contents

PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements (Unaudited)***

MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2006	December 31, 2005 (As restated see note 3)
	(In thousands, except share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 373,909	$ 728,592
Restricted cash		50,489
Short-term marketable securities	454,258	316,298
Accounts receivable, net of allowance for doubtful accounts of $1,559 and $2,389, respectively	130,166	159,130
Prepaid expenses and prepaid taxes	118,634	79,132
Deferred income taxes	227,508	204,208
Other current assets	28,697	28,490
Total current assets	1,333,172	1,566,339
Long-term marketable securities	325,496	212,131
Restricted cash	1,042	939
Property and equipment, net	91,425	85,692
Deferred income taxes	230,023	237,970
Intangible assets, net	84,535	80,086
Goodwill	488,646	437,488
Other assets	17,701	15,589
Total assets	$ 2,572,040	$ 2,636,234
LIABILITIES		
Current liabilities:		
Accounts payable	$ 30,821	$ 34,678
Accrued SEC settlement		50,000
Accrued income taxes	65,712	76,740
Accrued compensation	56,306	55,781
Accrued marketing	25,365	15,172
Other accrued liabilities	85,192	70,288
Deferred revenue	632,533	575,665

Total current liabilities	895,929	878,324
Deferred revenue, less current portion	181,138	176,141
Accrued taxes and other long-term liabilities	170,610	147,128
Total liabilities	1,247,677	1,201,593
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: 172,351,116 shares at June 30, 2006 and 170,453,210 shares at December 31, 2005; Outstanding: 159,788,634 shares at June 30, 2006 and 167,688,210 shares at December 31, 2005	1,724	1,705
Treasury stock, at cost: 12,562,482 shares at June 30, 2006 and 2,765,000 shares at December 31, 2005	(302,755)	(68,395)
Additional paid-in capital	1,495,109	1,443,743
Deferred stock-based compensation		(8,146)
Accumulated other comprehensive income	27,969	33,923
Retained earnings	102,316	31,811
Total stockholders equity	1,324,363	1,434,641
Total liabilities and stockholders equity	$ 2,572,040	$ 2,636,234

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

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005 (As restated see note 3)	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005 (As restated see note 3)
	(In thousands, except per share data) (Unaudited)			
Net revenue:				
Service and support	$ 156,257	$ 135,646	$ 305,910	$ 268,659
Subscription	95,649	77,828	188,375	145,906
Product	25,700	29,740	58,569	60,213
Total net revenue	277,606	243,214	552,854	474,778
Cost of net revenue:				
Service and support	13,657	6,249	26,609	12,445
Subscription	25,350	15,935	46,453	29,594
Product	14,708	14,013	30,395	31,267
Amortization of purchased technology	5,789	4,449	10,193	8,862
Total cost of net revenue	59,504	40,646	113,650	82,168
Operating costs:				
Research and development	49,638	45,054	93,785	83,089
Marketing and sales	90,245	78,833	173,730	149,781
General and administrative	55,298	29,467	92,046	62,685
SEC and compliance costs	3,352		3,772	
Amortization of intangibles	2,851	3,559	5,649	7,130
Restructuring charges	568	3,676	1,119	6,023
In-process research and development	460	4,000	460	4,000
Total operating costs	202,412	164,589	370,561	312,708
Income from operations	15,690	37,979	68,643	79,902
Interest and other income	7,198	6,621	18,663	12,008
Gain (loss) on investments, net	16	(298)	(86)	(946)
Income before provision for (benefit from) income taxes	22,904	44,302	87,220	90,964
Provision for (benefit from) income taxes	(3,294)	8,627	16,715	24,305
Net income	$ 26,198	$ 35,675	$ 70,505	$ 66,659
Other comprehensive income:				

Unrealized gain (loss) on marketable securities, net of reclassification adjustment for gains (losses) recognized on marketable securities during the period and income tax	$ 394	$ 938	$ 579	$ (481)
Foreign currency translation loss	(3,305)	(2,312)	(6,533)	(2,231)
Comprehensive income	$ 23,287	$ 34,301	$ 64,551	$ 63,947
Net income per share Basic	$ 0.16	$ 0.22	$ 0.43	$ 0.41
Net income per share Diluted	$ 0.16	$ 0.21	$ 0.43	$ 0.40
Shares used in per share calculation Basic	159,418	163,513	162,163	163,198
Shares used in per share calculation Diluted	161,294	167,440	163,984	167,403

