



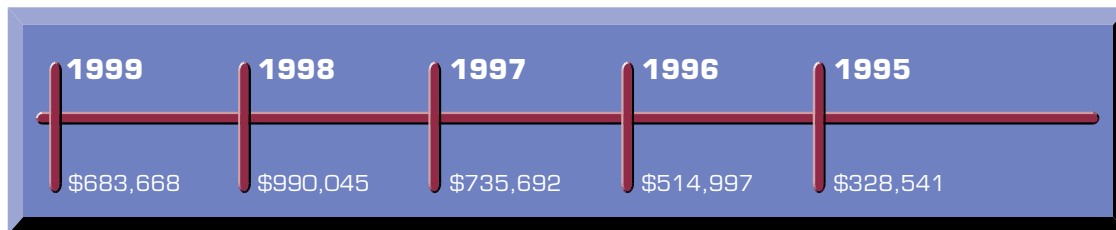


SEARCH Financial Highlights

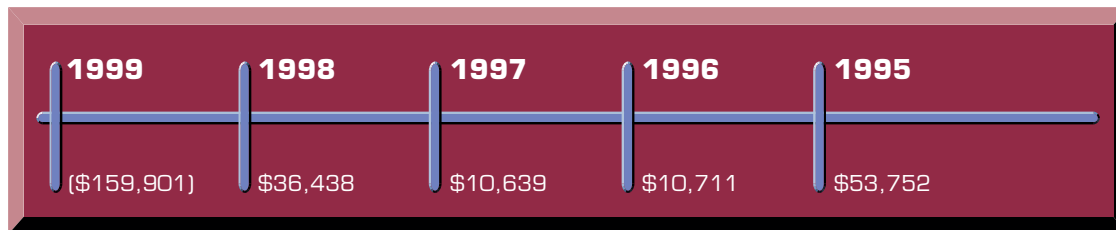
YEAR ENDED DECEMBER 31 (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	1999	1998	1997	1996	1995
Net Revenue	\$683,668	\$990,045	\$735,692	\$514,997	\$328,541
Net Income (Loss)	(\$159,901)	\$36,438	\$10,639	\$10,711	\$53,752
Net Income (Loss) per share, diluted	(\$1.15)	\$0.26	\$0.08	\$0.09	\$0.45

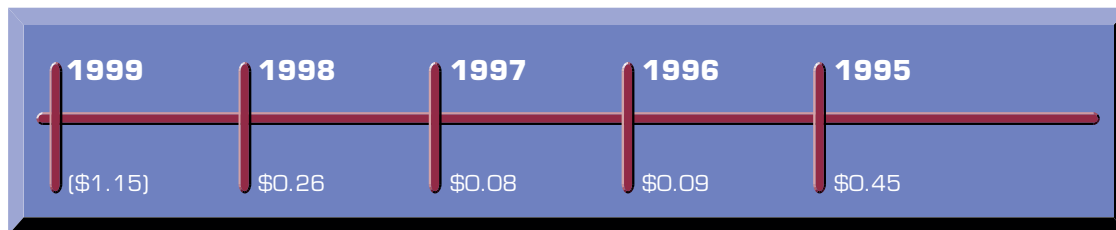
NET REVENUE (THOUSANDS)



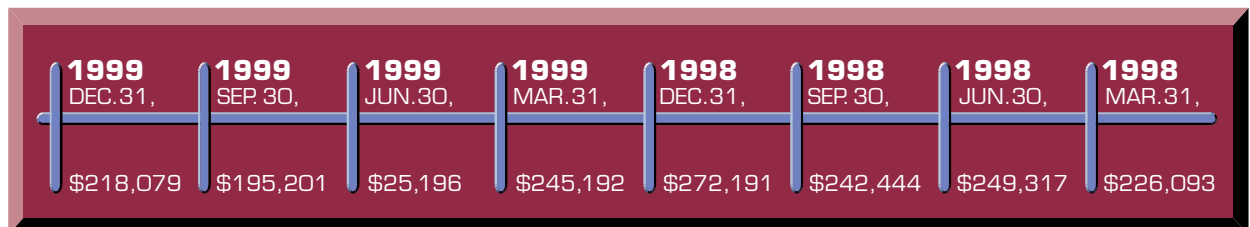
NET INCOME (THOUSANDS)



EARNINGS PER SHARE (DILUTED, DOLLARS)



QUARTERLY NET REVENUE (THOUSANDS)





>> SEARCH Letter to Our Shareholders

1999 was a turbulent year for Network Associates. After tremendous growth in 1998, the task of integrating our newly acquired companies created significant operational challenges this year. The most fundamental challenge we faced was an underlying shift in the dynamics of the marketplace: the rapid adoption of e-business. Customers moved from integrated enterprise suites to tactical deployment of point products.

Out of the disappointment of early 1999—and in response to the shift in customer needs—grew our next-generation strategy: to be the leader in security and availability in the burgeoning e-business market. Because the two most formidable tasks for IT professionals today are securing their e-businesses and ensuring Web uptime—in other words, making sure that the store is not only safe but always open.

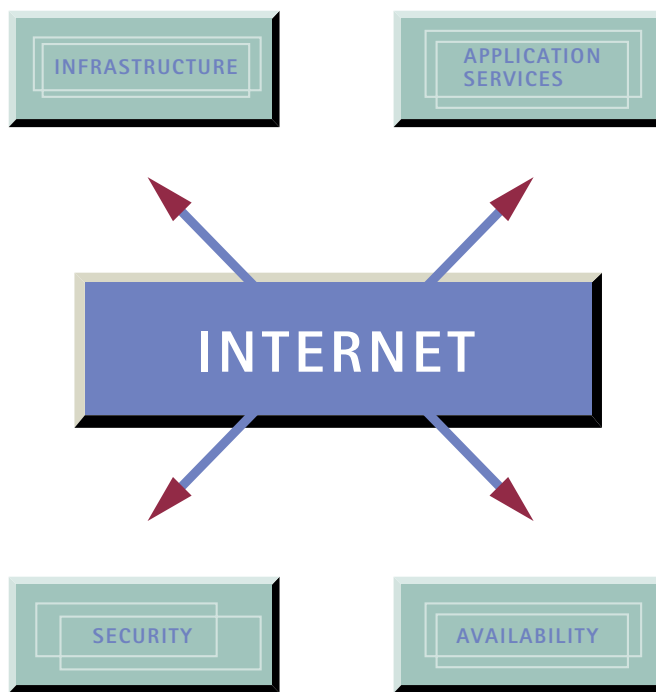
To accomplish this goal, we created four business units (BUs) and two subsidiaries, allowing us to expose the value of Network Associates' tremendous assets. The four BUs—PGP Security, Sniffer Technologies, Magic Solutions and McAfee—focus on our traditional infrastructure businesses: two dealing with security, the other two with availability. The two subsidiaries, McAfee.com and myCID.com, are new application service providers (ASPs) in the fast-growing services market.

Our BU strategy is threefold. First, it allows independent valuation of our assets. Long term, we hope to show the value of these assets by turning them into independent subsidiaries and creating a strong portfolio for investors. Thus,

the value of Network Associates will be the summation of the value of its portfolio business units.

Secondly, our strategy will attract and retain employees through incentive-based equity compensation. Intellectual property drives our business, and that means finding and keeping the best people.

NETWORK ASSOCIATES INTERNET STRATEGY



Security and availability are the two most pressing needs for e-businesses. Network Associates delivers both, through infrastructure and application services, via traditional means and over the Internet.

Finally, this new strategy helps us get closer to customers and ensure the fastest communication for new product deployment and resolution of any product issues. It's much like transforming a cruise ship into a fleet of speedboats.

With the amazing growth of the Internet, the market potential for e-business is astounding. It stands to completely transform the software industry from product-based to service-based. As a pioneer in the delivery of application services and managed services for security and availability, Network Associates is well positioned to meet customers' needs in this new world, creating a foundation for significant growth and the enhancement of shareholder value.

In closing, I want to thank everyone, our shareholders, customers and all our employees around the world, for their patience and persistence in weathering this turbulent year. We believe our new strategy puts us on very solid ground, allowing us to deliver against the ever-evolving customer requirements rising out of the phenomenal development of the Internet. Together, we'll get Network Associates back on track and reach even greater levels of success in 2000.



A handwritten signature in black ink, appearing to read 'William L. Larson'.

William L. Larson

Chairman & CEO

Network Associates, Inc.



SECURITY AND AVAILABILITY FOR E-BUSINESS

The world has changed. The catalyst for this change is the Internet and its effect on business. Suddenly, IT professionals are confronted with the need to set up e-businesses immediately. Their focus has shifted from deploying large, complex enterprise software suites—taking months or even years to complete—to deploying tactical point products.

OUR STRATEGY

In 1999, Network Associates undertook a focused realignment of the company into four business units (BUs) and two subsidiaries.

- PGP Security, which offers firewall, intrusion detection and encryption products
- Sniffer Technologies, with its protocol analyzer products
- Magic Solutions, which provides Web-based service desk solutions
- McAfee, delivering world-class anti-virus products
- McAfee.com, delivering online software applications through an Internet browser
- MyCIO.com, one of the world's first infrastructure application service providers of managed security and availability

These services build on Network Associates' historic franchise. They leverage common technology, the lower-cost G&A structure of the parent company and a large pre-existing customer base.

THE VALUE OF OUR ASSETS

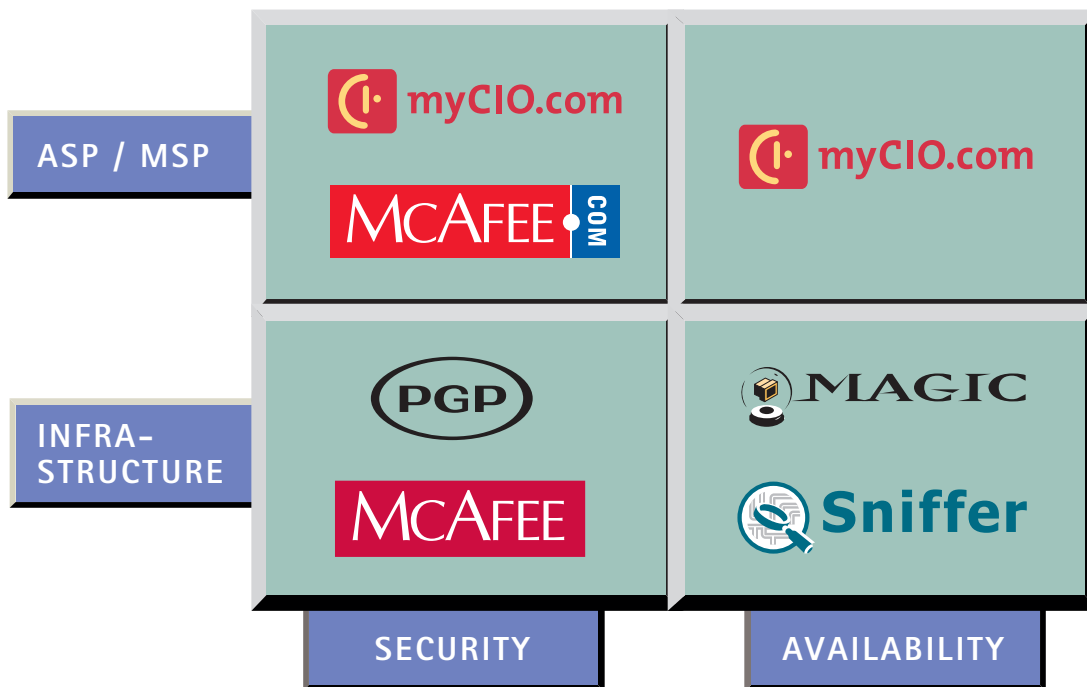
In addition to serving customers better, the BU strategy allows Network Associates to unlock the tremendous value of its assets by forming independent subsidiaries and creating a strong portfolio for investors.

McAfee.com, of which Network Associates owns more than 80 percent, is the strongest proof to date of the company's ability to accomplish this goal successfully. McAfee.com has quickly become one of the world's largest business-to-consumer global application service providers (ASPs). The McAfee.com subscriber base grew to over 200,000 by the end of 1999, making it one of the fastest-growing paid subscription services on the Internet.

In December 1999, McAfee.com completed its initial public offering. Originally priced at \$12, shares in McAfee.com quickly tripled, ultimately raising \$79 million and establishing McAfee.com with an independent market cap of nearly \$2 billion. Network Associates' own share price increased significantly after the McAfee.com IPO, benefiting all shareholders. Finally, myCIO.com, a business-to-business ASP for security and availability, was launched.

Network Associates continues to enjoy market share leadership in the anti-virus and performance management markets; 90 percent of the Fortune 100 are Network Associates customers. Network Associates' products continue to receive industry awards, and the company enjoys positive relationships with customers which will be further enhanced by this new business unit structure. Network Associates is poised to succeed.

NETWORK ASSOCIATES SOLUTION STRATEGY



Now Network Associates delivers six related businesses sharing highly aligned common technology.



SEARCH myCIO.com

MyCIO.com is one of the world's first infrastructure application service providers (ASPs) to deliver managed network security and availability services to businesses via the Internet. MyCIO.com's ASaP services are built around industry-leading technologies, like McAfee, PGP and Sniffer, guaranteeing customers continuous, uninterrupted protection against threats to their e-business infrastructures.

“IS DECISION MAKERS ARE TURNING TO INTERNET-BASED SECURITY SERVICE OFFERINGS...AND FREEING UP VALUABLE IS RESOURCES FOR CORE APPLICATION PROJECTS WITHIN THE ENTERPRISE.” Aberdeen Group

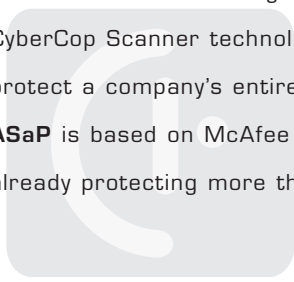
Solving one of the biggest challenges in managing network security—keeping protection updated from the latest viruses and other threats—myCIO.com's ASaP services are versionless, continuously updated and self-managing. Now companies can add a virtual staff of experts who are always up to date on the latest technological developments.

CyberCop ASaP from myCIO.com is one of the world's first 100% Web-based managed vulnerability services based on CyberCop Scanner technology. The only managed service to protect a company's entire desktop environment, **VirusScan ASaP** is based on McAfee Total Virus Defense technology, already protecting more than 70 million desktops worldwide.

