McAfee, Inc.
Form 10-Q
August 09, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

or

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

For the transition period from to

Commission file number: 0-20558

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 þ No o

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

As of July 30, 2004, 156,219,258 shares of the registrant s common stock, $0.01 par value, were outstanding.

THIS DOCUMENT CONTAINS 71 PAGES.
THE EXHIBIT INDEX IS ON PAGE 69.

MCAFEE, INC.

FORM 10-Q

June 30, 2004

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MCAFEE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2004	December 31, 2003
	(In thousands, except share and per share data) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 355,518	$ 333,651
Short-term marketable securities	183,105	174,499
Accounts receivable, net	115,985	170,218
Prepaid expenses, income taxes and other current assets	110,749	97,616
Deferred taxes	182,857	160,550
Assets held for sale		24,719
Total current assets	948,214	961,253
Long-term marketable securities	330,607	258,107
Restricted cash	20,749	20,547
Property and equipment, net	106,238	111,672
Deferred taxes	164,767	199,196
Intangible assets, net	92,205	105,952
Goodwill	441,352	443,593
Other assets	6,346	20,178
Total assets	$2,110,478	$2,120,498
LIABILITIES		
Current liabilities:		
Accounts payable	$ 22,072	$ 32,099
Accrued liabilities	126,415	147,281
Deferred revenue	434,488	342,795
Current portion of convertible debt	339,079	
Liabilities related to assets held for sale		23,310
Total current liabilities	922,054	545,485
Deferred revenue, less current portion	102,077	116,762
Convertible debt		347,397
Other long term liabilities	240,649	222,765
Total liabilities	1,264,780	1,232,409
Commitments and contingencies (Notes 11 and 12)		
STOCKHOLDERS EQUITY		
Preferred stock, $0.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none		
Common stock, $0.01 par value:		
Authorized: 300,000,000 shares; Issued: 164,698,647 shares and 162,071,798 shares at June 30, 2004 and December 31, 2003, respectively;		
Outstanding: 155,685,447 shares and 161,721,798 shares at June 30, 2004 and December 31, 2003, respectively	1,647	1,621

Additional paid-in capital	1,125,479	1,087,625
Deferred stock-based compensation	(320)	(598)
Accumulated other comprehensive loss	30,573	34,027
Accumulated deficit	(161,709)	(229,879)
Treasury stock, at cost: 9,013,200 shares and 350,000 shares at June 30, 2004 and December 31, 2003, respectively	(149,972)	(4,707)
Total stockholders equity	845,698	888,089
Total liabilities and stockholders equity	$2,110,478	$2,120,498

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 OPERATIONS AND

COMPREHENSIVE INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
	(In thousands, except per share data) (Unaudited)			
		(As Restated, See Note 13)		(As Restated, See Note 13)
Net revenue:				
Product	$ 80,007	$119,204	$163,738	$246,510
Services and support	145,671	97,821	281,018	189,829
Total net revenue	225,678	217,025	444,756	436,339
Cost of net revenue:				
Product	24,496	20,365	47,448	39,055
Services and support	9,792	13,002	20,639	26,232
Amortization of purchased technology	3,276	2,776	6,669	4,517
Total cost of net revenue	37,564	36,143	74,756	69,804
Operating costs and expenses:				
Research and development(1)	44,346	45,965	89,725	92,395
Marketing and sales(2)	96,114	87,045	189,072	175,986
General and administrative(3)	35,722	29,780	62,436	57,988
(Gain) loss on sale of assets and technology	274	(904)	(45,404)	(941)
Provision for (recovery from) doubtful accounts, net	149	(64)	674	(387)
Reimbursement related to litigation settlement	(5,890)		(24,991)	
Amortization of intangibles	3,516	3,721	7,089	8,732
Restructuring charge	682	6,826	2,872	22,607
In-process research and development		6,600		6,600
Total operating costs	174,913	178,969	281,473	362,980
Income from operations	13,201	1,913	88,527	3,555
Interest and other income	4,224	2,660	8,575	7,208
Interest and other expenses	(2,137)	(2,034)	(2,878)	(5,205)
Loss on repurchase of zero coupon convertible debentures		(136)		(2,727)
Gain (loss) on sale of marketable securities	(1,319)	500	(831)	1,548
Income before provision for income taxes and cumulative effect of change in accounting principle	13,969	2,903	93,393	4,379
Provision for income taxes	3,769	412	25,223	556
Income before cumulative effect of change in accounting principle	10,200	2,491	68,170	3,823
Cumulative effect of change in accounting principle, net of tax				11,142