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

MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2006	2005 (As restated see note 3)
	(In thousands) (Unaudited)	
Cash flows from operating activities:		
Net income	$ 70,505	$ 66,659
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	33,207	34,516
(Recovery of) provision for doubtful accounts, net	(376)	1,150
Non-cash restructuring charge	1,119	3,726
Interest released from restricted cash	489	
Acquired in-process research and development	460	4,000
(Discount) premium amortization on marketable securities	(3,355)	486
Loss (gain) on sale of assets and technology	153	(711)
Loss on sale of investments	86	946
Deferred income taxes	(21,830)	(13,417)
Non-cash stock-based compensation expense	25,792	1,114
Excess tax benefits from stock-based compensation	(4,392)	
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	34,941	32,922
Prepaid expenses, prepaid taxes and other assets	(38,938)	(9,648)
Accounts payable and other accrued liabilities	(17,493)	5,752
Deferred revenue	44,630	75,751
Net cash provided by operating activities	124,998	203,246
Cash flows from investing activities:		
Purchase of marketable securities	(558,651)	(448,776)
Proceeds from sales of marketable securities	182,789	323,334
Proceeds from maturities of marketable securities	128,383	68,525
Decrease (increase) in restricted cash	49,897	(7)
Purchase of property, equipment and leasehold improvements	(21,968)	(16,648)
Proceeds from sale of assets and technology		1,500
Acquisitions, net of cash acquired	(65,869)	(20,200)
Net cash used in investing activities	(285,419)	(92,272)
Cash flows from financing activities:		
Proceeds from issuance of common stock from option and stock purchase plans	29,810	50,175

Excess tax benefits from stock-based compensation		4,392		
Repurchase of common stock		(234,360)		(47,351)
Net cash (used in) provided by financing activities		(200,158)		2,824
Effect of exchange rate fluctuations on cash		5,896		(20,256)
Net (decrease) increase in cash and cash equivalents		(354,683)		93,542
Cash and cash equivalents at beginning of period		728,592		291,155
Cash and cash equivalents at end of period	$	373,909	$	384,697
Non-cash investing activities:				
Unrealized gain (loss) on marketable securities, net	$	579	$	(481)
Accrual for purchase of property, equipment and leasehold improvements	$	2,256	$	
Fair value of assets acquired in business combinations, excluding cash acquired	$	75,156	$	20,925
Liabilities assumed in business combinations	$	9,287	$	725
Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	46,289	$	25,203
Cash received from income tax refunds	$	2,657	$	1,775

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

McAfee, Inc. and our wholly-owned subsidiaries (we , us or our) are a worldwide security technology company that secures systems and networks from known and unknown threats around the world. Our 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 (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 June 30, 2006 and December 31, 2005 and for the three and six months ended June 30, 2006 and June 30, 2005. All 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 (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 condensed 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 year ended December 31, 2006 filed simultaneously with this quarterly report on Form 10-Q.

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 June 30, 2006, and results of operations and cash flows for the interim periods presented have been included. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year or for any future periods.

Significant Accounting Policies

We believe that, other than the adoption of SFAS 123(R) on January 1, 2006, there have been no significant changes to our critical accounting policies and estimates during the six months ended June 30, 2006. Note 2, *Summary of Significant Accounting Policies* of the notes to consolidated financial statements in our annual report on Form 10-K for the year ended December 31, 2006, which is filed simultaneously with this quarterly report on Form 10-Q, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. We have also described our policy for the restatement of our stock-based compensation expense below.

Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards, No. 123(R), *Share-Based Payment* (SFAS 123(R)), which is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation* (SFAS 123), and supersedes APB No. 25, *Accounting for Stock Issued to Employees* (APB 25). Among other items, SFAS 123(R) requires companies to record compensation expense for stock-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 stock-based awards include stock options, restricted stock awards, restricted stock units and our Employee Stock Purchase Plan (ESPP).

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Prior to our adoption of SFAS 123(R), we applied the intrinsic value method set forth in APB 25 to calculate the compensation expense for stock-based awards. Under APB 25, we did not recognize any compensation expense for our ESPP. For restricted stock awards and units, the calculation of compensation expense under APB 25 and SFAS 123(R) is the same, with the only exception being that forfeitures are estimated under SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard to all stock-based awards issued on or after January 1, 2006 and any outstanding stock-based awards that were issued but not vested as of January 1, 2006. Accordingly, our condensed consolidated financial statements for the three and six months ended June 30, 2005 have not been restated to reflect the impact of SFAS 123(R). During the three and six months ended June 30, 2005, we recognized stock-based compensation expense of $3.9 million and $1.1 million, respectively, related to grant date intrinsic value resulting from revised accounting measurement dates, the exchange of McAfee.com options in 2002, the re-pricing of options in 1999 and restricted stock awards. See Note 4 for additional information.