Firewall ASaP is one of the world's first managed three-in-one appliances for integrated security, virus protection and VPN. **WebShield ASaP** protects networks by stopping viruses at the Internet gateway.

MyCIO.com's ASaP applications also deliver sophisticated Web-based management reports to find vulnerabilities, identify trends and make planning decisions. So customers can solve problems before they occur.

INTERNET-MANAGED IS SERVICES



myCIO.com
Your Chief Internet Officer





SEARCH McAfee.com

McAfee.com is a technology-centric company focused on developing the next generation of Internet services. It delivers online applications through an Internet browser, eliminating the need to install, configure and manage the technology on a consumer's local PC. By providing sophisticated applications online, McAfee.com is changing the way software is developed, delivered and experienced. By the end of 1999, McAfee.com had 1.6 million trial subscribers from over 230 countries.

“McAfee.com has found a way to deliver a service online that customers are willing to pay for, a relatively rare event in the world of online commerce.”

Peggy O'Neill, Principal Analyst, NetRatings Inc.

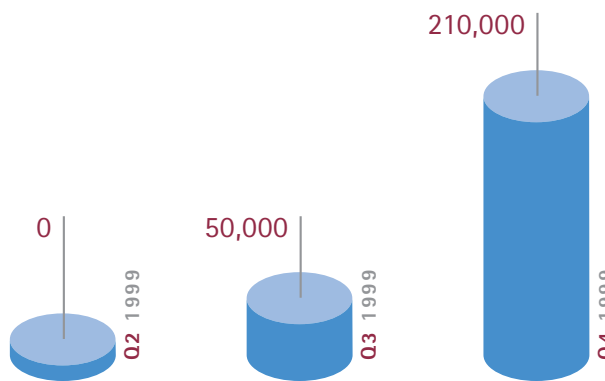
The **McAfee Clinic** is our premium online subscription service. Consumers worldwide can now use their browsers to visit www.mcafee.com, where they can scan their PCs for viruses, protect data from hackers, clean and optimize their hard drives and update applications and operating systems. The Clinic includes online versions of award-winning products such as **VirusScan**, **Uninstaller**, **First Aid**, and **Oil Change**.

McAfee.com recently acquired Signal9 Solutions Canada Inc. Signal9's award-winning ConSeal Private Desktop and ConSeal PC Firewall were integrated into McAfee.com under the name **McAfee Personal Firewall**. This service is designed to protect consumer and small business PCs from hackers trying to steal data or initiate denial of service attacks.

In response to the growing concern regarding privacy in advertising, McAfee.com developed **Silhouette**, the Internet's first rules-based, completely anonymous, privacy-ensured targeted advertising service. This new technology allows advertisers to serve up highly targeted advertisements based on personal profiles, all while protecting user privacy.

Many new strategic partnerships were announced. McAfee.com and Excite@Home introduced a range of services to upgrade, protect and manage PCs of @Home broadband subscribers. McAfee.com also signed with Driveway Corporation to deliver online storage, and with GlobalSCAPE to distribute McAfee Clinic and LinkShare. The company will add more new services and build strategic partnerships to leverage McAfee.com's status as a first-mover and build upon its position as one of the largest consumer application service providers on the globe.

PAID SUBSCRIBER BASE



In only eight months, McAfee.com has developed one of the largest subscriber bases on the Internet.





SEARCH PGP Security

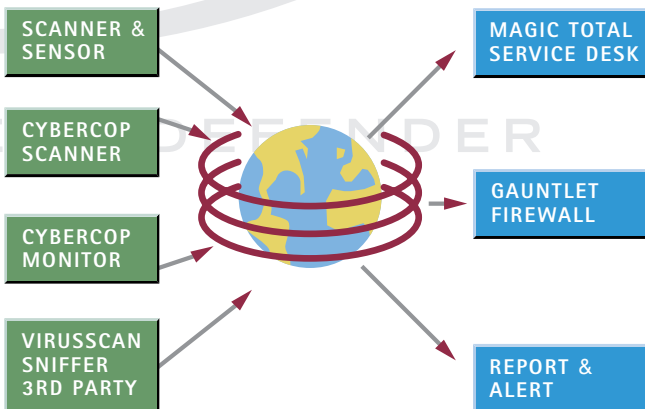
With its easy-to-use yet powerful solutions, PGP Security utilizes several well-known security brands to help companies worldwide secure their e-business operations through firewall, encryption, intrusion detection, risk assessment and VPN technologies.

“NO OTHER VENDOR HAS ALL THE RIGHT PIECES.” *Hurwitz Group*

Gauntlet firewall: Now companies get broad protection at the Internet gateway. Gauntlet firewall delivers integrated anti-virus protection, a built-in standards-based VPN server, and spam and content filtering. Trusted by more banks, military agencies, and leading e-commerce sites, it is one of the fastest firewalls available.

CyberCop Intrusion Protection: The industry’s highly rated intrusion detection and risk assessment solution, CyberCop continually scans the network for weak spots, monitors for suspicious activity, and even sets traps that help identify and repel intruders. The CyberCop proactive set of tools is made up of fully coordinated products—CyberCop Scanner, CyberCop Monitor and CyberCop Sting. In 1999, we enhanced CyberCop Scanner with “AutoFix” technology, allowing the immediate repair of security holes.

ACTIVE SECURITY IN ACTION

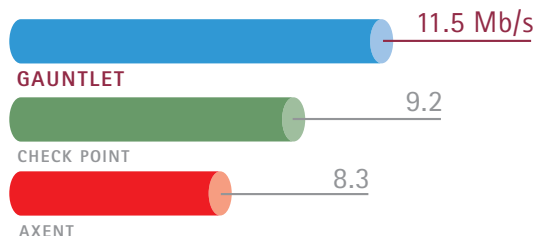


Only PGP integrates all components into your security policy.

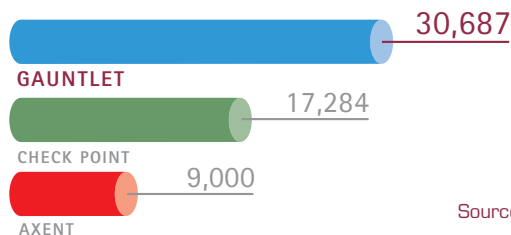
PGP: More than half of all secure communications over the Internet are protected by PGP. Used by over 70% of the Fortune 500, **PGP E-Business Server** secures sensitive financial and customer information. **PGP Data Security** gives companies the worldwide de facto standard for encryption. **PGP VPN** creates secure, encrypted tunnels between corporate offices, remote users and business partners.

In December 1999, the U.S. government granted Network Associates a license to export its market-leading PGP encryption software, ending a decades-old ban on the export of strong, e-business-enabling encryption products.

FIREWALL THROUGHPUT



MAXIMUM CONCURRENT CONNECTIONS



Source: DataComm 1999

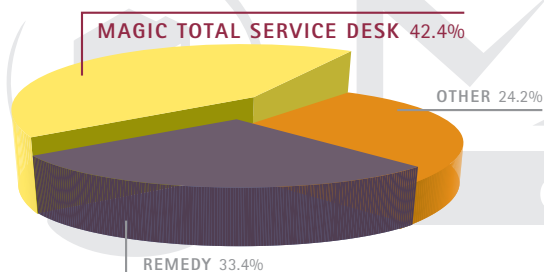


SEARCH Magic Solutions

In today's fast-paced, highly competitive e-business environment, employee and customer satisfaction can make or break a company's reputation, potential and revenue. IT organizations need a complete solution to manage customer support. Magic Solutions' flagship product, **Magic Total Service Desk**, is one of the world's first 100% Web-based, 100% customizable help desk solutions. The Magic Total Service Desk product gives IT staff everything they need to create their own IT portal and deploy a browser-based service desk solution.

But the Magic Total Service Desk solution extends beyond the standard help desk function of simply ticketing trouble. Magic's Event Orchestrator technology helps root out problems and eliminate them before they reach end users. Then Magic goes even further to act as an end-to-end backbone for desktop, security and event management. More than just a simple business application, Magic promotes information sharing, facilitates workflow, improves service delivery, helps reduce total cost of ownership and supports long-term planning.

MAGIC HELP DESK MARKET SHARE



U.S. Market Share on Windows NT Platform
Source: Dataquest, June 1998

COMPLETE CUSTOMIZATION NAVIGATOR BAR

- Problem Mgmt**
 - Help Desk
 - Tech Monitor
 - Knowledge Search
 - Remote Control
- Service Level Mgmt**
 - Service Level Agreements
 - Service Level Agreement Rules
- Crisis Mgmt**
 - White Board
 - White Board Notice
- Asset Mgmt**
 - Work Order
 - Configurations
 - Inventory Items
 - ZAC Scanned Inventory
 - Service Contracts
 - Vendors
- Network Mgmt**
 - Network Informant
 - DSPro
- Event Mgmt**
 - Event Orchestrator

Create Your Own IT Portal

- Add Links to Internal/ External Web Sites
- Organize Selections
- Create Specific Views for Each Work Group

“THE BEST OUT-OF-THE-BOX SOLUTION... WITH ITS FLASHY CLIENT INTERFACE, QUICK TICKET-ISSUING CAPABILITIES AND SLICK KNOWLEDGE-BASE SUPPORT.” *PC Week*

E-business problems disappear





SEARCH Sniffer Technologies

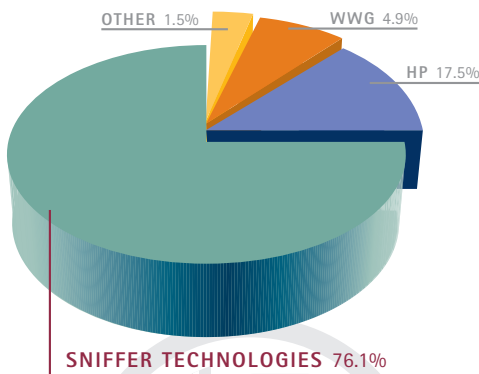
Sniffer Technologies is one of the industry's number one solutions for reducing network downtime and improving performance.

Sniffer Technologies delivers award-winning network management tools to help companies proactively monitor their network, resolve problems, perform at peak efficiency and realize the highest returns on their investments. Built for today's complex networks, Sniffer Technologies provides expert analysis and troubleshooting for the enterprise and across the Internet. In 1999, Network Associates enhanced Sniffer Technologies with features that allow companies to cost-effectively analyze distributed networks.

Sniffer Technologies is also the best way to manage voice, video and data over a single network. It provides higher-quality voice services by analyzing Voice Over IP (H.323) call setup configurations.

“IF YOU ARE RUNNING A DIVERSE TOPOLOGY AND PROTOCOL ENVIRONMENT, THEN CONSIDER THIS SUITE. (SNIFFER TECHNOLOGIES) PROTOCOL DECODES SHINE IN TERMS OF BREADTH AND DEPTH...SNIFFER TECHNOLOGIES PRO EXPERT IS GUARANTEED TO TELL YOU SOMETHING YOU DIDN'T KNOW ABOUT YOUR NETWORK, AND IN WORDS THAT YOU WILL UNDERSTAND.” *InfoWorld*

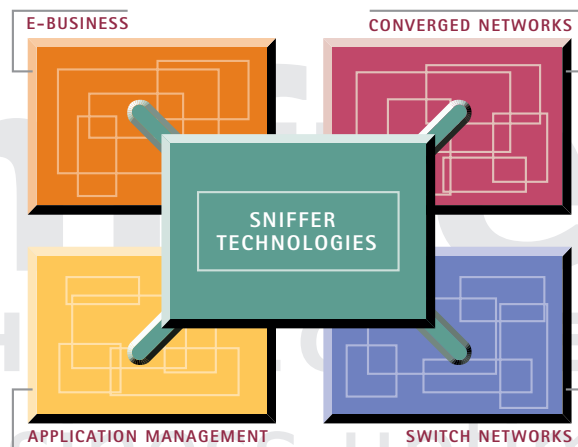
NETWORK ANALYSIS MARKET SHARE



Source: International Data Corporation

Sniffer Technologies is the only network management tool that can identify and solve problems at all layers of the network—from application to database, from server links to client transactions—all in a single family and in real time.

IMPROVES PERFORMANCE IN ALL AREAS





SEARCH McAfee

A virtual cornerstone of our company, McAfee is a proven leader in Internet, server and desktop protection.

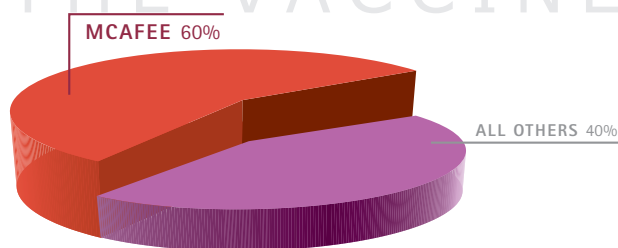
McAfee Active Virus Defense guards systems from infection via floppy disks, Internet downloads, email attachments, networks, shared files, CD-ROMs, online services and more. **VirusLogic**, introduced in 1999, detects and cleans newly emerging virus threats. In fact, McAfee achieves proven detection and cleaning in leading lab tests.

McAfee Active Virus Defense provides centralized control with the most enterprise-ready solution, simple enterprise software distribution via push and/or pull technologies, integration with established management tools, and native Microsoft Exchange and Lotus Notes solutions.

“IT’S EASY TO SEE HOW MCAFEE GOT TO BE THE 600-POUND GORILLA OF ENTERPRISE VIRUS SECURITY.”

Internet World, Editor’s Choice Award

ANTI-VIRUS MARKET SHARE

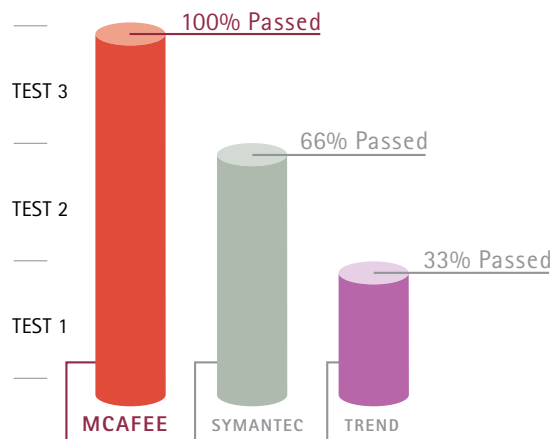


Source: CSI

The first line of defense in Active Virus Defense is the **McAfee Anti-Virus Emergency Response Team (AVERT)**. Twice as large as any competitor’s team and active on six continents, it’s a highly expert force of virus fighters. Their mission is to identify new viruses and deploy new cures instantly, before most businesses even know there is a threat.