Net income	$ 10,200	$ 2,491	$ 68,170	$ 14,965
Other comprehensive income:				
Unrealized loss on marketable securities, net	$ (2,373)	$ (77)	$ (2,123)	$ (766)
Foreign currency translation gain (loss)	(2,307)	8,026	(1,333)	10,485
Comprehensive income	$ 5,520	$ 10,440	$ 64,714	$ 24,684
Basic income per share:				
Income before cumulative effect of change in accounting principle	$ 0.06	$ 0.02	$ 0.42	$ 0.02
Cumulative effect of change in accounting principle, net of taxes				0.07
Net income per share basic	$ 0.06	$ 0.02	$ 0.42	$ 0.09
Shares used in per share calculation basic	160,313	160,341	161,800	159,954
Diluted income per share:				
Income before cumulative effect of change in accounting principle	$ 0.06	$ 0.02	$ 0.40	$ 0.02
Cumulative effect of change in accounting principle, net of taxes				0.07
Net income per share diluted	$ 0.06	$ 0.02	$ 0.40	$ 0.09
Shares used in per share calculation diluted	163,925	164,608	184,705	165,053

(1) Includes stock-based compensation charges of $258 and $576 for the three months ended June 30, 2004 and 2003, respectively, and $1,572 and $1,318 for the six months ended June 30, 2004 and 2003, respectively.

(2) Includes stock-based compensation charges of $51 and $158 for the three months ended June 30, 2004 and 2003, respectively, and $687 and $414 for the six months ended June 30, 2004 and 2003, respectively.

(3) Includes stock-based compensation charges of $131 and $225 for the three months ended June 30, 2004 and 2003, respectively, and $407 and $1,194 for the six months ended June 30, 2004 and 2003, respectively.

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 CASH FLOWS

	Six Months Ended June 30,	
	2004	**2003**
	(In thousands) (Unaudited)	(As Restated, see Note 13)
Cash flows from operating activities:		
Net income	$ 68,170	$ 14,965
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of change in accounting principle		(11,142)
Depreciation and amortization	33,565	31,215
Acquired in-process research and development		6,600
Provision for (recovery from) doubtful accounts, net	674	(387)
Non-cash interest expense on convertible notes	1,050	2,112
Premium amortization on marketable securities	3,064	
(Gain) loss on sale of assets and technology	(45,404)	867
(Gain) loss on sale of marketable securities	831	(1,548)
Loss on redemption of zero coupon convertible debentures		2,727
Deferred taxes	13,430	(35,502)
Stock-based compensation charges	2,666	2,926
Change in fair value of derivative, net	(2,971)	(2,115)
Changes in assets and liabilities, net of acquisitions and divestitures:		
Accounts receivable	54,176	51,341
Prepaid expenses, taxes and other	(5,144)	6,790
Accounts payable and accrued liabilities	(13,667)	4,116
Deferred revenue	83,087	16,899
Net cash provided by operating activities	193,527	89,864
Cash flows from investing activities:		
Purchase of marketable securities	(603,731)	(666,969)
Proceeds from sale and maturity of marketable securities	516,601	625,545
Increase in restricted cash	(202)	(186)
Proceeds from sale of Magic, net	47,565	
Purchase of property and equipment	(15,952)	(41,124)
Purchase of IntruVert, net of cash acquired		(92,393)
Purchase of Entercept, net of cash acquired		(123,605)
Other	(28)	(178)
Net cash used in investing activities	(55,747)	(298,910)
Cash flows from financing activities:		
Proceeds from issuance of stock from option and stock purchase plans	36,955	20,479
Redemption of zero coupon convertible debentures		(177,289)
Repurchase of common stock	(145,265)	