In the three months ended June 30, 2006, we recognized stock-based compensation expense of $12.1 million in our condensed consolidated financial statements, which included $6.8 million for stock options, $4.5 million for restricted stock awards and units and $0.8 million for our ESPP. In the six months ended June 30, 2006, we recognized stock-based compensation expense of $25.8 million in our condensed consolidated financial statements, which included $17.7 million for stock options, $6.5 million for restricted stock awards and units and $1.6 million for our ESPP. 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 123(R), (iii) compensation expense for restricted stock award and unit grants made both before and after January 1, 2006 and (iv) compensation expense for our ESPP in accordance with SFAS 123(R).

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 123(R), 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 method. In addition, SFAS 123(R) requires forfeitures of stock-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.

SFAS 123(R) requires us to calculate the pool of excess tax benefits, or the additional paid-in capital 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 123(R)-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 stock-based compensation, which among other things, provides a simplified method for estimating the beginning additional paid-in capital pool balance.

Restatement of Stock-Based Compensation

As discussed in Note 3, we have restated our condensed consolidated financial statements as a result of an independent stock option investigation conducted by a special committee of our board of directors. We previously applied APB 25 and its related interpretations, including Financial Accounting Standards Board Interpretation No. 44 *Accounting for Certain Transactions Involving Stock Compensation an interpretation of APB Opinion No. 25* (FIN 44), and provided the required pro forma disclosure under SFAS 123 through the year ended December 31, 2005. Under APB 25, non-cash, stock-based compensation expense is recognized for any option with intrinsic value on the accounting measurement date. An option is deemed to have intrinsic value when the exercise price is below the market price of the underlying stock on the accounting measurement date. Certain of our stock

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

options were incorrectly measured prior to the completion of required approvals and granting actions. After revising the measurement date for these options, certain options were deemed to have intrinsic value and, as a result, there should have been stock-based compensation expense for each of these options under APB 25 equal to the number of option shares multiplied by their intrinsic value on the revised measurement date. That expense should have been amortized over the vesting period of the option. These financial statements reflect the adjustments required to properly record stock-based compensation for options with revised measurement dates.

Starting in the year ended December 31, 2006, we adopted SFAS 123(R). As a result, for 2006, the additional stock-based compensation expense required to be recorded for these stock options was equal to the fair value on the revised measurement date for options vesting in 2006 or later.

As a result of the investigation, we determined that the original measurement dates we used for accounting purposes for certain option and restricted stock grants to employees from April 1995 through April 2005 were not appropriate and, in some instances, such dates were chosen with the benefit of hindsight so as to intentionally, and not inadvertently or as a result of administrative error, give more favorable exercise prices. We revised measurement dates and recorded stock-based compensation expense due to the following errors:

- annual merit grant allocation and/or approval not complete on the original measurement date,
- the key terms for a substantial portion of the grants in an annual merit grant had been determined with finality prior to the original measurement date, with a reduction in the exercise price on the original measurement date, which represented a repricing,
- original accounting measurement date prior to approval date,
- original accounting measurement date prior to employment commencement date,
- incorrect or inconsistent approval and employment commencement date documentation,
- clerical errors in director grants,
- correction of accounting errors, primarily options historically accounted for as variable awards, or
- post-employment option modifications previously not recorded.

After reviewing available relevant documentation, a general hierarchy of documentation was considered when establishing the revised measurement date for accounting purposes. The hierarchy was considered in evaluating each grant on an individual basis based on the particular facts and circumstances. The documentation considered when available was:

- *Minutes of board of directors, compensation committee and/or delegated committee*: Approved minutes represent the best available evidence of grant approval. The investigative team was able to validate the occurrence of board of director and compensation committee meetings on the stated dates in most cases through director payment records, billing records of outside legal counsel who attended the meetings or a signature on the minutes by external legal counsel.