VirusScan: Already protecting 70 million desktops worldwide, VirusScan is a world premier virus detection and removal solution across all platforms.

1999 INITIAL ICSA DETECTION CERTIFICATION TESTS FOR WINDOWS NT



Source: International Computer Security Association

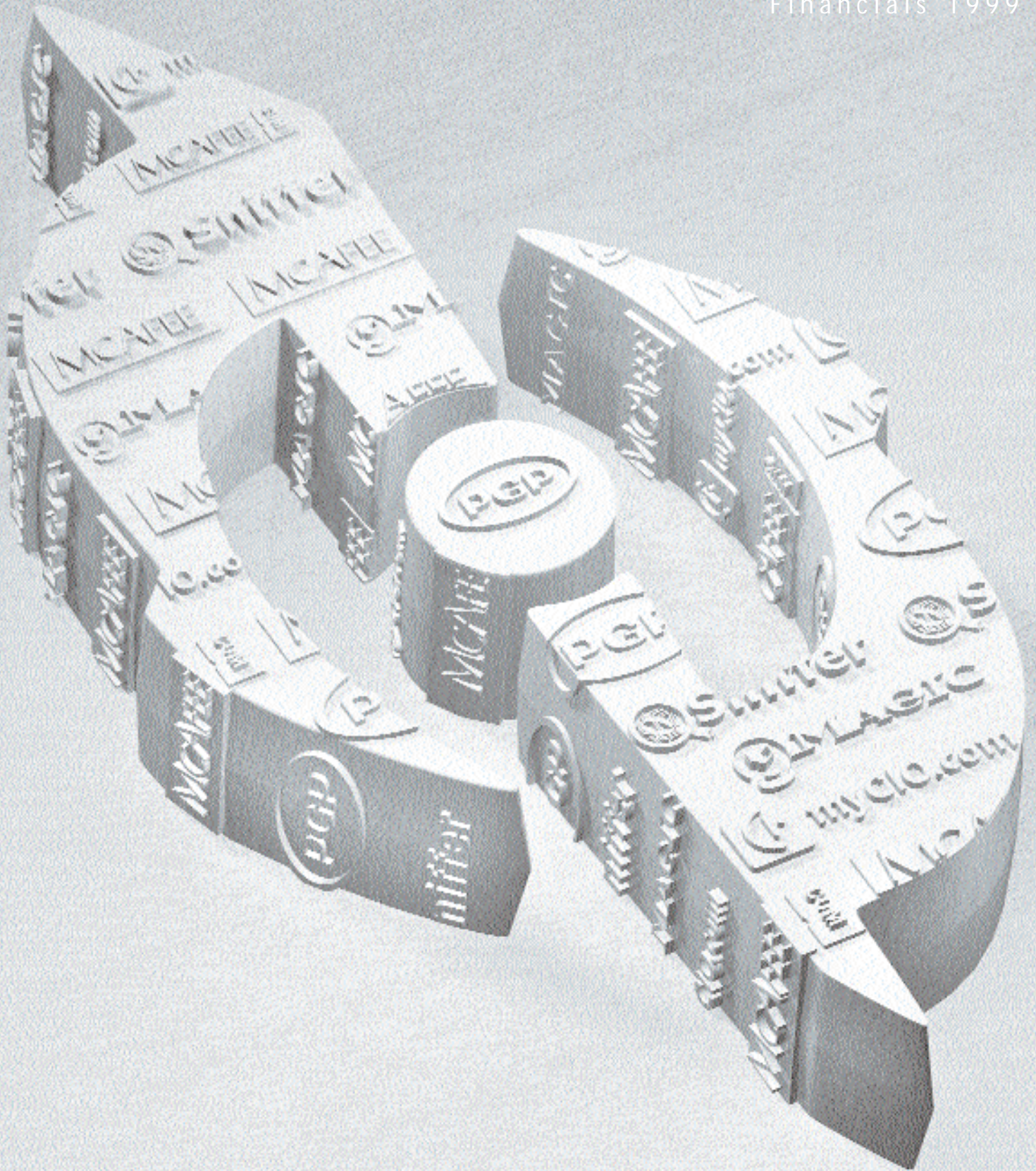




SEARCH Customers

EVENT ORCHESTRATOR





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SELECTED FINANCIAL DATA

Years Ended December 31,	1999	1998	1997	1996	1995
(In Thousands, Except Per Share Amounts)					
STATEMENTS OF OPERATIONS DATA:					
Net revenue	\$683,668	\$990,045	\$735,692	\$514,997	\$328,541
Income (loss) from operations	(138,199)	119,966	61,947	57,568	73,941
Income (loss) before income taxes	(130,658)	138,167	82,813	65,419	82,989
Net income (loss)	(159,901)	36,438	10,639	10,711	53,752
Net income per share, diluted	(\$1.15)	\$0.26	\$0.08	\$0.09	\$0.45
Shares used in per share calculation – diluted	138,695	138,609	132,729	125,502	119,243
Years Ended December 31,	1999	1998	1997	1996	1995
BALANCE SHEET DATA:					
Working capital	\$285,665	\$537,056	\$247,811	\$307,478	\$179,049
Total assets	1,479,394	1,536,721	805,350	613,867	366,280
Deferred revenue and taxes	163,816	205,598	129,557	91,020	68,838
Long term debt and other liabilities	379,267	374,123	2,353	—	—
Total equity	\$660,106	\$722,838	\$492,501	\$425,671	\$251,810

We have restated our financial results to incorporate the following companies acquired through pooling of interests: Anyware, CSB, Dr Solomon's, Nordic, QA, Secure, Syscon (all acquired in 1998) and Helix, Jade, Network General, SHBV (all acquired in 1997). In addition, results for the nine months ended September 30, 1998 and each of the years ended December 31, 1997, 1996 and 1995 have been restated from those previously reported to reflect a change in the purchase price allocation and related amortization of intangibles for acquisitions accounted for by the purchase method of accounting.

Dr Solomon's had a fiscal year ended May 31. Financial statements for the periods through December 31, 1997 reflect the combination of our operating results for the years ended December 31, 1997, 1996, and 1995 and the operating results of Dr Solomon's for the years ended November 30. Restated financial statements for the year ended December 31, 1998 reflect our operating results for the year ended December 31, 1998 and the operating results of Dr Solomon's for the thirteen months ended December 31, 1998.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

Fiscal Years Ended December 31, 1999, 1998 and 1997

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

Years Ended December 31,	1999	1998	1997
NET REVENUE:			
Product	69%	84%	86%
Services and support	31	16	14
Total revenue	100	100	100
COST OF REVENUE:			
Product	13	14	15
Services and support	5	4	4
Total cost of revenue	18	18	19
OPERATING COSTS AND EXPENSES:			
Research and development	22	14	14
Marketing and sales	54	30	30
General and administrative	18	8	11
Amortization of intangibles	9	4	2
Stock compensation charge	2	—	2
Acquisition and other related costs	(3)	14	13
Total operating costs and expenses	102	70	72
Income (loss) from operations	(20)	12	8
INTEREST AND OTHER INCOME			
	4	4	3
INTEREST AND OTHER EXPENSE			
Income (loss) before provision for income taxes	(3)	(2)	—
	(19)	14	11
PROVISION FOR INCOME TAXES			
Net income (loss)	4	10	10
	(23)%	4%	1%

Net Revenue. Net revenue decreased 31% to \$683.7 million in 1999 from \$990.0 million in 1998, including an \$18.2 million increase in revenue from McAfee.com. Net revenue increased 35% from \$735.7 million in 1997 to \$990 million in 1998, including a \$3.8 million increase in revenue from McAfee.com. The decrease in net revenue from 1998 to 1999 is due to our decision to limit distributor orders in an effort to realign channel inventory levels as a result of Year 2000 concerns and increasing sales cycles for our products. From 1997 to 1998, the increase in net revenue is due to the increase in product revenue and services and support revenues described below.

Product revenue decreased 43% to \$474.1 million in 1999 from \$831.4 million in 1998, and increased 31% from \$634.3 million in 1997. The decrease in net revenue from 1998 to 1999 is due to our decision to limit distributor orders in an effort to realign channel inventory levels as a result of Year 2000 concerns and increasing sales cycles for our products.

Services and support revenues include revenues from software support, maintenance contracts, education and consulting services, as well as those revenues from customer support and maintenance contracts, which are deferred and recognized

over the related service period. Service revenues increased 32% to \$209.6 million in 1999 from \$158.7 million in 1998, and 56% from \$101.4 million in 1997. The increase in services and support revenues resulted from growth in all categories of service revenues, principally due to the growth of our installed customer base and the resulting renewal of maintenance contracts.

We have historically experienced significant growth in net income (before acquisition and related costs) and net revenue. However, our rate of growth has slowed in recent periods due to increased price competition, a maturing anti-virus market and an increasingly higher base from which to grow. Our growth rate and net revenue depend significantly on renewals of existing orders as well as expanding our customer base. If our renewal rate or our pace of new customers slows, our net revenues and operating results would be adversely affected.

International revenue accounted for approximately 40%, 36% and 36% of net revenue for 1999, 1998 and 1997, respectively. The increase in international net revenue as a percentage of net revenue from 1998 to 1999 was due primarily to increased acceptance of our products in international markets and the continued investment in international operations. We expect that international revenues will increase in absolute terms. To minimize the impact of foreign currency fluctuations, we use non-leveraged forward currency contracts. However, our future results of operations may be adversely affected by currency fluctuations or by costs associated with currency risk management strategies. Other risks inherent in international revenue generally include the impact of longer payment cycles, greater difficulty in accounts receivable collection, unexpected changes in regulatory requirements, seasonality due to the slowdown in European business activity during the third quarter, tariffs and other trade barriers, uncertainties relative to regional economic circumstance, political instability in emerging markets, and difficulties staffing and managing foreign operations. These factors may have a material adverse effect on our future international license revenue. Further, in countries with a high incidence of software piracy, we may experience a higher rate of piracy of our products.

Cost of Net Revenue. Cost of Net Revenue decreased 29% to \$126.5 million in 1999 from \$177.0 million in 1998, and increased 25% from \$142.1 million in 1997. The decrease in cost of net revenues from 1998 to 1999 was primarily due to the decrease in net revenue. From 1997 to 1998 the increase in cost of net revenue is due to the increase in cost of product revenue and cost of services and support revenue described below.

Our cost of product revenue consists primarily of the cost of media, manuals and packaging for products distributed through traditional channels, royalties and, with respect to certain Sniffer products, computer platforms and other hardware components. Cost of product revenues decreased 35% to \$88.7 million in 1999 from \$137.4 million in 1998. From 1997 to 1998, cost of product revenues increased 23% from \$111.6 million. The decrease in cost of product revenues from 1998 to 1999 was primarily due to a corresponding decrease in product revenues. The increase in cost of product revenues from 1997 to 1998 was due to a corresponding increase in product revenues. As a percentage of net product revenue, cost of product revenue was 19% in 1999, 17% in 1998 and 18% in 1997.

Cost of services and support revenue consists principally of salaries and benefits related to employees providing customer support and consulting services. In 1999, cost of services and support revenue decreased 5% to \$37.7 million from \$39.7 million in 1998. Costs stayed relatively flat in 1999. From 1997 to 1998, cost of services and support revenue increased 30% from \$30.5 million. The increase is due to increase in net revenue. Costs increased at a higher rate than revenue due to the shift in the mix of support and professional services revenue versus revenue from warranty and maintenance contracts previously deferred. Cost of services and support revenue as a percentage of net services and support revenue was 18% in 1999, 25% in 1998 and 30% in 1997.

To the extent that the percentage of our net revenue which is generated through traditional distribution channels increases, our cost of net revenue will increase.

Research and Development. Research and development expenses consist primarily of salary and benefits for our development and technical support staff. Research and development expenses increased 9% to \$148.2 million in 1999 from \$135.5 million in 1998. Research and development expenses increased from 1998 to 1999 due to the increase in staffing and equipment expense to support growth in our product and service offerings. From 1997 to 1998, research and development expenses increased 31% from \$103.1 million. These increases were primarily a result of the expansion of our product development and technical support staff and, to a lesser extent, the increased use of independent contractors. As a percentage of net revenue, research and development expenses were 22% in 1999, 14% in 1998 and 14% in 1997. We anticipate that research and development expenses will continue to increase in absolute dollars, but may fluctuate as a percentage of net revenue.

We believe that our ability to maintain our competitiveness will depend in large part upon our ability to enhance existing products, develop and acquire new products, and develop and integrate acquired products. The market for computer software is characterized by low barriers to entry and rapid technological change, and is highly competitive with respect to timely product introductions. The timing and amount of research and development expenses may vary significantly based upon the number of new products and significant upgrades under development, and products acquired during a given period.

Marketing and Sales. Marketing and sales expenses consist primarily of salary, commissions and benefits for marketing, sales and customer support personnel, and costs associated with advertising and promotions. Marketing and sales expenses increased 25% to \$367.3 million in 1999 from \$294.8 million in 1998. From 1997 to 1998, marketing and sales expenses increased 33% from \$222.2 million in 1997. These increases were primarily due to continued investment in the marketing of

our products and services, hiring and training of our enterprise level sales force, and advertising and promotions for McAfee.com. As a percentage of net revenue, marketing and sales expense was 54% in 1999, 30% in 1998 and 30% in 1997. We anticipate that marketing and sales expenses will continue to increase in absolute dollars, but may fluctuate as a percentage of net revenue.

General and Administrative. General and administrative expenses consist principally of salary and benefit costs for administrative personnel and general operating costs. General and administrative expenses increased 49% to \$124.7 million in 1999 from \$83.9 million in 1998 due to a charge to cover \$31.8 million in doubtful accounts, the development of our e-commerce business systems, expansion of our IT infrastructure and the implementation of our new SAP Human Resources module. From 1997 to 1998, general and administrative expenses increased 1% from \$83.1 million in 1997 to \$83.9 million in 1998. As a percentage of net revenues, general and administrative expenses were 18.0%, 8.0% and 11.0% in the years ended December 31, 1999, 1998 and 1997, respectively.