Net cash used in financing activities	(108,310)	(156,810)
Effect of exchange rate fluctuations	(7,603)	22,798
Net increase (decrease) in cash and cash equivalents	21,867	(343,058)
Cash and cash equivalents at beginning of period	333,651	674,226
Cash and cash equivalents at end of period	$ 355,518	$ 331,168
Non cash investing activities:		
Unrealized loss on marketable securities	$ (2,123)	$ (766)
Fair value of assets acquired in business combinations	$	$ 238,545
Liabilities assumed in business combinations	$	$ 29,147
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	$ 12,144	$ 5,157
Cash paid for interest	$ 4,902	$ 5,258

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

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Business

McAfee, Inc. (formerly Networks Associates, Inc.) and its wholly owned subsidiaries (the Company) are a leading supplier of computer security solutions designed to prevent intrusions on networks and protect computer systems from the next generation of blended attacks and threats. The Company offers two families of products, McAfee System Protection Solutions and McAfee Network Protection Solutions. The Company s computer security solutions are offered primarily to large enterprises, governments, small and medium-sized businesses and consumer users. The Company operates its 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

Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of the Company as of June 30, 2004 and for the three and six months ended June 30, 2004 and June 30, 2003. All significant intercompany accounts and transactions have been eliminated in consolidation. These condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. 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, 2003 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, the Company believes 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 the Company s Annual Report on Form 10-K for fiscal year ended December 31, 2003.

In the opinion of management, all adjustments (which include normal recurring adjustments, except as disclosed herein) necessary to fairly present the Company s financial position as of June 30, 2004, and results of operations and cash flows for the three and six months ended June 30, 2004 and June 30, 2003 have been included. The results of operations for the three and six months ended June 30, 2004 are not necessarily indicative of the results to be expected for the full fiscal year or for any future periods.

Certain amounts from 2003 have been reclassified to conform to the 2004 presentation.

Proforma Stock Compensation Disclosure

As permitted by Statement of Financial Accounting Standard (SFAS) No. 123, *Accounting for Stock-Based Compensation,* (SFAS 123) and as amended by SFAS No. 148, *Accounting for Stock- Based Compensation Transition and Disclosure,* (SFAS 148), the Company accounts for employee stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employee,* (APB 25), and Financial Accounting Standards Board (FASB) Interpretation No. 44, *Accounting for Certain Transactions Involving Stock-Based Compensation, an interpretation of APB Opinion No. 25* (FIN 44) and the related interpretations in accounting for its stock-based compensation plans. Stock-based compensation related to non-employees is based on the fair value of the related stock or options in accordance with SFAS 123 and its interpretations. Expense associated with stock-based compensation is amortized over the vesting period of each individual award.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company utilized the following assumptions in calculating the estimated fair value of each stock option and for its employee stock purchase plan (ESPP) using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants and the ESPP:

	Three and Six Months Ended June 30, 2004	2003
Stock option grants:		
Risk free interest rate	3.66%	3.37%
Expected life	4 years	4 years
Volatility	87.98%	93.48%
Dividend yield	None	None
ESPP:		
Risk free interest rate	1.29%	1.43%
Expected life	1.25 years	1.25 years
Volatility	58%	72%
Dividend yield	None	None

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provision of SFAS 123 to all of its stock-based compensation plans.