Unanimous Written Consents (UWCs): UWCs have an effective date that represents the date grants were approved by the compensation committee or delegated committee. For compensation committee UWCs in 2004 and 2005, we were not able to rely on certain UWC effective dates due to other evidence indicating that certain grants were approved subsequent to the UWC effective date. We were able to locate other evidence to determine the approval date of these grants, such as approval documentation in emails and evidence of the date UWCs were signed. There were no options granted in compensation committee UWCs from 2001 through 2003. For UWCs prior to 2001, compensation committee members had historically resolved to grant options, and such action was then documented in a UWC, with the effective date being the date the granting action was taken. With the exception of one UWC, no evidence was located that

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

contradicted a UWC effective date as the approval date for any compensation committee grants prior to 2001. We have therefore placed reliance on the compensation committee UWCs prior to 2001.

Option allocations for annual merit grants: Allocations may be evidenced by signed and dated hard-copy schedules or electronic spreadsheets that list the employees and number of options granted to each employee. Email communications to which the electronic spreadsheets were attached also provided evidence of the date allocations were completed. We were able to validate whether allocation schedules were substantially complete by confirming individual grants in the allocation files to the actual grants reflected in our stock administration database. There were minimal changes to allocations after the date we determined that they were substantially complete.

Database dates: The database date (DB date) indicates the date an option grant was entered into the stock administration database. Entry into the stock administration database represents the best evidence of a date no later than when the grants were determined with finality.

DB dates were applied on a grant by grant basis, resulting in multiple measurement dates for annual merit grants for which there were multiple DB dates.

Correspondence or other written documentation: Written communication was in the form of grant notification letters from the human resource or stock administration departments stating the key terms of a grant, stock option agreements, employment offer or promotion letters stating the number of options to be granted and automated email notifications from human resources or our third-party broker. Written communication was primarily used to corroborate other available evidence used to determine measurement dates for annual merit grants, with the assumption that communication would not occur until the terms of the grants were determined with finality.

APB 25 defines the measurement date as the first date upon which the number of options and exercise price are known. Our determination of the revised measurement date was based on our assessment that a grant was determined with finality and was no longer subject to change. Such determinations involved judgment and careful evaluation of all relevant facts and circumstances for each grant. The following are the judgments involved in determining revised measurement dates.

Date of Execution of UWC

For certain grants, we were unable to locate contemporaneous documentation confirming that a compensation committee meeting, or a meeting by a delegated level of authority, occurred on the effective date of the UWC. For compensation committee UWCs with effective dates in 2004 and 2005, which cover 0.4 million options, we discovered instances in which documented approval actually occurred subsequent to the UWC effective date. The revised measurement date in these instances is the documented approval date. There were no options granted in compensation committee UWCs from 2001 through 2003. For UWCs prior to 2001, which cover 9.4 million options, and all delegated committee UWCs, the compensation or delegated committee resolved to grant options, and later documented such resolutions in UWCs, with an effective date which reflected the date of the granting action. With the exception of one UWC, no evidence was located that contradicted a UWC with an effective date as the approval date for any compensation committee grants prior to 2001. For UWCs prior to 2001, we did not locate any evidence that caused us to question the reliability of UWCs, outside one instance discussed above. We have therefore placed reliance on the compensation committee UWCs prior to 2001.

Annual Merit Grants

For annual merit grants, a pool of options was allocated among non-executive employees, and in certain years for executives as well, in conjunction with their annual performance review. We located evidence that allocations were completed and grants determined with finality on a business unit/geographic region basis, resulting in multiple measurement dates for annual merit grants. For grants not included in complete allocations, we have selected the

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

DB date as the revised measurement date as the terms of grants were determined with finality on or prior to the database entry dates.

For the 1999 annual merit grant, we determined that a significant portion of the grants had revised measurement dates prior to the original measurement dates, which resulted in compensation charges. The exercise price for these options was then reduced to the closing stock price on the original measurement date of the options, which we considered to be a repricing. These options have been accounted for as variable awards in the restatement in accordance with FIN 44.

Incorrect or Inconsistent Approval and Employment Commencement Documentation

We identified certain grants to executives and directors for which the approval documentation and/or employment commencement date documentation were incorrect or inconsistent. These grants were assigned an original grant date other than the approval date, or prior to the actual employment commencement date. In these instances, the occurrence of the meeting on the stated date in the approval documentation was validated based on director payment records or the billing records of external legal counsel who attended the meeting. We were able to determine the correct employment commencement date based on human resources and payroll records. The actual meeting date for the approval of such grants, or employment commencement date, if later, was used as the revised measurement date.