Amortization of Intangibles and Stock Compensation Charges. We expensed \$74.0 million, \$43.2 million and \$30.5 million of amortization related to intangibles and stock compensation charges in the years ended December 31, 1999, 1998 and 1997, respectively. Intangibles consist of purchased goodwill and certain technology acquired through acquisitions. Stock compensation charges relate to the repricing of employee stock options and the issuance of McAfee.com stock options to our executives and employees. We do not expect to incur charges related to these McAfee.com option grants in the future. However, we do not expect significant stock based compensation charges related to repriced employee stock options. The increase in amortization related to intangibles is due to the acquisitions of Magic Solutions, Inc. ("Magic Solutions"), CyberMedia, and Virex and NetOctopus products by Dr Solomon's.

ACQUISITION AND OTHER RELATED COSTS
YEAR ENDED DECEMBER 31, 1999

The following table is a summary of acquisitions by the Company in the three years ended December 31, 1999:

	Common Stock issued in pooling of interests	Purchase price of purchase transactions
1998		
Syscon	1,230 shares	
Nordic	30,508 shares	
Magic Solutions		\$140.3 million
TIS	6,755,540 shares	
Secure	567,000 shares	
CSB	9,815 shares	
QA	305,557 shares	
Anyware	228,204 shares	
Dr Solomon's	15,813,142 shares	
CyberMedia		\$174.3 million
1997		
Network General	17,900,000 shares	
Jade K.K.	504,107 shares	
Schuijers Holdings B.V.	95,582 shares	
3DV Technology, Inc.		\$20.0 million
Compusul Consultores de Informatica, Ltda.		\$2.6 million plus \$1.0 million contingently payable
Cinco Networks, Inc.		\$26.0 million
Paradigm Agency Pty. Ltd.		\$2.0 million
Helix Software Company	825,000 shares	
Pretty Good Privacy, Inc.		\$35 million plus warrants to purchase 375,000 shares of Common Stock at \$40 per share

The following table summarizes the activity during the year ended December 31, 1999, in the reserves for acquisition and other costs established in the second and third quarters of 1998 (in thousands):

	Direct Transaction Costs	Severance & Benefits	Lease Costs	Asset Write-downs	Other	Total
Balance, December 31, 1998	\$9,900	\$8,338	\$5,508	\$1,405	\$2,144	\$27,295
Paid out or charged against the related assets	(5,712)	(1,549)	(804)	(140)	(104)	(8,309)
Adjustment to liability	(4,188)	(6,789)	(4,704)	(1,265)	(2,040)	(18,986)
Balance, December 31, 1999	\$0	\$0	\$0	\$0	\$0	\$0

For the year ended December 31, 1999, activity with respect to these reserves consisted principally of the payment of accrued direct transaction costs and severance benefits, and adjustments to remaining accruals. All expenditures related to these accruals have been completed, and the excess reserves, \$18,986,000, were credited to Acquisition and related charges.

The following table summarizes the activity during the year ended December 31, 1999, in the reserves for acquisition and other costs established in the year ended December 31, 1997 (in thousands):

	Direct Transaction Costs	Severance & Benefits	Lease Costs	Asset Write-downs	Other	Total
Balance, December 31, 1998	\$(36)	\$539	\$(422)	\$484	\$374	\$939
Paid out or charged against the related assets	(193)	(58)	(942)	0	0	(1,193)
Adjustment to liability	229	(481)	1,364	(484)	(374)	254
Balance, December 31, 1999	\$0	\$0	\$0	\$0	\$0	\$0

For the year ended December 31, 1999, activity with respect to these reserves consisted principally of expenditures related to accrued lease termination costs and adjustments to remaining accruals. All expenditures related to these accruals have been completed, and an additional expense, \$254,000, was charged to Acquisition and related charges.

YEAR ENDED DECEMBER 31, 1998

In connection with the acquisitions accounted for as poolings of interests, we incurred direct transaction costs and other restructuring and related charges in the amount of \$85.8 million in the year ended December 31, 1998. In connection with the acquisitions accounted for as purchase transactions, we incurred charges of \$49.8 million in the year ended December 31, 1998, consisting principally of the write-off of acquired in-process research & development. The following is a summary of these charges together with charges for certain restructuring activities taken by us during the year ended December 31, 1998 (\$000's):

	Direct Transaction Costs	Severance & Benefits	Lease Costs & Asset Write-downs	In-process R&D	Other	Total
TIS	\$15,023	\$3,818	\$4,414	\$—	\$(924)	\$22,331
Dr Solomon's Secure	19,898	11,425	18,312	—	0	49,635
Magic Solutions	500	500	1,200	—	100	2,300
CyberMedia	—	—	—	27,014	—	27,014
Restructuring costs-Q2	—	11,318	8,644	—	610	20,572
Restructuring costs-Q3	—	3,285	370	—	—	3,655
Reversal of excess reserves	(6,750)	(2,276)	(3,909)	—	214	(12,721)
Total Charges	\$28,671	\$28,070	\$29,031	\$49,844	\$ —	\$135,616

Direct transaction costs included \$18.0 million in investment banking fees, \$9.2 million in legal and accounting fees, and \$1.5 million in filing fees, travel and other costs. Lease costs and asset write-downs include the costs of closing approximately 33 facilities throughout the world (\$12.2 million), the disposal of excess and obsolete assets [generally computer equipment which did not comply with our standards (\$12.0 million)], and the write-off of goodwill and intangibles associated with discontinued Dr Solomon's products (\$4.8 million). The Dr Solomon's write-off related to two minor products which we discontinued and which had no sales subsequent to the Dr Solomon's acquisition.

The severance and benefits charges relate to company-wide reductions in force following our major acquisitions in the second and third quarters of 1998 of approximately 784 employees, of which 107 were in research and development functions, 302 were in sales and marketing functions, and the remainder were in administrative and other support functions. Substantially all terminated employees left our employment in the period the related accounting charge was recorded. We retained a limited number of employees from each acquisition for short transition periods. The cost of these employees was charged to operating expenses during the transition period.

The lease costs represent an estimate of lease expense during the period prior to re-leasing the property together with losses on subleases, if any. The leased facilities were substantially vacated in the period in which the related accounting charges were recorded. The costs related to any facilities which we used during this period were charged to operations. However, these charges were not material. Asset write-downs, exclusive of the intangible assets of Dr Solomon's described above, comprised \$5.6 million in losses on company-owned buildings (which were written down to estimated values) and \$10.3 million in net losses of computer and other miscellaneous assets. In general, this equipment was discarded or sold for nominal value. Due to the immediate consolidation of facilities, depreciation allocable to these facilities and the related assets, during the transition

period, was not material. All the facilities acquired in our 1998 acquisitions identified for closure have been disposed of or subleased as of December 31, 1999.

The in-process research and development costs comprise approximately \$22.8 million and \$27.0 million in connection with the acquisitions of CyberMedia in the three months ended September 30, 1998 and Magic Solutions in the three months ended June 30, 1998, respectively. The following is a summary of the projects acquired and the assumptions used in determining the value of the in-process research and development costs.

CYBERMEDIA

The ongoing projects at CyberMedia at the time of the purchase included upgrade versions of four products (First Aid 6.0 and 7.0, UnInstaller 6.0, Guard Dog 3.0, and Oil Change 3.0), as well as work on technologies to be used in two of our projects (a replacement product for PC Medic and McAfee Office). These upgrades will include new interfaces with the Internet, enhanced use of Active-X controls and Java-enhanced user interfaces. At the date we acquired CyberMedia, we estimated that, on average, 42% of the development effort had been completed and that the remaining 58% of the development effort would take approximately 12 months to complete and would cost \$2.7 million. The efforts required to complete the development of these projects principally relate to additional design efforts to integrate the technologies into our suite of products, finalization of coding, and completion of prototyping, verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of our more effective distribution channel. In conformity with the SEC's revised guidelines for accounting for in-process technologies, these cash flows were discounted back to their net present value using a discount rate of 28% (which

represents a premium of approximately 5% over our average weighted cost of capital) and excluding the value attributable to the use of the in-process technologies on future products. As of December 31, 1999, the projects related to this acquisition were completed.

MAGIC SOLUTIONS

The ongoing projects at Magic Solutions at the time of the purchase comprised an upgrade version of Support Magic 4.0, Magic Solutions' current product. This upgrade, known as Merlin Enterprise, represents new technologies with significantly enhanced functionality, including increased scalability, a 32-bit browser-based technology, an enhanced user interface and integrated management features. At the date we acquired Magic Solutions, we estimated that, on average, 80% of the development effort had been completed and that the remaining 20% of the development effort would take approximately 12 months to complete and would cost \$1.8 million. The efforts required to complete the development of these projects principally relate to additional design efforts to

integrate the technologies into our suite of products, finalization of coding, and completion of prototyping, verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of our more effective distribution channel. In conformity with the SEC's revised guidelines for accounting for in-process technologies, these cash flows were discounted back to their net present value using a discount rate of 28% (which represents a premium of approximately 5% over our average weighted cost of capital) and excluding the value attributable to the use of the in-process technologies in future products. As of December 31, 1999, the projects related to this acquisition were completed.

YEAR ENDED DECEMBER 31, 1997

The Acquisition and other related costs for 1997 comprise (i) the write-off of acquired in-process research and development projects of companies acquired in purchase accounting transactions; (ii) direct transaction costs of companies acquired in pooling-of-interests transactions; (iii) accrual for severance and benefits for terminations; and (iv) lease costs and asset write-downs in connection with the Network General merger. The following is a summary of these charges (in thousands):

	Direct Transaction Costs	Severance & Benefits	Lease Costs & Asset Write-downs	In-process R&D	Other	Total
Network General	\$15,347	\$11,083	\$18,916	\$ —	\$ 603	\$45,949
Helix (acquired by NAI)	—	—	—	—	1,874	1,874
Paradigm (acquired by NAI)	—	—	—	—	2,330	2,330
PGP (acquired by NAI)	—	—	—	3,937	—	3,937
Sybari (acquired by NAI)	—	—	—	—	1,100	1,100
Datawatch (acquired by Dr Solomon's)	—	—	—	9,336	—	9,336
Haystack (acquired by TIS)	3,535	—	—	—	—	3,535
Cinco (acquired by Network General)	—	—	—	5,234	—	5,234
3DV (acquired by Network General)	—	—	—	19,504	—	19,504
Total Charges	\$18,882	\$11,083	\$18,916	\$38,011	\$5,907	\$92,799

Direct transaction costs included \$14.0 million in investment banking fees, \$3.7 million in legal and accounting fees, \$709,000 in filing fees and \$438,000 in other related charges.

The severance and benefits charges relate to company-wide reductions in force, following our acquisition of Network General, PGP and Helix in the fourth quarter, of approximately 186 employees across all employee groups. The termination plan, which took place in January 1998, was finalized and approved by management prior to December 31, 1997. The employees to be terminated and the benefit arrangements were communicated to employees on December 31, 1997. A limited number of employees were retained for a short period to help with the transition. Costs associated with these transition employees were charged to operations during the transition period.

Lease costs and asset write-downs include \$3.8 million related to the costs of closing approximately 35 facilities throughout the world and the disposal of excess and obsolete assets (generally computer equipment which did not comply with our standards) of \$15.1 million.

The lease costs of \$3.8 million represent an estimate of lease expense during the period prior to re-leasing the property together with losses on subleases, if any. The costs, excluding amortization of leasehold improvements related to any facilities which were used during a short transition period, were charged to operations. However, these charges were not material. Due to the immediate consolidation of facilities, depreciation allocable to these facilities during the transition period was also not material. Asset write-downs of \$15.1 million comprised the write-off of leasehold improvements (\$9.6 million) and the sale or abandonment of old and obsolete equipment (\$5.5 million) which was discarded or sold for nominal value. To the extent that such equipment was used during the transition period, depreciation (which was not material) was charged to operations. Facilities identified for closure were available for sale or sublease as of December 31, 1997.

The Helix charge related to direct transaction costs (\$838,000), severance costs (\$495,000) and other related charges (\$541,000)

incurred in connection with the Helix acquisition which was accounted for under the pooling method of accounting.

The Paradigm charge related to the write-off of the purchase price paid in our acquisition of an Australian distributor, Paradigm Agency Ltd., who had the right to use the McAfee brand name in Australia. This acquisition was part of our initiative to establish a direct presence in major foreign markets and to recapture brand names in these countries.

The Sybari Technology charge related to a buyout in December 1997 of a license agreement entered into earlier in 1997. The buyout was motivated in an effort to resolve potential disputes with Sybari, and the technology was considered obsolete at the time of the buyout and had no alternative use in our products.

The in-process research and development costs in 1997 comprise approximately \$5.2 million, \$3.9 million, \$19.5 million and \$9.3 million in connection with the acquisitions of Cinco Networks, Inc., PGP, 3DV and Datawatch, respectively. The following is a summary of the projects acquired in the PGP and Cinco acquisitions and the assumptions used in determining the value of the in-process research and development costs. The 3DV projects in process at the date of the Network General merger, together with all other 3DV technologies, were discontinued at that date.

PGP

The ongoing projects at PGP at the time of the purchase included upgrade versions of PGP Product Suite components, including PGP for Personal Privacy, PGP for Business Security and PGP Certificate Server. These upgrades will include features such as improved key recovery certificate management and key splitting, and enhanced user interfaces. On the date we acquired PGP, we estimated that, on average, 20% of the development effort had been completed and that the remaining 80% of the development effort would take approximately six months to complete and would cost \$3.6 million. The efforts required to complete the development of these projects principally relate to additional design efforts to integrate the technologies into our suite of products, finalization of coding, and completion of prototyping,

verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of our more effective distribution channel. In conformity with the SEC's revised guidelines for purchased in-process technologies, these cash flows were discounted back to their net present value using a discount rate of 27% (which represents a premium of approximately 5% over PGP's average weighted cost of capital) and excluding the value attributable to the use of the in-process technologies in future products. If we do not deploy commercially accepted products based on the acquired in-process technologies, operating results could be adversely affected in future periods. Additionally, the failure of any particular project would impair the value of other intangibles, particularly goodwill, acquired from PGP. As of December 31, 1999, the projects related to this acquisition were completed.