	Three Months Ended June 30, 2004	2003	Six Months Ended June 30, 2004	2003
Net income, as reported	$10,200	$ 2,491	$ 68,170	$ 14,965
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	(7,939)	(16,188)	(17,084)	(34,053)
Add back: Stock-based employee compensation expense, net of tax; included in reported net income	264	575	1,600	1,756
Pro forma net income (loss)	$ 2,525	$(13,122)	$ 52,686	$(17,332)
Net income (loss) per share:				
Basic as reported	$ 0.06	$ 0.02	$ 0.42	$ 0.09
Basic pro forma	$ 0.02	$ (0.08)	$ 0.33	$ (0.11)
Diluted as reported	$ 0.06	$ 0.02	$ 0.40	$ 0.09
Diluted pro forma	$ 0.02	$ (0.08)	$ 0.32	$ (0.11)

The impact on pro forma income (loss) per share and net income (loss) in the table above may not be indicative of the effect in future periods as options vest over several years and the Company continues to grant stock options to employees.

New Accounting Pronouncements

Accounting for Enhancements to One-Time Termination Benefits

In September 2003, the FASB issued FASB Staff Position No. FAS 146-1, *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an*

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Enhancement to an Ongoing Benefit Arrangement (FSP FAS 146-1). FSP FAS 146-1 clarifies circumstances when additional termination benefits offered in connection with an exit or disposal activity, in substance, are (a) enhancements to an ongoing benefit arrangement and, therefore, subject to the provisions of FASB Statements No. 87, No. 88, No. 106 and No. 112 or (b) one-time termination benefits subject to FASB Statement No. 146. The guidance in this FSP is effective for exit or disposal activities initiated in interim or annual reporting periods beginning after September 15, 2003. The Company adopted this FSP on October 1, 2003 and its adoption did not have a significant impact on the Company s financial position, results of operations or cash flows.

Accounting for Consolidation of Variable Interest Entities

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), which was revised in December 2003 and subsequently referred to as FIN 46R. FIN 46R has been subsequently interpreted by three FASB Staff Positions. FIN 46 and FIN 46R applied immediately to variable interest entities (VIEs) created after January 31, 2003 and no later than the end of the first interim or annual reporting period ending after December 15, 2003. The adoption of FIN 46 and FIN 46R (and related interpretations) had no impact as the Company has no investments in special purpose entities.

The Meaning of Other-Than-Temporary Impairment

In March 2004, the Emerging Issues Task Force (EITF) reached consensus on Issue 03-01 (EITF 03-01), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.* EITF 03-01 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting guidance of EITF 03-01 is effective for periods beginning after June 15, 2004, while the disclosure requirements are effective for periods ending after June 15, 2004. The Company does not believe that the adoption of EITF 03-01 will have a material impact on its financial position, results of operations or cash flows.

Accounting Change

Effective January 1, 2003, the Company changed its method for recognizing commission expenses to sales personnel. Prior to January 1, 2003, the Company s policy had been to expense the commissions as incurred, however, the Company believes that expensing the commissions as incurred does not provide a fair representation of the income from operations where part or all of the revenue related to these sales transactions is deferred and recognized over time. Commission expense directly related to sales transactions is now deferred and recognized ratably over the same period as the related revenue is recognized and recorded, which the Company believes will provide greater transparency into its performance.

As required by accounting principles generally accepted in the United States of America, the cumulative effect of the change in accounting principle effective January 1, 2003 resulted in a one-time credit of $11.1 million, net of income taxes.

3. Stock-Based Compensation

The Company has recorded stock-based compensation charges of $0.4 million and $1.0 million before taxes in the three months ended June 30, 2004 and 2003, respectively, and $2.7 million and $2.9 million before

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

taxes in the six months ended June 30, 2004 and 2003, respectively. These charges are comprised of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Exchange of McAfee.com options	$334	$323	$2,166	$1,063
Existing executives	106	106	213	212
Former employees		5	146	1,126
Extended life of vested options of terminated employees		525	141	525
Total stock-based compensation	$440	$959	$2,666	$2,926