Lack of Approval Documentation

For grants totaling 2.2 million options, primarily in the years from 1996 through 2001, we were unable to locate approval documentation. In these instances, we examined available evidence, including email communications and grant communication letters, to determine the revised measurement date. We also performed an analysis to determine whether these grants were recorded on dates where the stock price was at a low point, which would result in a lower exercise price. It does not appear that these grants were priced opportunistically, and we did not discover any evidence that contradicted the original grant date. Therefore, we did not revise the measurement dates for these grants.

Communication Dates

For certain grants, we were unable to locate evidence of communication of the key terms (*i.e.*, number of options and exercise price) to the employee. We did not discover any evidence during the investigation that the communication of key terms was intentionally delayed, or there were any significant delays. In the absence of evidence to the contrary, we have concluded that communication of the key terms occurred prior to or within a reasonable period of time of the completion of all required granting actions.

We believe that our methodology, based on the best available evidence, results in reasonable measurement dates for our stock option grants.

Inventory

Inventory, which consists primarily of finished goods owned at fulfillment partner locations and inventory sold into our channel which has not been sold through to the end-user, is stated at lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first in, first out basis. Inventory balances are included in other current assets in our condensed consolidated balance sheets, and are $3.9 million as of June 30, 2006 and $4.4 million as of December 31, 2005.

Deferred Costs of Revenue

Deferred costs of revenue, which consist primarily of costs related to revenue-sharing and royalty arrangements, are included in prepaid expenses and prepaid taxes and other assets on our condensed consolidated balance

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

sheets. We only defer direct and incremental costs related to revenue-sharing arrangements and recognize such deferred costs proportionate to the related revenue recognized. As of June 30, 2006, our deferred costs are $53.5 million, compared to $28.8 million at December 31, 2005.

SEC and Compliance Costs

SEC and compliance costs include expenses associated with 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, which was finalized in 2006, and expenses related to the investigation into our stock option granting practices.

Recent Accounting Pronouncements

Noncontrolling Interests

In December 2007, the Financial Accounting Standards Board (FASB), issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51* (SFAS 160). SFAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for us beginning January 1, 2009. We do not expect the adoption of SFAS 160 to have a material impact on our consolidated financial position, results of operations or cash flows.

Business Combinations

In December 2007, the FASB revised SFAS No. 141, *Business Combinations* (SFAS 141(R)), to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141(R) establishes principles and requirements for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed, and any noncontrolling interest in an acquisition, at their fair value as of the acquisition date. SFAS 141(R) is effective for us beginning January 1, 2009. We are currently assessing how the adoption of SFAS 141(R) will impact our consolidated financial position, results of operations and cash flows.

Fair Value Option

In February 2007, the FASB, issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 1* (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value, with unrealized gains and losses related to these financial instruments reported in earnings at each subsequent reporting date. SFAS 159 is effective for us beginning January 1, 2008. We do not expect the adoption of SFAS 159 to have a material impact on our consolidated financial position, results of operations or cash flows.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements regarding fair value measurement. Where applicable, SFAS 157 simplifies and codifies fair value related guidance previously issued within generally accepted accounting principles. Although SFAS 157 does not require any new fair value measurements, its application may, for some entities, change current practice. SFAS 157 is effective for us beginning January 1, 2008. We do not expect the adoption of SFAS 157 to have a material impact on our consolidated financial position, results of operations or cash flows.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting for Uncertainty in Income Taxes

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109,* or (FIN 48) which clarifies the accounting for uncertainty in tax positions. This interpretation requires that we recognize in our financial statements the impact of a tax position, if that position is more likely than not of being sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of the beginning of 2007, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. As a result of the implementation of FIN 48, as of January 1, 2007 we recognized a decrease of $125.6 million in the liability for unrecognized tax benefits, a $3.4 million increase in acquisition related goodwill, a $101.2 million increase in additional paid-in capital, and a $27.8 million increase in retained earnings. As of January 1, 2007 and after the impact of changes noted above, unrecognized tax benefits totaled $40.2 million and accrued interest and penalties totaled $10.7 million (net of any tax benefit) for an aggregate amount of $50.9 million. Of the $50.9 million, $47.5 million, if recognized, would favorably affect our effective tax rate while the remaining amount would reduce goodwill.