CINCO

The ongoing projects at Cinco at the time of the purchase comprised upgrade versions of NetXRay, WebXRay and Distributed NetXRay, Cinco's current products. At the date we acquired Cinco, we estimated that, on average, 80% of the development effort had been completed and that the remaining 20% of the development effort would take approximately 4 months to complete and would cost \$240,000. The efforts required to complete the development of these projects principally relate to the completion of prototyping, verification, and testing activities required to establish that products associated with the technologies can be successfully introduced. The value of the in-process technologies was determined by estimating the projected net cash flows related to products, including costs to complete the development of the technologies or products, and the future net revenues that may be earned from the products, excluding the value attributed to integration

with our products or that may have been achieved due to efficiencies resulting from the combined sales force or the use of our more effective distribution channel. In conformity with the SEC's revised guidelines for purchased in-process technologies, these cash flows were discounted back to their net present value using a discount rate of 37.5% and excluding the value attributable to the use of the in-process technologies in future products. If we do not deploy commercially accepted products based on the acquired in-process technologies, operating results could be adversely affected in future periods. Additionally, the failure of any particular project would impair the value of other intangibles, particularly goodwill, acquired from Cinco Networks. As of December 31, 1999, the projects related to this acquisition were completed.

Interest and Other Income. Interest and miscellaneous income decreased to \$24.5 million in 1999 from \$33.4 million in 1998 and increased from \$21.0 million in 1997. Interest and other income decreased from 1998 to 1999 due to a decrease in interest income. Interest income decreased due to the reduced cash balances resulting from the acquisitions of Magic and CyberMedia and cash used to fund operating activities during the year. Interest and other income increased from 1997 to 1998 primarily as a result of the investment of the funds from our Zero Coupon Convertible Subordinated Debentures (the "Debentures") issued in February 1998.

Interest and Other Expense. Interest and other expense increased to \$17.3 million in 1999 from \$15.2 million in 1998 and \$87,000 in 1997. Interest and other expense increased from 1998 to 1999 primarily due to the \$2.5 million loss on the liquidation of our DirectWeb investment. Interest expense increased from 1997 to 1998 primarily due to the interest expense related to the issuance of our Zero Coupon Convertible Subordinated Debentures (the "Debentures") in February 1998.

Provision for Income Taxes. Our provision for income taxes was \$29.2 million, \$101.7 million and \$72.2 million in 1999, 1998, 1997, respectively. Our effective tax rate for 1999, 1998

and 1997 was 30%, 32% and 37%, respectively, excluding the effect of one-time non-deductible in-process research and development, merger and other acquisition costs and amortization of intangibles and stock compensation charges and the operating loss related to our decision to limit distributor orders.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 1999, we had \$316.8 million in cash and cash equivalents and \$469.6 million in marketable securities, for a combined total of \$786.4 million.

Net cash provided by (used in) operating activities was \$(23.3) million, \$96.0 million and \$132.0 million in 1999, 1998 and 1997, respectively. Net cash used in operating activities in 1999 consisted primarily of net loss before depreciation and amortization, bad debt expense, stock compensation charge and interest on the Debentures and deferred taxes. In addition, there were decreases in accounts receivable, prepaid expenses and other assets, and an increase in accounts payable and accrued liabilities, which was offset by a decrease in deferred revenue. Net cash provided by operating activities in 1998 consisted primarily of net income before acquired in-process research and development, depreciation and amortization, and interest on the Debentures, as well as an increase in deferred revenue, and the tax benefit from exercise of non-qualified stock options. Increases in accounts receivable and prepaids and other assets and decreases in accounts payable and accrued liabilities offset these factors. Net cash provided by operating activities in 1997 consisted primarily of net income before acquired in-process research and development and depreciation and amortization, plus increases in accounts payable and accrued liabilities, deferred revenue and the tax benefit from exercise of non-qualified stock options. Increases in accounts receivable and deferred taxes offset these factors.

Our accounts receivable balance as a percentage of sales may increase due to our increased emphasis on server/enterprise-based sales, a higher percentage of indirect sales through our channel partners and expanding international sales, both of which typically have longer payment terms. Additionally, our

receivable collection has become more dependent on the longer payment cycle for VARs, distributors and system integrators. To address this increase in accounts receivable and to improve cash flow, we may from time to time take actions to encourage earlier payment of receivables and sell receivables. To the extent that our accounts receivable balance increases, we will be subject to greater general credit risks with respect thereto.

Net cash used in investing activities was \$168.5 million, \$318.8 million and \$145.2 million in 1999, 1998 and 1997, respectively, primarily reflecting purchases of marketable securities and additions to fixed assets.

Net cash provided by financing activities was \$96.6 million in 1999, consisting primarily of the proceeds associated with the exercise of non-qualified stock options, sale of put options, and proceeds from the McAfee.com initial public offering, which was offset by the repayment of notes payable and repurchase of our Common Stock. Net cash provided by financing activities was \$489.8 million in 1998, consisting primarily of the proceeds from the issuance of the Debentures as well as proceeds and tax benefits associated with the exercise of non-qualified stock options. Net cash provided by financing activities was \$5.2 million in 1997, consisting primarily of the proceeds and tax benefits associated with the exercise of non-qualified stock options partially offset by the repurchase of common stock.

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

YEAR 2000 ISSUE

The Year 2000 issue is the result of computer programs using two digits rather than four digits in the date code fields. Computer program software may recognize a two-digit date code field using "00" as the year 1900 rather than the year 2000 (the "Year 2000 issue"). Year 2000 issues occurring in our own infrastructure or in the infrastructures of our major distributors, suppliers, customers, vendors and financial service organizations could impact us.

We evaluated and addressed the impact of the Year 2000 issue in the following four program areas: Commercial Product Compliance, Internal Systems and Technology Compliance, Supplier and Business Partner Compliance, and Facilities and Safety Compliance. For all these areas, we inventoried the affected items, assessed the corrective action that was needed and then corrected the indicated items. We utilized primarily internal resources in implementing our Year 2000 program. In addition, we have worked with our key suppliers and business partners to ensure they have proper procedures in place to address their own Year 2000 issues.

As of December 31, 1999, we completed our Year 2000 compliance program. We believe that all key systems are Year 2000 compliant, and as of March 30, 2000 we have incurred no significant disruption in operations. Contingency plans have been created and are in place for our key systems and operations. We have a Year 2000 compliance team that is still monitoring any Year 2000 issues which may still arise.

There can be no guarantee that the systems of other companies on which we rely are Year 2000 compliant, or that a failure to be Year 2000 compliant by another company would not have a material adverse effect on us. Because our products are able to operate in the Year 2000 and beyond, we do not anticipate exposure to material product defect or similar litigation. Any such litigation, however, could have a material adverse effect on our business, results of operations and financial condition. We also may not receive any assistance, damages or other relief as a result of our initiation of any litigation related to the Year 2000 issue.

Through December 31, 1999, we have incurred approximately \$4.5 million in connection with our Year 2000 compliance program.

Our management will continue to periodically report the results of our Year 2000 compliance program to the Audit Committee of our Board of Directors.

EURO

On January 1, 1999, the "euro" was introduced. On that day, the

exchange ratios of the currencies of the eleven countries participating in the first phase of the European Economic and Monetary Union were fixed. The euro became a currency in its own right and the currencies of the participating countries, while continuing to exist for a three-year transition period, are now fixed denominations of the euro. The conversion to the euro will have significant effects on the foreign exchange markets and bond markets and is requiring significant changes in the operations and systems within the European banking industry. Our information system is designed to accommodate multi-currency environments. As a result, we have the flexibility to transact business with vendors and customers in either euro or traditional national currency units. For those countries where bank accounts were not automatically translated into dual currency bank accounts, we maintain separate euro accounts.

FINANCIAL RISK MANAGEMENT

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

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. Historically, our primary exposures related to nondollar-denominated sales and operating expenses in Japan, Canada, Australia, Europe, Latin America, and Asia. We have recently expanded our business activities in Europe. As a result, we expect to see an increase in exposures related to nondollar-denominated sales in several European currencies. At the present time, we hedge only those currency exposures associated with certain assets and liabilities denominated in nonfunctional currencies and do not generally hedge anticipated foreign currency cash flows. Our hedging activity is intended to offset the impact of currency fluctuations on certain nonfunctional currency assets and liabilities. The success of this activity depends upon estimates of transaction activity denominated in various currencies, primarily the Japanese yen, Canadian dollar, Australian dollar, and certain

European currencies. To the extent that these estimates are over or understated during periods of currency volatility, we could experience unanticipated currency gains or losses.

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

The following tables present the hypothetical changes in fair values in the securities held at December 31, 1999 that are sensitive to the changes in interest rates. The modeling technique used measures the change in fair market values arising from hypothetical parallel shifts in the yield curve of plus or minus 50 basis points (BPS), 100 BPS and 150 BPS over six and twelve-month time horizons. Beginning fair market values represent the market principal plus accrued interest and dividends at December 31, 1999. Ending fair market values are the market principal plus accrued interest, dividends and reinvestment income at six and twelve-month time horizons.

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

ISSUER	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			No Change in Interest	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	\$197.5	\$196.4	\$195.3	\$193.9	\$192.5	\$191.7	\$190.6
Municipal notes and bonds	57.2	56.9	56.6	56.1	55.9	55.7	55.4
Corporate notes, bonds and preferreds	479.9	479.5	478.6	478.0	477.4	476.7	475.9
Total	\$734.6	\$732.8	\$730.5	\$728.0	\$725.8	\$724.1	\$721.9

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

ISSUER	Valuation of Securities Given an Interest Rate Decrease of X Basis Points			No Change in Interest	Valuation of Securities Given an Interest Rate Increase of X Basis Points		
	150 BPS	100 BPS	50 BPS		50 BPS	100 BPS	150 BPS
U.S. Government notes and bonds	\$200.8	\$199.8	\$198.8	\$197.8	\$196.5	\$196.0	\$195.0
Municipal notes and bonds	57.6	57.3	57.2	56.9	56.8	56.6	56.4
Corporate notes, bonds and preferreds	485.6	484.9	484.4	484.0	483.5	482.9	482.2
Total	\$744.0	\$742.0	\$740.4	\$738.7	\$736.8	\$735.5	\$733.6

CONVERTIBLE DEBT

On February 13, 1998, we completed a private placement of Zero Coupon Convertible Subordinated Debentures due in 2018 (the "Debentures"). The Debentures, with an aggregate face amount at maturity of \$885.5 million, generated net proceeds to us of approximately \$337.6 million (after deducting the fee paid to the initial purchaser of the Debentures but no other expenses

of the placement). The initial price to the public for the Debentures was \$391.06 per \$1,000 of face amount at maturity, which equates to a yield to maturity over the term of the bonds of 4.75% (on a semi-annual bond equivalent basis). The Debentures are convertible into Common Stock at the rate of 8.538 shares per \$1,000 of face amount at maturity, which equates to an initial conversion price of \$45.80 per share.

The Debentures are subordinated in right of payment to all existing and future Senior Indebtedness (as defined) and effectively subordinated in right of payment to all indebtedness and other liabilities of our subsidiaries. The Debentures may be redeemed for cash at our option beginning on February 13, 2003. At the option of the holder, we will purchase the Debentures as of February 13, 2003, February 13, 2008 and February 13, 2013 at purchase prices (to be paid in cash or

Common Stock or any combination thereof, our election and subject to certain conditions) equal to the initial issue price plus accrued original issue discount to such dates. The Debentures may also be redeemed at the option of the holder if there is a Fundamental Change (as defined) at a price equal to the issue price plus accrued original issue discount to the date of redemption, subject to adjustment.

QUARTERLY OPERATING RESULTS (UNAUDITED)

Three Months Ended	Dec. 31, 1999	Sep. 30, 1999	Jun. 30, 1999	Mar. 31, 1999	Dec. 31, 1998	Sep. 30, 1998	Jun. 30, 1998	Mar. 31, 1998
(In Thousands, Except Per Share Data)								
STATEMENTS OF OPERATIONS AND OTHER DATA:								
Net revenues	\$218,079	\$195,201	\$25,196	\$245,192	\$272,191	\$242,444	\$249,317	\$226,093
Gross margin	183,758	161,864	1,642	209,949	232,838	197,888	199,444	182,827
Income (loss) from operations	11,204	(828)	(192,803)	44,228	80,970	8,167	(18,499)	49,328
Income (loss) before provision for income taxes	13,364	1,081	(190,905)	45,802	85,225	12,266	(14,348)	55,024
Net income (loss)	\$9,884	\$(241)	\$(195,785)	\$26,241	\$56,685	\$(14,444)	\$(38,547)	\$32,744
Diluted earnings (loss) per share	\$0.07	\$(0.00)	\$(1.41)	\$0.18	\$0.40	\$(0.11)	\$(0.29)	\$0.24
Shares used in per share calculation - diluted	143,783	139,038	138,478	142,607	149,002	133,531	131,503	140,412

The increase in revenues and operating income in 1998 and the decrease in revenues and operating income in 1999 are not necessarily indicative of future results. In addition, we believe that period-to-period comparisons of our financial results should not be relied upon as an indication of future performance. For example, in the second quarter of 1999, our revenue decreased 89.9% from the second quarter of 1998 due to our decision to limit distributor orders.

Our revenues and results of operations have been subject to significant fluctuations, particularly on a quarterly basis, and our revenues and results of operations could fluctuate significantly quarter to quarter and year to year. Causes of such fluctuations may include the volume and timing of new orders and renewals, the sales cycle for our products, the introduction of new products, distributor inventory levels and return rates, inventory levels, product upgrades or updates by us or our competitors,

changes in product mix, changes in product prices and pricing models, seasonality, trends in the computer industry, general economic conditions (such as the recent economic turbulence in Asia), extraordinary events such as acquisitions or litigation, and the occurrence of unexpected events.