Exchange of McAfee.com options. On September 13, 2002, the Company acquired the minority interest in McAfee.com. McAfee.com option holders received options for 0.675 of a share of Networks Associates, Inc. common stock plus $8.00 in cash, which will be paid to the option holder only upon exercise of the option, in exchange for each McAfee.com option. McAfee.com options to purchase 4.1 million shares were converted into options to purchase 2.8 million shares of the Company s common stock. The assumed options have been accounted for under the guidance in EITF Issue No. 00-23 *Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25* and FIN 44. Accordingly, these options are subject to variable accounting treatment, which means that a compensation charge has been measured initially at the date of the closing of the merger and then remeasured at the end of each reporting period. The initial charge was based on the excess of the closing price of the Company s stock over the exercise price of the options plus the $8.00 per share payable in cash, which will be paid upon exercise of the option. This compensation charge will initially be remeasured using the same methodology and recorded as an expense using the accelerated method of amortization under FIN 28. To the extent that the options issued were fully vested at the date of the closing of the McAfee.com acquisition, the Company immediately recorded a compensation expense of approximately $10.5 million. Fully vested options will continue to be remeasured using the same method and compensation charges will be recorded until the earlier of the date of exercise, forfeiture or cancellation without replacement. Charges related to unvested options will be recorded in deferred stock-based compensation in stockholders equity. Depending upon movements in the market value of the Company s common stock, this accounting treatment may result in significant additional stock-based compensation charges in future periods.

During the three months ended June 30, 2004 and 2003 and during the six months ended June 30, 2004 and 2003, the Company recorded a charge of approximately $0.3 million, $0.3 million, $2.2 million and $1.1 million, respectively, related to exchanged options subject to variable accounting. This stock based compensation charge was based on the Company s closing share price of $18.13 and $12.68 on June 30, 2004 and 2003, respectively. As of June 30, 2004, the Company had approximately 0.6 million outstanding exchanged options subject to variable accounting.

Existing executive. On January 15, 2002, the Company s board of directors approved a grant of 50,000 shares of restricted stock to Mr. Samenuk, its chairman and chief executive officer. The price of the underlying shares is $0.01 per share. The shares will vest and the Company s right to repurchase such shares will lapse as follows: 3,000 vested as of the grant date and 47,000 are restricted until January 15, 2005. The intrinsic value of the restricted stock was determined to be approximately $1.4 million and was estimated based on the difference between the exercise price of the restricted stock and the fair market value of the Company s common stock on January 15, 2002. During the three months ended June 30, 2004 and 2003, the Company recorded approximately $0.1 million in both periods, and for the six months ended June 30, 2004 and 2003, the Company recorded approximately $0.2 million in both periods related to stock-based compensation associated with Mr. Samenuk s 2002 restricted stock grant.

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Former employees. In November and December 2003, the Company extended the vesting period of two employees and also extended the period after which vesting ends to exercise their options. As these employees options continued to vest after termination and their exercise period was extended an additional 90 days, the Company recorded a one time stock-based compensation charge of approximately $0.1 million in the first quarter of 2004.

In July 2002, one of the Company s employees became a non-employee, but continued to provide services to the Company. As he was allowed to continue to hold his vested options beyond the normal exercise period after termination and continue to vest his options, the Company recorded a stock-based compensation charge corresponding to the fair value of his vested options. The unvested options were remeasured using the Black Scholes option valuation model and recognized over the remaining vesting period using the accelerated method of amortization required in FIN 28. Stock-based compensation of approximately $5,000 and $35,000 was expensed during the three and six months ended June 30, 2003, respectively. No future stock compensation charges will be recorded.

In October 2002, the Company terminated the employment of four former McAfee.com executives. These executives held McAfee.com options, which were exchanged for options to acquire the Company s common stock. These options are subject to variable accounting as discussed above. Upon the executives termination, the options held by these individuals were modified in accordance with existing change in control agreements and became fully vested. After December 31, 2002, all remaining options held by these former McAfee.com executives were exercised within the first quarter of 2003. As a result, the Company recorded a final stock-based compensation charge of $1.1 million during the three months ended March 31, 2003.