We file numerous consolidated and separate income tax returns in the United States federal and state jurisdictions and in many foreign jurisdictions. On an ongoing basis we are routinely subject to examination by taxing authorities throughout the world, including jurisdictions such as Australia, Canada, France, Germany, India, Ireland, Italy, Japan, the Netherlands and the United Kingdom. With few exceptions, we are no longer subject to United States federal income tax examinations for years before 2002 and are no longer subject to state and local or foreign income tax examinations by tax authorities for years before 1996.

We are presently under audit in many jurisdictions, including the United States and the Netherlands. The Internal Revenue Service is presently conducting a limited scope examination of our United States federal income tax returns for the calendar years 2002, 2003, 2004, and 2005. We are also in pre-filing discussions with the Netherlands tax authorities with respect to tax years 2004 and 2005. Currently, we are not able to predict the conclusion of these examinations.

Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 is effective as of the end of 2006, allowing a one-time transitional cumulative effect adjustment to beginning retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB 108. The application of SAB 108 did not have a material impact on our consolidated financial position, results of operations or cash flows.

How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement

In March 2006, the FASB s Emerging Issues Task Force released Issue 06-3, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF 06-3). A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes and the amount of taxes if reflected on a gross basis in the income statement. EITF 06-3 is effective for periods beginning after December 15, 2006. We present revenue net of sales taxes in our condensed consolidated statements of income and comprehensive income and did not change our policy as a result of EITF 06-3.

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accounting Changes and Error Corrections

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154), a replacement of APB Opinion No. 20, *Accounting Changes,* and SFAS No. 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 in 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. We have applied the provisions of SFAS 154 in disclosing the effects of the errors resulting from the incorrect measurement of stock options and other items discussed in these Notes.

The Meaning of Other-Than-Temporary Impairment

In November 2005, the FASB issued Staff Position No. 115-1 *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (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.* FSP 115-1 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.

3. Restatement of Condensed Consolidated Financial Statements and Special Committee and Company Findings

In this quarterly report on Form 10-Q, we are restating our condensed consolidated balance sheet as of December 31, 2005, our condensed consolidated statements of operations for the three and six months ended June 30, 2005 and the related condensed consolidated statement of cash flows for the six months ended June 30, 2005, as a result of an independent stock option investigation conducted by a special committee of our board of directors. In our 2006 Form 10-K to be filed with the SEC simultaneously with the filing of this Form 10-Q, we are restating our audited consolidated financial statements and related disclosures for the years ended December 31, 2005 and 2004, and our selected consolidated statement of operations and consolidated balance sheet data for the years ended December 31, 2005, 2004, 2003 and 2002. In addition, we are restating the unaudited quarterly financial information for the interim periods of 2005 and for the three months ended March 31, 2006.

In May 2006, we became aware of potential issues with respect to our historical stock option granting practices. Our management discovered irregularities in certain historical stock option grants during its initial internal review, and discussed these findings with the board of directors in late May 2006. Our board of directors established a special committee of independent directors to review our stock option granting practices and related accounting. The special committee was assisted by independent counsel and forensic accountants (the investigative team). The special committee investigation was completed in November 2007. The special committee concluded that there were both qualitative issues and accounting and administrative errors relating to our stock option granting practices. In this regard, the special committee concluded that certain former members of

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

management had acted inappropriately, giving rise to qualitative concerns. The qualitative concerns included the following:

in the case of our former general counsel, he and a former member of management participated in intentionally modifying one of the former general counsel s stock option grants so as to create a lower exercise price, and the former general counsel failed to disclose this unauthorized change to the board of directors prior to late May 2006;

in some instances, former members of management drafted corporate records, including employment documentation, board and compensation committee meeting minutes and actions by unanimous written consent, with the benefit of hindsight so as to choose measurement dates giving more favorable exercise prices, moreover, certain of these documents were used by us in making accounting determinations with respect to stock-based compensation;

during the course of the investigation, certain former members of management did not provide completely accurate or consistent information and in one case, provided documentation to the special committee that the special committee determined was intentionally altered; and

certain former members of senior management did not display the appropriate oversight and tone at the top expected by the board of directors.

In addition to the foregoing, management and the special committee concluded that (i) we had previously determined accounting measurement dates for certain stock option awards incorrectly, and, in some instances, such dates were chosen with the benefit of hindsight so as to intentionally, and not inadvertently or as a result of administrative error, give more favorable exercise prices; (ii) we had incorrectly accounted for a portion of one annual merit grant as fixed awards which should have been accounted for as variable awards as they were repriced, (iii) we had not previously accounted for certain modifications to stock option agreements, (iv) we made certain accounting errors in calculating stock-based compensation expense for options historically accounted for as variable awards and (v) income tax implications exist as a result of the revision of stock option measurement dates. We also corrected for other prior-period errors.