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

REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders
Networks Associates, Inc.
Santa Clara, California

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income, stockholders' equity and cash flows present fairly, in all material respects, the financial position of Networks Associates, Inc. and its subsidiaries at December 31, 1999 and December 31, 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999 in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

San Jose, California
January 24, 2000

CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(In thousands, except per share data)

Years Ended December 31,	1999	1998	1997
NET REVENUE:			
Product	\$474,097	\$831,363	\$634,269
Services and support	209,571	158,682	101,423
Total revenue	\$683,668	\$990,045	\$735,692
COST OF NET REVENUE:			
Product	\$88,729	\$137,374	\$111,552
Services and support	37,726	39,674	30,547
Total cost of net revenue	\$126,455	\$177,048	\$142,099
OPERATING COSTS AND EXPENSES:			
Research and development	\$148,213	\$135,475	\$103,051
Marketing and sales	367,293	294,812	222,194
General and administrative	124,669	83,946	83,083
Amortization of intangibles	58,400	43,182	12,866
Stock compensation charge	15,569	—	17,653
Acquisition and other related costs	(18,732)	135,616	92,799
Total operating costs and expenses	695,412	693,031	531,646
Income (loss) from operations	\$(138,199)	\$119,966	\$61,947
Interest and other income	\$24,546	\$33,447	\$20,953
Interest and other expense	(17,345)	(15,246)	(87)
Minority interest in loss of consolidated subsidiaries	340	—	—
Income (loss) before provision for income taxes	(130,658)	138,167	82,813
Provision for income taxes	29,243	101,729	72,174
Net income (loss)	\$(159,901)	\$36,438	\$10,639
OTHER COMPREHENSIVE INCOME (LOSS):			
Unrealized gain (loss) on investments	\$(1,610)	\$1,793	\$56
Foreign currency translation loss	(6,813)	(5,101)	(791)
Comprehensive income (loss)	\$(168,324)	\$33,130	\$9,904
Net income (loss) per share - basic	\$(1.15)	\$0.27	\$0.08
Shares used in per share calculation - basic	138,695	133,075	126,662
Net income (loss) per share - diluted	\$(1.15)	\$0.26	\$0.08
Shares used in per share calculation - diluted	138,695	138,609	132,729

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

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

Years Ended December 31,	1999	1998
ASSETS		
Current assets:		
Cash and cash equivalents	\$316,784	\$418,899
Short-term marketable securities	72,135	98,515
Accounts receivable, net of allowance for doubtful accounts of \$16,249 in 1999 and \$11,682 in 1998	174,646	260,784
Prepaid expenses and income taxes	33,038	59,554
Deferred taxes	79,186	65,866
Total current assets	675,789	903,618
Long-term marketable securities	397,447	216,457
Fixed assets, net	45,392	54,489
Deferred taxes	93,904	38,205
Intangible and other assets	266,862	323,952
Total assets	\$1,479,394	\$1,536,721
LIABILITIES		
Current liabilities:		
Accounts payable	\$13,723	\$20,881
Accrued liabilities	253,062	210,070
Deferred revenue	123,236	132,409
Notes payable	103	3,202
Total current liabilities	390,124	366,562
Deferred taxes	10,575	13,000
Deferred revenue, less current portion	30,005	60,189
Long-term debt and other liabilities	379,267	374,132
Total liabilities	\$809,971	\$813,883
Commitments and contingencies (Notes 7 and 5)		
Minority interest	9,317	—
STOCKHOLDERS' EQUITY		
Preferred Stock, \$.01 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: none in 1999 and one share in 1998		
Common Stock, \$.01 par value:		
Authorized: 300,000,000 shares; Issued: 139,419,528 shares in 1999 and 137,123,562 shares in 1998	1,387	1,371
Treasury stock	(11,023)	—
Additional paid-in capital	644,821	527,862
Cumulative other comprehensive income - unrealized gain (loss) on investments and foreign currency translation	(9,957)	(1,534)
Retained earnings	34,878	195,139
Total stockholders' equity	660,106	722,838
Total liabilities, minority interest and stockholders' equity	\$1,479,394	\$1,536,721

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

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

	Common Stock Shares	Common Stock Amount	Treasury Stock	Additional Paid-in Capital	Deferred Compensation	Other Comprehensive Income	Retained Earnings	Total
Balances, December 31, 1996	124,628	\$1,246	—	\$281,610	\$(944)	\$2,117	\$141,642	\$425,671
Elimination of net loss for Network General for the quarter ended March 31, 1997	1,689	17	(79,196)	83,702	—	396	6,420	11,339
Issuance of Common Stock upon exercise of stock options	4,999	50	35,126	—	—	—	35,176	
Issuance of Common Stock from Employee Stock Purchase Plan	549	6	—	6,925	—	—	—	6,931
Tax benefit from exercise of nonqualified stock options	—	—	—	39,941	—	—	—	39,941
Foreign currency translation	—	—	—	—	—	(791)	—	(791)
Unrealized gain on investments	—	—	—	—	—	56	—	56
Repurchase of Common Stock	(3,806)	(38)	79,196	(115,895)	—	—	—	(36,737)
Amortization of deferred stock compensation	—	—	—	—	276	—	—	276
Net income	—	—	—	—	—	—	10,639	10,639
Balances, December 31, 1997	128,059	1,281	—	331,409	(668)	1,778	158,701	492,501
Issuance of Common Stock upon exercise of stock options	8,560	86	—	144,646	—	—	—	144,732
Issuance of Common Stock from Employee Stock Purchase Plan	445	4	—	6,363	—	—	—	6,367
Tax benefit from exercise of nonqualified stock options	—	—	—	43,500	—	—	—	43,500
Foreign currency translation	—	—	—	—	—	(5,105)	—	(5,105)
Unrealized gain on investments	—	—	—	—	—	1,793	—	1,793
Amortization of deferred stock compensation	—	—	—	—	668	—	—	668
Exercise of warrants	59	—	—	1,944	—	—	—	1,944
Net income	—	—	—	—	—	—	36,438	36,438
Balances, December 31, 1998	137,123	1,371	—	527,862	—	(1,534)	195,139	722,838
Issuance of Common Stock upon exercise of stock options	1,196	12	1,414	17,471	—	—	(360)	18,537
Issuance of Common Stock from Employee Stock Purchase Plan	578	6	—	8,929	—	—	—	8,935
Repurchase of Common Stock	(685)	(7)	(12,437)	—	—	—	—	(12,444)
FSA conversion of Preferred Stock to Common Stock	438	4	—	—	—	—	—	4
Exercise of warrants	85	1	—	458	—	—	—	459
Proceeds from sale of put options	—	—	—	5,250	—	—	—	5,250
Compensation charge due to repricing of stock options and McAfee.com options	—	—	—	15,570	—	—	—	15,570
Capital contributed by minority stockholders of subsidiary	—	—	—	69,281	—	—	—	69,281
Foreign currency translation	—	—	—	—	—	(6,813)	—	(6,813)
Unrealized loss on investments	—	—	—	—	—	(1,610)	—	(1,610)
Net loss	—	—	—	—	—	—	(159,901)	(159,901)
Balances, December 31, 1999	138,735	\$1,387	\$(11,023)	\$644,821	\$—	\$(9,957)	\$34,878	\$660,106

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

Years Ended December 31,	1999	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$(159,901)	\$36,438	\$10,639
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Acquired in-process research and development	—	49,843	38,011
Depreciation and amortization	81,492	75,335	37,720
Write-down of owned facility	—	1,177	—
Stock compensation charge	15,570	—	—
Minority interest	(340)	—	—
Tax benefits from exercise of non-qualified stock options	—	43,500	39,941
Deferred taxes	(71,444)	(47,266)	(22,220)
Interest on convertible notes	17,332	14,525	—
Unrealized gain (loss) on investments	(1,610)	1,793	56
Bad debt expense	44,809	11,253	6,575
Changes in assets and liabilities:			
Accounts receivable	41,329	(109,029)	(58,085)
Prepays and other assets	25,150	(28,627)	(26,212)
Accounts payable and accrued liabilities	(23,635)	(2,300)	66,380
Deferred revenue	(39,357)	49,324	39,180
Net cash provided by (used in) operating activities	(23,335)	95,966	131,985
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of investment securities	(1,512,935)	(3,284,620)	(866,728)
Sale of investment securities	1,358,326	3,230,412	826,294
Proceeds from sale of fixed assets	6,518	—	—
Additions to fixed assets	(20,458)	(34,940)	(31,154)
Acquisition of CyberMedia	—	(119,958)	—
Acquisition of Magic Solutions	—	(109,717)	—
Acquisition of Cinco, Networks, Inc.	—	—	(25,079)
Acquisition of Compusul	—	—	(3,350)
Acquisition of 3DV Technology, Inc.	—	—	(20,000)
Acquisition of Paradigm	—	—	(1,833)
Acquisition of Datawatch	—	—	(9,336)
Acquisition of PGP	—	—	(24,974)
Elimination of Network General cash flow for the quarter ended March 31, 1997	—	—	11,339
Purchased intangibles	—	—	(374)
Net cash used in investing activities	(168,549)	(318,823)	(145,195)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Issuance of convertible debentures, net of issuance costs	—	337,624	—
Repayment of notes payable	(3,085)	(837)	(125)
Proceeds of McAfee.com initial public offering, net	78,945	—	—
Issuance of stock under stock option and stock purchase plans	27,471	151,099	42,110
Proceeds from sale of put options	5,250	—	—
Repurchase of Common Stock	(12,443)	—	(36,738)
Exercise of warrants	459	1,944	—
Net cash provided by financing activities	96,597	489,390	5,247
Effect of exchange rate fluctuations on cash and cash equivalents	(6,828)	(5,105)	(791)
Net increase (decrease) in cash and cash equivalents	(102,115)	261,868	(8,754)
Cash and cash equivalents at beginning of year	418,899	157,031	165,785
Cash and cash equivalents at end of year	\$316,784	\$418,899	\$157,031
Supplemental disclosure of cash flow information:			
Cash paid during the year for income taxes	\$32,318	\$68,446	\$14,316

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND BUSINESS

Networks Associates, Inc. (the "Company"), formally McAfee Associates, Inc., develops, markets, distributes and supports network security and network management software products. The Company's markets are worldwide and include corporate, governmental, and institutional users as well as resellers and distributors throughout the world. Software products and updates are delivered primarily through electronic distribution under two-year subscription licenses and as boxed products sold through the retail channel. International sales and support are provided by subsidiaries in principal European markets and independent agents and distributors elsewhere internationally. The Company changed its name to Networks Associates, Inc. in connection with the combination of McAfee Associates and Network General, in December 1997.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Financial Statement Presentation

The accompanying consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. Certain reclassifications have been made to the prior years' financial statements to conform to the current year's presentation. These reclassifications had no effect on the prior years' stockholders' equity or net income.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Specifically, significant estimates are required in the valuation of intangible assets acquired in purchase combinations including amounts accounted for as in-process research and development, costs accrued for restructuring merged businesses, allowances for doubtful accounts and sales returns, and valuation allowances for deferred tax assets. Actual results could differ from those estimates.

Certain Risks and Concentrations

The Company's product revenues are concentrated in the computer software industry, which is highly competitive and rapidly changing. Significant technological changes in the industry or customer requirements, or the emergence of competitive products with new capabilities or technologies could adversely affect operating results. Also, a majority of the Company's revenues are derived from sales to distributors and resellers. Significant changes in operations, buying behavior or financial stability of our channel partners could adversely affect operating results. In addition, a significant portion of the Company's revenue and net income is derived from international sales and distributors. Fluctuations of the U.S. dollar against foreign currencies, changes in local regulatory or economic conditions, piracy or significant dislocations in local distribution channels could adversely affect operating results.

The Company maintains the majority of cash balances and all of its short-term investments with six financial institutions. The Company invests with high-credit quality financial institutions and, by policy, limits the amount of credit exposure to any one financial institution. The Company has significant accounts receivable from several major distributors and from customers across a broad demographic base. Management of the Company performs ongoing credit evaluations of its customers and maintains allowances for doubtful accounts.

Certain of the Company's products contain critical components supplied by a single or a limited number of third-parties. The Company has been required to purchase and inventory certain of the computer platforms around which it designs its products so as to ensure an available supply of the product for its customers. Any significant shortage of these platforms or other components, or the failure of the third-party supplier to maintain or enhance these products, could have a material adverse affect on the Company's results of operations.

Foreign Currency Translation

The Company considers the local currency to be the functional

currency for its international subsidiaries. Assets and liabilities denominated in foreign currencies are translated using the exchange rate on the balance sheet date. Translation adjustments resulting from this process are charged or credited to equity. Revenues and expenses are translated at average exchange rates prevailing during the year. Foreign currency transaction gains and losses, which to date have not been material, are included in the determination of net income.

Revenue Recognition

Revenue from product licenses is generally recognized when a customer purchase order has been received, a license agreement has been delivered, the software or system has been shipped (or software has been electronically delivered), remaining obligations are insignificant, and collection of the resulting account receivable is probable. Maintenance revenue for providing product updates and customer support is deferred and recognized ratably over the service period. For contracts with multiple obligations (e.g. deliverable and undeliverable products, maintenance and other services), the Company allocates revenue to each component of the contract based on objective evidence of its fair value, which is specific to the Company. Revenue from hardware products is recognized upon shipment subject to a reserve for returns. Revenues on rental units under operating leases and service agreements are recognized ratably over the term of the rental or service period.

Revenue generated from products sold through traditional channels where the right of return exists is reduced by reserves for estimated sales returns. Such reserves are based on estimates developed by management. As unsold products in these distribution channels are exposed to rapid changes in consumer preferences or technological obsolescence due to new operating environments, product updates or competing products, it is reasonably possible that these estimates will change in the near term.

Government Contracts

The Company enters into research and development contracts with government agencies under various pricing arrangements. Revenue from "cost-plus-fixed-fee" contracts is recognized on the basis of reimbursable contract costs incurred during the period,

plus a percentage of the fixed fee. Revenue from "time and material" contracts is recognized on the basis of hours utilized, plus other reimbursable contract costs incurred during the period. Revenue from "firm-fixed-price" contracts is recognized on the percentage-of-completion method. Under this method, individual contract revenues are recorded based on the percentage relationship that contract costs incurred bear to management's estimate of work completed. Losses, if any, are accrued when their occurrence becomes known and the amount of the loss is reasonably determined.

Under government contracts, the Company is subject to audit by the Defense Contract Audit Agency (DCAA) which could result in the renegotiation of amounts previously billed. The DCAA has performed audits of the Company's costs through 1996. Management believes that the results of such audits will not have a material adverse impact on the Company's financial position or results of operations.

Research and Development

Research and development expenditures are charged to operations as incurred. Under the Company's development process, technological feasibility is established on completing a working model. Subsequent costs for the Company have not been significant and all software development costs have therefore been expensed.

Advertising Costs

Advertising production costs are expensed as incurred. Media (TV and print) placement costs are expensed in the period the advertising appears. Total advertising and promotional expenses were \$58.8 million, \$30.4 million and \$22.6 million for the years ended December 31, 1999, 1998 and 1997, respectively.

Cash and Cash Equivalents

Cash equivalents are comprised of highly liquid debt instruments with original maturities of 90 days or less.