Repriced options. On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with an exercise price of $11.063, the then current fair market value of its common stock. Options to purchase a total of 10.3 million shares were cancelled and the same number of new options were granted. During the three and six months ended June 30, 2004 and 2003, the Company did not incur a charge related to these repriced options subject to variable plan accounting. For the three and six months ended June 30, 2004 and 2003, the Company s stock-based compensation charge calculation related to options subject to variable plan accounting was based on quarter-end per share price of the Company s stock of $18.13 and $12.68, respectively. The Company will incur stock-based compensation charges if the Company s stock price increases above $20.375 per share. As of June 30, 2004, the Company had options to purchase approximately 0.4 million shares, which were outstanding and subject to variable plan accounting.

Extended life of vested options held by terminated employees. During a significant portion of 2003, the Company suspended exercises of stock options until its required public company reports were filed with the SEC. The period during which stock options were suspended is known as the blackout period. Due to the blackout period, the Company extended the exercisability of any options of terminated employees that would otherwise expire during the blackout period for a period of time equal to a specified period after termination of the blackout period. Accordingly, the Company recorded a stock-based compensation charge on the date the options should have terminated based on the intrinsic value of the option on the modification date and the option price. During the three and six months ended June 30, 2003 and the six months ended June 30, 2004, the Company recorded a stock-based compensation charge of $0.5 million and $0.1 million, respectively.

4. Business Combinations and Divestitures

IntruVert Networks, Inc.

On May 14, 2003, the Company acquired 100% of the outstanding capital shares of IntruVert Networks, Inc., (IntruVert) a provider of network-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for $98.1 million in cash and $5.2 million of

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MCAFEE, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

direct expenses, totaling $103.3 million. The Company acquired IntruVert to enhance its network protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company s current product offering, and sell IntruVert products to its existing customer base. The results of operations of IntruVert have been included in these condensed consolidated financial statements since the date of acquisition.

The Company recorded approximately $5.7 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The ongoing project at IntruVert at the time of purchase was the development of the Infinity model of the IntruShield sensor. The product was completed in the third quarter of 2003. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to five years or a weighted average period of 4.5 years. The Company accrued approximately $0.3 million in duplicative site costs for lease space no longer being utilized and permanently vacated related to the IntruVert acquisition. The accrual has been fully utilized.

As part of the IntruVert acquisition, the Company cancelled all outstanding IntruVert restricted stock and outstanding stock options and agreed to make cash payments to former IntruVert employees contingent upon their continued employment with the Company based on the same vesting terms of their restricted stock or stock option agreements. The payments to former IntruVert employees are recorded ratably over the vesting period as salary expense as the employees are currently providing services to the Company. Payments under the restricted stock plan are paid monthly from an escrow account and will total approximately $3.0 million from the purchase date through the fourth quarter of 2006. Payments under the stock option plan are being paid monthly through the Company s payroll and will total approximately $4.1 million from the purchase date through the second quarter of 2007. Cash payments that were fully vested at the date of acquisition were included in the purchase price. If a former IntruVert employee ceases employment with the Company, unvested payment amounts will be returned to the Company.

Entercept Security Technologies, Inc.

On April 30, 2003, the Company acquired 100% of the outstanding capital shares of Entercept Security Technologies, Inc. (Entercept), a provider of host-based intrusion prevention solutions designed to proactively detect and stop system and network security attacks before they occur, for $121.9 million in cash and $3.9 million of direct expenses, totaling $125.8 million. The Company acquired Entercept to enhance its system protection product line, achieve a leading position in the emerging intrusion prevention marketplace, embed the acquired technologies in the Company s current product offering, and sell Entercept products to its existing customer base. The results of operations of Entercept have been included in these condensed consolidated financial statements since the date of acquisition.