Option grants previously accounted for using incorrect measurement dates

Annual merit grant allocation and/or approval not complete on the original measurement date

Our investigation found in 1996 through 2004: (i) differences between the original accounting measurement date and the date of final approval of certain executive merit grants and (ii) inadequate documentation supporting the original accounting measurement date as the actual allocation completion date for non-executive merit grants and certain executive merit grants. We revised approximately 13,000 merit grant measurement dates to be based on the best available evidence of when the grant allocations were substantially complete or approval occurred, if applicable, or lacking that, evidence when the options were input into the stock administration database. In 1996 through 2005, we recorded $70.4 million of additional stock-based compensation to be recognized over the applicable service periods related to these revised measurement dates. Of the total amount of stock-based compensation expense associated with revising the measurement dates of our annual merit grants, $69.6 million was recognized in periods prior to 2005 and

$0.8 million was recognized in 2005. Of the expense recognized in 2005, we recognized $0.2 million and $0.4 million, respectively, related to the three and six months ended June 30, 2005.

Original accounting measurement date prior to approval date

In 1996 through 2005, we recorded $15.8 million of additional stock-based compensation expense to be recognized over the applicable service periods for 12.6 million options associated with grants originally measured on dates that preceded the evidenced date of approval by the party with the requisite authority. Of the total amount of

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

stock-based compensation expense associated with revising the measurement dates of grants that previously preceded the evidenced date of approval, $13.5 million was recognized in periods prior to 2005 and $2.3 million was recognized in 2005. Of the expense related to 2005, we recognized $0.6 million and $1.4 million, respectively, for the three and six months ended June 30, 2005. These adjustments included a $2.5 million charge for grants to two former executives on the same date, a $2.1 million charge for a grant to a former president and a $1.1 million charge for a grant to a former executive.

Original accounting measurement date prior to employment commencement date

We corrected accounting measurement dates for 5.4 million options granted from 1995 through 2002 resulting in additional stock-based compensation expense of $6.3 million to be recognized over the applicable service periods for grants that preceded the actual employment commencement date. Substantially all of the stock-based compensation expense resulting from revising the measurement dates of these new hire grants was recognized prior to 2005. These adjustments included a $1.3 million stock-based compensation expense for a grant to a former chief financial officer.

Incorrect or inconsistent approval and employment commencement date documentation

In 2000 through 2005, we recorded additional stock-based compensation expense of $4.8 million to be recognized over the applicable service periods for seven grants of stock options or restricted stock awards to former executives and a director where the documented approval date or employment commencement date was different than the actual approval date or employment commencement date. Of the total amount of stock-based compensation expense associated with revising the measurement dates of these grants, $4.5 million was recognized in periods prior to 2005, and $0.3 million was recognized in 2005. Of the stock-based compensation expense related to 2005, we recognized $0.1 million for the three and six month ended June 30, 2005. Specifically the $4.8 million of expense consists of the items discussed in the remainder of this paragraph. We corrected the measurement date for options and restricted stock awarded to a former executive where the original measurement date was prior to his employment commencement date and evidence of approval by a committee with requisite authority. We recorded $3.3 million of stock-based compensation expense related to this revised measurement date. We corrected the measurement date for options granted to our former chief executive officer that had been originally measured and recorded on the day following the compensation committee s actual approval date, resulting in $0.7 million of additional stock-based compensation expense. In addition, we determined that the actual start date for a former executive was two weeks subsequent to the original measurement date; therefore, we corrected the measurement date for the options and recorded $0.5 million of additional stock-based compensation expense. In addition, we recorded a stock-based compensation expense totaling $0.3 million to correct three executive or director grants where the documented grant effective date originally used in the measurement of stock-based compensation expense was different than the available evidence supporting the actual approval date due to clerical errors.

Repriced annual merit grant

The 1999 annual merit grant consisted of 2.1 million options which had an original measurement date of April 20, 1999. We determined that the key terms were determined with finality for approximately 1.6 million of these options in March 1999, and that the exercise price was reduced to $11.06 on April 20, 1999, which represents a repricing. As the stock price on the revised measurement date in March 1999 exceeded the exercise price, there was grant date intrinsic value, which was recognized over the requisite service period. Additionally, the options are accounted for as variable awards in accordance with FIN 44 due to the repricing on April 20, 1999. The total stock-based compensation expense associated with this repricing is $6.7 million, $6.9 million of which we recognized in periods prior to 2005, and $0.2 million benefit which we recognized in 2005. We recognized variable expense of $0.1 million and a $0.2 million benefit, respectively, for the three and six months ended June 30, 2005.