Marketable Securities

All marketable securities are classified as available-for-sale

securities. Available-for-sale securities are carried at fair value in accordance with Statement of Financial Accounting Standards No. 115 ("SFAS 115"). Short-term marketable securities are those with original maturities greater than 90 days but less than one year. Long-term marketable securities have original maturities greater than one year. Unrealized gains and losses on marketable securities are reported net of related taxes as a separate component of stockholders' equity. Realized gains and losses on sales of all such investments are reported in earnings and computed using the specific identification cost method.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material and related manufacturing overhead.

Long Lived Assets

Fixed Assets

Fixed assets are stated at cost. Depreciation and amortization of fixed assets is provided using the straight-line method over the estimated useful lives of the assets (2 to 5 years). Upon disposal, the asset and related accumulated depreciation is removed from the records and the related gain or loss is recorded in the results of operations.

Intangible Assets

Intangible assets include the estimated fair market values of purchased technology, when the related products or products under development are considered technologically feasible, and goodwill arising from acquisitions and other intangibles. Intangibles are amortized over their estimated useful lives (typically 3 to 7 years).

In accordance with FASB Statement 121, "Accounting for the Impairment of Long Lived Assets and for Long Lived Assets to be Disposed Of," the Company assesses impairment losses on long lived assets, principally goodwill and purchased technology, when events or changes in circumstances indicate that the carrying amount may not be recoverable. Impairment is considered to have occurred when the undiscounted future net cash flows the

assets are expected to generate are less than the carrying value of the related asset. If such assets are considered to be impaired, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds the present value of the future net cash flows.

Fair Value of Financial Instruments

Carrying amounts of the Company's financial instruments, including cash and cash equivalents, investments, accounts receivable, accounts payable and accrued liabilities, approximate fair value due to their short maturities.

The fair value of the Company's convertible debentures is based on the current market value. The carrying amount and estimated fair value of convertible debentures at December 31, 1999 were \$378.3 million and \$369.4 million, respectively.

Net Income (Loss) Per Share

Net income (loss) per share has been computed in accordance with SFAS 128. Basic net income (loss) per share is computed using the weighted average common shares outstanding during the period. Diluted net income (loss) per share is computed using the weighted average common shares and common equivalent shares outstanding during the period.

3. BUSINESS COMBINATIONS AND ACQUISITIONS

The Company made no acquisitions in 1999 and the following acquisitions in 1998 and 1997:

CyberMedia, Inc.

On September 9, 1998, the Company obtained control of CyberMedia, Inc. ("CyberMedia"), a provider of desktop utility software solutions, when CyberMedia's stockholders tendered approximately 97% of the outstanding shares to the Company for \$9.50 per share in cash. On September 10, 1998, a subsidiary of the Company merged into CyberMedia in a transaction in which CyberMedia shares not tendered were converted into the right to receive the same per share cash price paid in the tender offer. Total cash paid to stockholders was \$130.4 million. The transaction was accounted for as

a purchase transaction. The total purchase price including transaction costs and assumed net liabilities was approximately \$174.3 million. As the Company had assessed and formulated its plans to terminate certain CyberMedia employees and close certain CyberMedia facilities as of the acquisition date, the total purchase price includes related liabilities of \$13.3 million. Of the total purchase price, \$22.8 million was allocated to in-process research and development. In addition, \$12.2 million was allocated to existing technology and other intangibles and \$139.3 million to goodwill, to be amortized over 3 and 7 years, respectively. To determine the value of the in-process research and development, the Company considered, among other factors, the stage of development of each project at the time of acquisition, the time and cost needed to complete each project, expected income from the projects, and the projected incremental cash flows from the projects when completed, and any associated risks. Associated risks include the inherent difficulties and uncertainties in completing a project and thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets. This analysis resulted in \$22.8 million being assigned to in-process research and development projects which had not yet reached technological feasibility and did not have alternative future use.

Dr Solomon's Group PLC

On August 13, 1998, the Company acquired Dr Solomon's Group PLC ("Dr Solomon's"), (the "Acquisition"), a European-based publicly-held provider of anti-virus software products for approximately 15.3 million shares of the Company's Common Stock (including 1.7 million shares held in trust pending the exercise of certain outstanding and fully vested Dr Solomon's options). In the Acquisition, each outstanding ordinary share of Dr Solomon's was exchanged for 0.27625 shares of Common Stock of the Company. The Company assumed all outstanding options to acquire Dr Solomon's ordinary shares.

The Acquisition was accounted for as a pooling of interests, and therefore all prior period financial statements have been restated to include the results of Dr Solomon's for all periods presented. Financial statements for the years ended December 31, 1997, 1996 and 1995 reflect the combination of the operating results of the Company for the years ended December 31, 1997, 1996 and 1995 and the operating results of Dr Solomon's for the years ended November 30, 1997, 1996 and 1995. The results of operations for the year ended December 31, 1998 reflect the results of operations of the Company for the year ended December 31, 1998 and the results of operations of Dr Solomon's for the thirteen months ended December 31, 1998.

Separate and combined results of operations for the periods prior to the merger are as follows (in thousands, except per share data):

	Year Ended December 31,			Six Months Ended June 30,	
	1997	1996	1995	1998	1997
REVENUES:					
Networks Associates	\$656,322	\$470,722	\$305,206	\$419,512	\$313,991
Dr Solomon's	\$79,370	\$44,275	\$23,335	\$55,898	\$35,167
Combined	\$735,692	\$514,997	\$328,541	\$475,410	\$349,158
NET INCOME (LOSS):					
Networks Associates	\$10,635	\$67,447	\$52,890	\$(6,305)	\$38,503
Dr Solomon's	\$4	\$(56,736)	\$862	\$502	\$3,678
Combined	\$10,639	\$10,711	\$53,752	\$(5,803)	\$42,181
NET INCOME (LOSS) PER SHARE - DILUTED:					
Networks Associates	\$0.09	\$0.58	\$0.48	\$(0.05)	\$0.33
Dr Solomon's	\$0.00	\$(6.34)	\$0.10	\$0.03	\$0.24
Combined	\$0.08	\$0.09	\$0.45	\$(0.04)	\$0.32

Trusted Information Systems

On April 28, 1998, the Company acquired Trusted Information Systems ("TIS"), a publicly-held provider of comprehensive security systems for computer networks. The acquisition was accounted for as a pooling of interests, and therefore all prior period financial statements have been restated to include the results of TIS for all periods presented. In the acquisition, a wholly owned subsidiary of the Company merged with and into TIS; TIS became a wholly owned subsidiary of the Company; and all outstanding Common Stock of TIS was converted into approximately 6.8 million shares of Common Stock of the Company, at an exchange ratio of 0.4845. The Company also assumed all outstanding options and other rights to acquire TIS capital stock.

Magic Solutions International, Inc.

On April 1, 1998, the Company acquired all of the outstanding capital stock and options of Magic Solutions International, Inc. ("Magic Solutions"), a privately held provider of internal help desk and asset management solutions, for approximately \$109.8 million in cash. The acquisition was accounted for using the purchase method of accounting, and the total purchase price was \$140.3 million, including transaction costs and assumed net liabilities. As the Company had assessed and formulated its plans to terminate certain Magic Solutions employees and close the Magic Solutions facilities as of the acquisition date, the total purchase price includes related liabilities of \$8.7 million. Approximately \$27.0 million of the total purchase price was expensed as purchased in-process research and development. The remaining excess of the purchase price over the net assets acquired was \$113.3 million, of which \$20.3 million has been recorded as purchased technology and trademarks and \$92.9 million as goodwill, which are being amortized on a straight-line basis over 5 and 7 years, respectively. To determine the value of the in-process research and development, the Company considered, among other factors, the stage of development of each project at the time of acquisition, the time and cost needed to complete each project, expected income from the projects, and the projected incremental cash flows from the projects when completed, and any associated risks. Associated risks include the inherent difficulties and uncertainties in completing a project and

thereby achieving technological feasibility and risks related to the impact of potential changes in future target markets. This analysis resulted in \$27.0 million being assigned to in-process research and development projects which had not yet reached technological feasibility and did not have alternative future use.

The following summary, prepared on a pro forma basis, combines the results of operations as if CyberMedia and Magic Solutions had been acquired as of the beginning of the periods presented, after including the impact of certain adjustments, such as amortization of intangibles, the write-off of in-process technology and the related income tax effects (dollars in thousands, except per share amounts):

Years Ended December 31,	1998	1997
(unaudited)		
Revenue	\$1,003,636	\$851,004
Net loss	(42,556)	(59,337)
Net loss per share	(0.32)	(0.47)

The pro forma results are not necessarily indicative of what actually would have occurred if the acquisition had been in effect for the entire periods presented. In addition, they are not intended to be a projection of future results and do not reflect any synergies that might be achieved from combined operations.

Other Acquisitions

On May 15, 1998, the Company acquired Secure Networks, Inc. ("Secure"). The aggregate consideration payable in the acquisition was 567,000 shares of the Company's Common Stock. The acquisition was accounted for as a pooling of interests, and therefore all prior period financial statements have been restated to include the results of Secure for all periods presented. Secure, based in Canada, is a developer and licensor of network security auditing software.

On August 31, 1998, the Company acquired QA Information Security Holding AB ("QA"). The consideration payable in the acquisition was 305,557 shares of the Company's Common Stock, in a transaction accounted for as a pooling of interests.

QA, based in Sweden, is a distributor of network security products.

On July 30, 1998, the Company acquired Anyware Seguridad Informatica S.A. ("Anyware"). The aggregate consideration payable in the acquisition was 228,204 shares of the Company's Common Stock, in a transaction accounted for as a pooling of interests. Anyware, based in Madrid, Spain, is a developer and distributor of anti-virus software products. The Company's financial statements have been restated for these poolings, the effect of which was not material.

The following table is a summary of acquisitions by the Company in the three years ended December 31, 1999:

	Common Stock issued in pooling of interests	Purchase price of purchase transactions
1998		
Syscon	1,230 shares	
Nordic	30,508 shares	
Magic Solutions		\$140.3 million
TIS	6,755,540 shares	
Secure	567,000 shares	
CSB	9,815 shares	
QA	305,557 shares	
Anyware	228,204 shares	
Dr Solomon's	15,813,142 shares	
CyberMedia		\$174.3 million
1997		
Network General	17,900,000 shares	
Jade K.K.	504,107 shares	
Schuijers Holdings B.V.	95,582 shares	
3DV Technology, Inc.		\$20.0 million
Compusul		\$2.6 million plus \$1.0 million contingently payable
Cinco Networks, Inc.		\$26.0 million
Paradigm Agency Pty. Ltd.		\$2.0 million
Helix Software Company	825,000 shares	
Pretty Good Privacy, Inc.		\$35 million plus warrants to purchase 375,000 shares of Common Stock at \$40 per share

4. MARKETABLE SECURITIES

At December 31, 1999 and 1998, marketable securities are summarized as follows (in thousands):

Available-For-Sale Securities 1999	Amortized Cost	Aggregate Fair Value	Unrealized Loss
(In thousands)			
U.S. Government debt securities	\$192,730	\$191,121	\$(1,587)
Municipal debt securities	69,676	68,954	(723)
Corporate debt securities	475,241	474,264	(960)
	\$737,647	\$734,339	\$(3,270)

Unrealized gains at December 31, 1999 include \$3.4 million related to unrealized gain on our investments in equity securities.

At December 31, 1999, all marketable debt securities had scheduled maturities of less than three years. Marketable debt securities totaling \$268.1 million have maturities of less than 3 months and are classified as cash equivalents.

Available-For-Sale Securities 1998	Amortized Cost	Aggregate Fair Value	Unrealized Gain (Loss)
(In thousands)			
U.S. Government debt securities	\$148,363	\$148,221	\$(142)
Municipal debt securities	53,463	53,677	214
Corporate debt securities	275,270	275,980	710
	\$477,096	\$477,878	\$782

Unrealized gains at December 31, 1998 include \$1.0 million related to unrealized gain on our investments in equity securities. At December 31, 1998, marketable debt securities totaling \$162.9 million had maturities of less than 3 months and are classified as cash equivalents.

5. DERIVATIVES

During fiscal year 1997, the Company began using forward foreign exchange contracts to hedge certain assets denominated in foreign currencies. For these instruments, risk reduction is assessed on a transaction basis, and the instruments are designated as a hedge and are highly inversely correlated to the hedged item as required by generally accepted accounting principles. Gains and losses on these hedges are included in the carrying amount of the assets and are ultimately recognized in income. If a hedging instrument ceases to qualify for hedge accounting, it is accounted for on a mark to market basis, and any subsequent gains and losses are recognized currently in income. The Company does not use any derivatives for trading or speculative purposes.

Forward Exchange Contracts

The Company conducts business globally. As a result, it is exposed to movements in foreign currency exchange rates. The Company enters into forward exchange contracts to hedge exposures associated with nonfunctional currency assets and liabilities denominated in Canadian, Australian, and several European currencies.

The Company does not generally hedge anticipated foreign currency cash flows nor does the Company enter into forward contracts for trading purposes. Gains and losses on the contracts are reported in other income and generally offset gains or losses from the revaluation of nonfunctional currency assets and liabilities. The forward contracts range from one to three months in original maturity.

The forward contracts outstanding and their unrealized gains and (losses) are presented below (in thousands):

	Notional Value Purchased	Notional Value Sold	Unrealized Gain (Loss)
Australian Dollar	\$—	\$6,600	\$(143)
Canadian Dollar	—	14,980	(309)
Dutch Guilder	—	—	—
Euro	37,571	—	(6)
Other European Currencies	43,626	—	258
	\$81,197	\$21,580	\$(200)

6. BALANCE SHEET DETAIL (IN THOUSANDS)

December 31,	1999	1998
FIXED ASSETS:		
Furniture and fixtures	\$15,918	\$16,520
Computers, demonstration and rental equipment	105,203	97,665
Leasehold improvements	13,191	13,464
	134,312	127,649
Less accumulated depreciation	(88,920)	(73,160)
	\$45,392	\$54,489
INTANGIBLES ASSETS (SEE NOTE 2):		
Purchased technology	\$68,490	\$68,905
Other	1,261	1,261
Goodwill	327,024	327,760
	396,775	397,926
Less accumulated amortization	(143,535)	(86,350)
	253,240	311,576
Other assets	13,622	12,376
	\$266,862	\$323,952
ACCRUED LIABILITIES:		
Accrued compensation	\$38,150	\$26,954
Accrued acquisition and merger costs	41	28,234
Accrued compensation - Cinco acquisition	—	10,837
Accrued legal and accounting	9,669	12,482
Accrued inventory	10,193	10,068
Accrued taxes	147,472	64,744
Other accrued expenses	47,537	56,751
	\$253,062	\$210,070

Depreciation and amortization expense for the years ended December 31, 1999, 1998 and 1997 was \$81.5 million, \$75.3 million and \$37.7 million respectively.