The Company recorded approximately $0.9 million for acquired in-process research and development which was fully expensed upon purchase because technological feasibility had not been established and there was no alternative use for the projects under development. The ongoing project at Entercept at the time of purchase in was a Linux version of their current product. The project is delayed and product availability is expected in the fourth quarter of 2004. The intangibles acquired in the acquisition, excluding goodwill, are being amortized over their estimated useful lives of two to six years or a weighted average period of 5.6 years.

The Company accrued $2.8 million in duplicative sites costs for permanently vacated facilities at the acquisition date. The accrual will be fully utilized by 2006, the end of the original lease term. In the fourth quarter of 2003, the Company entered into a sublease for the vacated facility, and therefore, adjusted the

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accrual by the value of the sublease. The following is a summary of activity in the restructuring accrual related to Entercept (in thousands):

Original accrual, April 30, 2003	$ 2,837
Cash payments	(989)
Adjustments	(1,137)
Balance, June 30, 2004	$ 711

As part of the Entercept acquisition, the Company assumed all outstanding unvested Entercept cash bonus units and agreed to make specified per unit cash payments to former Entercept employees contingent upon their continued employment with the Company for one year based on the vesting terms of such units, generally one year. The payments to former Entercept employees were expensed monthly as salary expense as the employees provided services to the Company. All amounts were fully paid from escrow in May 2004.

Management determined the purchase price allocation of the above acquisitions 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 and the assistance of valuation consultants. The following is a summary of the assets acquired and liabilities assumed in the acquisitions (in thousands):

	IntruVert Networks, Inc.	Entercept Security Technologies, Inc.	Total Assets Acquired and Liabilities Assumed
Deferred tax assets	$ 436	$ 10,560	$ 10,996
Technology	18,200	21,700	39,900
Other intangible assets	1,900	2,800	4,700
Cash	10,986	1,028	12,014
Goodwill	71,598	99,565	171,163
Other assets	4,984	3,517	8,501
Total assets acquired	108,104	139,170	247,274
Current liabilities	2,649	4,739	7,388
Deferred tax liabilities	7,839	9,555	17,394
Total liabilities assumed	10,488	14,294	24,782
Net assets acquired	$ 97,616	$ 124,876	$ 222,492
In-process research and development (expensed)	5,700	900	6,600
Total acquisition cost	$ 103,316	$ 125,776	$ 229,092

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MCAFEE, INC. AND SUBSIDIARIES

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The following unaudited pro forma financial information presents the combined results of the Company, IntruVert and Entercept as if the acquisitions had occurred at the beginning of 2003 (in thousands except per share amounts):

	Three Months Ended June 30, 2003	Six Months Ended June 30, 2003
Net revenue	$217,925	$439,956
Net income	$ 4,965	$ 6,631
Basic net income per share	$ 0.03	$ 0.04
Shares used in per share calculation basic	160,341	159,954
Diluted net income per share	$ 0.03	$ 0.04
Shares used in per share calculation diluted	164,608	165,053

The above unaudited pro forma financial information includes adjustments for interest income on cash disbursed for the acquisitions, amortization of identifiable intangible assets and adjustments for expenses incurred in conjunction with the acquisitions. The pro forma financial information excludes the effects of the in-process research and development totaling $6.6 million that was expensed immediately.

Magic Solutions

In December 2003, the Company announced the sale of its Magic Solutions product line (Magic) to BMC Software for approximately $47.0 million in cash plus final purchase price adjustments. At December 31, 2003, the carrying values of assets and liabilities related to Magic were presented as held for sale on the consolidated balance sheet. The following were the components of the Magic at December 31, 2003 (in thousands):

Assets:	
Accounts receivable, net of allowance for doubtful accounts of $215	$12,991
Prepaid expenses	888
Inventory	20
Equipment, net	1,023
Goodwill	9,797
Assets held for sale	$24,719
Liabilities:	
Accounts payable	$ 215
Accrued liabilities	1,050
Deferred revenue	22,045
Liabilities related to assets held for sale	$23,310