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Post-employment option modifications previously not recorded

We identified various modifications of fixed awards that had previously not been accounted for that resulted in additional stock-based compensation expense of $23.1 million. These adjustments had no impact in periods subsequent to 2004. Modifications include extensions of time allowed to exercise options after an employee has terminated or continued vesting of option awards subsequent to termination. Specifically the $23.1 million of expense includes the two items discussed in the remainder of this paragraph. For one grant in 1998, we did not correctly account for a continuation of vesting of employee options for an employee and director. Upon termination as an employee, the director began providing services to us under a separate agreement. Our investigation determined that we should have accounted for the employee options that continued to vest subsequent to his termination using the fair value method, which resulted in additional stock-based compensation expense of $3.7 million from 1998 through 2002. In addition, for a separate award in 1998 we recorded additional stock-based compensation expense of $6.5 million for an in-substance acceleration of vesting when we entered into an arrangement allowing a former employee to continue vesting in his options for nine months after termination.

Correction of accounting errors, primarily options historically accounted for as variable awards

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 exercise prices at the current fair value of the stock. These repriced options were granted in the money, as the exercise price of the repriced options, which was based on the $11.06 closing price on April 22, 1999, was less than the closing price of $13.75 on April 28, 1999, the date the repricing price was accepted by the employees. We recognized the resulting intrinsic value of the options as compensation expense over the requisite service periods. In accordance with FIN 44, the repriced stock options were subject to variable accounting treatment beginning on July 1, 2000, the FIN 44 effective date.

We previously applied the transition guidance provided in FIN 44 for 2.6 million unvested repriced options at July 1, 2000 inappropriately. Upon properly applying FIN 44 transition guidance, we recognized additional stock-based compensation expense of $9.2 million over the remaining service periods of the unvested options. We recognized $9.3 million in periods prior to 2005 and a $0.1 million benefit in 2005. Of the stock-based compensation expense related to 2005, we recognized a $0.1 million benefit for both the three and six months ended June 30, 2005.

We recognized a $0.2 million reduction in stock-based compensation expense previously recognized related to the accounting for the exchange of options upon the acquisition of the remaining minority interest of our McAfee.com subsidiary. We recognized $0.6 million and $0.4 million in expense for the three and six months ended June 30, 2005, respectively, for this correction.

We also recognized stock-based compensation expense totaling $0.9 million related to the grant of equity instruments of one of our subsidiaries to corporate employees, all of which was recognized prior to 2005. We have accounted for these grants using the fair value method.

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effect of errors on stock-based compensation, before tax

As a result of the investigation, the original accounting measurement dates for approximately 15,600 grants were revised in the periods 1995 through 2005, errors to variable awards were corrected and charges for modifications previously unaccounted for were recorded resulting in a total of $137.4 million additional stock-based compensation expense to be recognized over the applicable vesting periods, including $134.0 million for periods prior to January 1, 2005 and $3.4 million for 2005, respectively. Approximately 98% of the total intrinsic value (the stock price on the revised measurement minus the exercise price) recognized as a result of the investigation results from grants made during the period 1995 through 2003. The following table classifies by year total additional stock-based compensation expense by the reason for the revision to the accounting measurement date (in thousands):

	1995	1996	1997	1998	1999	2000
Reason for revised accounting measurement date:						
Annual merit grant allocation and/or approval not complete on the original measurement date	$	$ 82	$ 1,485	$ 12,931	$ 11,409	$ 13,242
Original accounting measurement date prior to approval date		262	291	809	1,701	1,302
Original accounting measurement date prior to employment commencement date	487	1,659	1,713	1,181	908	271
Incorrect or inconsistent approval and employment commencement date documentation						14
Clerical errors in director grants		10	43	57	47	16
Total of intrinsic charges for revised measurement dates	487	2,013	3,532	14,978	14,065	14,845
Repriced annual merit grant						1,003
Post-employment option modifications previously not recorded				11,420	3,502	3,419
Correction of accounting errors, primarily options historically accounted for as variable awards					275	1,223
Total	$ 487	$ 2,013	$ 3,532	$ 26,398	$ 17,842	$ 20,490

Table of Contents

MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)