7. COMMITMENTS

Leases

The Company leases its operating facilities under non-cancelable operating leases, which expire at various times ranging from the year 2000 through 2013. In addition, the company has leased certain equipment with various lease expiration dates.

At December 31, 1999, future minimum payments under non-cancelable operating leases are as follows (in thousands):

Year Ending December 31,	
2000	23,874
2001	19,336
2002	16,589
2003	11,931
2004 and thereafter	88,158
	\$159,888

Rent expense for the years ended December 31, 1999, 1998 and 1997 amounted to \$15.1 million, \$10.8 million and \$12.4 million, respectively.

8. CONVERTIBLE DEBENTURES

On February 13, 1998, the Company completed a private placement of zero coupon convertible subordinated debentures due in 2018 (the "Debentures"). The debentures, with an aggregate face amount at maturity of \$885.5 million, generated net proceeds to the Company of approximately \$337.6 million. The initial price to the public for the debentures was \$391.06 per \$1,000 of face amount at maturity, which equates to a yield to maturity over the term of the bonds of 4.75% (on a semi-annual bond equivalent basis). The debentures are convertible into Common Stock at the rate of 8.538 shares per \$1,000 of face amount at maturity, which equates to an initial conversion price of \$45.80 per share. The Debentures are subordinated in right of payment to all existing and future Senior Indebtedness (as defined) and effectively subordinated in right of payment to all indebtedness and other liabilities of the Company's subsidiaries.

The Debentures may be redeemed for cash at the option of the Company beginning on February 13, 2003. At the option of the holder, the Company will purchase the Debentures on February 13, 2003, February 13, 2008 and February 13, 2013 at purchase prices (to be paid in cash or Common Stock or any combination thereof, at the election of the Company and subject to certain conditions) equal to the initial issue price plus accrued original issue discount to such dates. The Debentures may also be redeemed at the option of the holder if there is a Fundamental Change (as defined) at a price equal to the issue price plus accrued original issue discount to the date of redemption, subject to adjustment.

9. EMPLOYEE BENEFIT PLANS

401(k) and Profit Sharing Plan

Under the Company's 401(k) and Profit Sharing Plans, the Board of Directors, at its discretion, can match employee contributions in an amount not to exceed 20% of total compensation. Annual amounts provided by the Company under the plan to date have not been material.

Employee Stock Purchase Plan

Under the 1994 Employee Qualified Stock Purchase Plan, the Company can grant stock purchase rights to all eligible employees during one-year offering periods with exercise dates approximately every six months (beginning each August and February). The Company has reserved 3.8 million shares of Common Stock for issuance under the plan. Shares are purchased through employees' payroll deductions at exercise prices equal to 85% of the lesser of the fair market value of the Company's Common Stock at either the first day of an offering period or the last day of such offering period. No participant may purchase more than \$21,250 worth of Common Stock in any one calendar year.

10. MCAFEE.COM

McAfee.com is an Internet destination dedicated to updating, upgrading, and managing PCs over the Web for single-use retail, non-corporate consumers. In December 1998, the Company incorporated McAfee.com Corporation in Delaware as a wholly owned subsidiary. Since January 1, 1999, the Company has

contributed certain assets and liabilities to McAfee.com and has entered into certain inter-company arrangements including technology, licenses, shared facilities, functions, services, and tax sharing agreements. In December 1999, McAfee.com completed its initial public offering and began publicly trading under the symbol of "MCAF." The Company received net proceeds of \$78.9 million. The Company owns all of the outstanding Class B common stock, representing approximately 83% of McAfee.com's outstanding common stock at December 31, 1999.

In January 1999, executives of Networks Associates were granted options to purchase 1,710,000 shares (after restatement for the effects of a 2-for-1 stock split in June 1999, a reverse 3-for-5 stock split in July 1999, and share reduction/cancellation in September 1999) of McAfee.com common stock. In September and October 1999, certain Network Associates employees were also granted options to purchase 379,000 shares of McAfee.com common stock. As of December 31, 1999, all these options were fully vested. In connection with these options, the Company recorded total compensation expense for the year ended December 31, 1999 of approximately \$6.7 million.

11. STOCKHOLDERS' EQUITY

Preferred Stock

The Company has authorized 5,000,000 shares of Preferred Stock, par value \$.01 per share. The Company's Board of Directors has authority to provide for the issuance of the shares of preferred stock in series; to establish from time to time the number of shares to be included in each such series; and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations or restrictions thereof, without any further vote or action by the shareholders.

At December 31, 1998 there was one share of Series A Preferred Stock outstanding, which was issued in connection with the acquisition of FSA. The share of Series A preferred stock had no preferential rights other than the right to cast a number of votes equal to the number of common shares issuable in exchange for certain exchangeable non-voting shares of FSA. During 1999, that single preferred share was converted into

437,589 shares of the Company's Common Stock. At December 31, 1999, there was no Preferred Stock outstanding.

Stock Option Plans

In June 1997, the Board of Directors approved the 1997 Stock Incentive Plan (the "1997 Plan") to replace the 1995 Stock Incentive Plan. Under the amended 1997 Plan, the Company has reserved 16,475,000 shares for issuance to employees, officers, directors, third-party contractors and consultants. The plan provides for an option price no less than 100% of the fair market value of the Company's Common Stock on the date of grant for incentive stock options granted to employees and officers (including directors who are also employees) or 85% of the fair market value on the date of grant for all others. The options may be exercisable immediately or over time, generally vest 25% one year after commencing employment or from date of grant, and vest thereafter in monthly increments over three years. All options under the option plan expire ten years after grant.

Under the amended Stock Option Plan for Outside Directors, the Company has reserved 1,132,813 shares for issuance to certain members of its Board who are not employees of the Company or any affiliated corporation. The plan provides for an option price at fair market value of the Company's Common Stock on the date of grant. The initial grant to each outside director generally vests ratably over a three-year period. Subsequent option grants will vest after three years from the date of grant. All options under the option plan expire ten years after grant.

In December 1999, the Board of Directors approved the 2000 Nonstatutory Stock Option Plan. The company has reserved 3,000,000 shares for issuance to employees, officers, directors, third-party contracts and consultants. The plan provides for an option price at fair market value of the Company's Common Stock on the date of grant. The options vest over a period of four years: 25% vest one year from the date of grant and the remaining vest ratably in monthly increments over three years. All options under the option plan expire ten years after grant. As of December 31, 1999, no options had been granted from this plan.

Aggregate activity under stock option plans is as follows:

	Shares Available for Grant	Outstanding Options			
		Number of Shares	Price Per Share	Aggregate Price	Weighted Avg. Ex. Price
Balances, December 31, 1996	3,656,831	19,424,310	\$0.48 - \$74.23	232,579,079	\$11.98
Additional shares authorized	8,775,000				
Eliminate NGC duplicate period	83,016	223,466	\$0.53 - \$43.79	1,106,862	\$4.95
Shares granted	(9,669,921)	9,669,921	\$0.23 - \$79.21	282,196,266	\$29.18
Shares exercised	—	(4,998,801)	\$0.53 - \$40.20	(35,126,226)	\$7.03
Shares canceled	4,247,884	(4,247,884)	\$0.65 - \$44.42	(79,717,708)	\$18.77
Balances, December 31, 1997	7,092,810	20,071,012	\$0.23 - \$44.42	401,038,273	\$19.98
Additional shares authorized	3,000,000	—			
Shares granted	(11,397,414)	11,397,414	\$21.41 - \$121.80	419,774,937	\$36.83
Shares exercised	—	(8,560,824)	\$0.06 - \$44.42	(144,646,193)	\$16.90
Shares canceled	3,587,906	(3,587,906)	\$0.65 - \$48.38	(92,013,391)	\$25.65
Balances, December 31, 1998	2,283,302	19,319,696	\$0.06 - \$121.80	584,153,626	\$30.24
Additional shares authorized	9,200,000	—			
Shares granted	(16,881,939)	16,881,939	\$11.06 - \$56.00	242,970,168	\$14.39
Shares exercised	—	(1,196,165)	\$0.06 - \$44.42	(18,537,384)	\$15.50
Shares canceled	14,921,896	(14,921,896)	\$0.48 - \$121.80	(482,328,792)	\$33.08
Balances, December 31, 1999	9,523,259	20,083,574	\$0.06 - \$56.00	\$326,257,618	\$16.24

At December 31, 1999, a total of 8,133,388 options to purchase Common Stock were exercisable at an average exercise price of \$16.98. During 1999, the Company used 431,552 shares of treasury stock to fulfill employee option exercises.

At December 31, 1998 and December 31, 1997, approximately 3.7 million and 5.5 million outstanding options, respectively, were exercisable. The weighted average exercise price for exercisable options was \$21.59 and \$14.17 at December 31, 1998 and December 31, 1997, respectively.

The following information regarding the stock option program and employee stock purchase programs is provided in compliance with SFAS 123, "Accounting for Stock Based Compensation." The Company has elected to continue accounting for such plans in accordance with APB No. 25.

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/99	Weighted Average Remaining Contractual Life (yrs)	Weighted Average Exercisable Price	Number Exercisable at 12/31/99	Weighted Average Exercise Price
\$0.00 - \$12.18	10,649,094	7.5	\$10.49	4,706,161	\$9.77
\$12.18 - \$24.36	5,068,101	8.2	\$16.73	648,886	\$17.23
\$24.36 - \$36.54	4,107,517	6.7	\$28.84	2,696,756	\$28.68
\$36.54 - \$48.72	256,362	8.3	\$43.30	81,585	\$43.47
\$48.72 - \$60.90	2,500	2.1	\$56.00	0	0
\$0.00 - \$60.90	\$20,083,574	7.5	\$16.24	8,133,388	\$16.98

The fair market value of options granted has been calculated using the Black-Scholes option pricing model using the multiple option approach. A typical option grant vests over a four-year period. Parameters for the option analysis are listed below.

	1999	1998	1997
Risk-free interest rate	5.47%	5.04%	5.39%
Expected life (years)	4	4	4
Volatility	0.97	0.63	0.66
Dividend yield	0	0	0

The weighted average expected life of the option grants was estimated based on examination of previously exercised options over the life of the program. Volatility was estimated on a monthly basis since the company became public in October of 1992. The average volatility for the 36-month period from January 1997 through December 1999 was 75%. The Company has not paid a dividend, and has no plans to do so.

The weighted average fair value of options granted in 1999, 1998 and 1997 was \$14.39, \$19.08 and \$18.29, respectively.

The company has also estimated the fair value of purchase rights issued under the Employee Stock Purchase Program. Rights under this plan were also evaluated using the Black-Scholes option-pricing model. The company's plan is described in Note 9. Purchase periods occur twice yearly and each effectively contains a 6 and 12 month option.

	February 1997	August 1997	February 1998	August 1998	February 1999	August 1999
Risk-free interest rate	5.40%	5.44%	5.36%	5.28%	4.52%	5.01%
Expected life	6,12 mos	6,12 mos	6,12 mos	6,12 mos	6,12 mos	6,12 mos
Volatility	0.66	0.66	0.63	0.63	0.66	0.66
Dividend yield	—	—	—	—	—	—

The weighted average fair value of options granted pursuant to the Employee Stock Purchase Program in 1999, 1998 and 1997 was \$21.43, \$14.81 and \$10.77, respectively.

The following pro forma income information has been prepared following the provisions of SFAS 123.

	1999	1998	1997
Net loss – pro forma (thousands)	\$(209,890)	\$(35,002)	\$(46,671)
Net loss per share – diluted – pro forma	\$(1.51)	\$(0.26)	\$(0.37)

The impact on pro forma earnings per share and net income, in the table above, may not be indicative of the effect in future years as options vest over several years and the company continues to grant stock options to new employees. This policy may or may not continue.

Warrants

Pursuant to the acquisition of PGP, the Company issued warrants to purchase 375,000 shares of Common Stock at a price of \$40 per share, which expire, subject to certain extensions, on June 5, 2000. As of December 31, 1999, warrants for 315,816 shares were outstanding. The warrants issued pursuant to the acquisition of PGP were valued using the Black-Scholes model, using the following parameters: Stock price \$50.44 (prior to a 3:2 stock split in May 1998); Exercise price \$60.00 (prior to the 3:2 stock split); Term 1 year; Volatility 66%; Annual dividend 0%; Discount rate 5.5%. The resulting valuation of the 375,000 warrants was \$2,722,500, the total amount of which was included in the purchase price allocation. In addition, warrants for the purchase of 6,340 shares of Common Stock issued in connection with the Company's 1995 acquisition of Assurdata were exercised during the year ended December 31, 1998.

Preferred Shares Rights Agreement

On October 19, 1998, pursuant to a Preferred Shares Rights

Agreement between the Company and BankBoston, N.A. as Rights Agent, the Board of Directors of the Company announced that it had declared a dividend distribution of one preferred share purchase right (a "Right") on each outstanding share of the Company's Common Stock. Each Right will entitle stockholders to buy one-one thousandth of a share of the Company's Series B Participating Preferred Stock at an exercise price of \$200.00. The Rights will become exercisable following the tenth day after a person or group announces the acquisition of 15% or more of the Company's Common Stock or announces commencement of a tender or exchange offer, the consummation of which would result in ownership by the person or group of 15% or more of the Common Stock of the Company. The Company will be entitled to redeem the Rights at \$0.01 per Right at any time on or before the tenth day following acquisition by a person or group of 15% or more of the Company's Common Stock. The dividend distribution was made on November 3, 1998, payable to the stockholders of record on November 3, 1998. The Rights will expire on October 20, 2008.

12. PROVISION FOR INCOME TAXES

Income taxes have been provided using the liability method, in accordance with FASB No. 109, "Accounting For Income Taxes."

Pre-tax book income (loss) from continuing operations for the years ended December 31 was earned in the following jurisdictions (in thousands):

	1999	1998	1997
Domestic	\$(219,456)	\$123,535	\$55,222
Foreign	88,798	14,632	27,591
	\$(130,658)	\$138,167	\$82,813

Significant components of the provision (benefit) for income taxes attributable to continuing operations are as follows (in thousands):

Years Ended December 31,	1999	1998	1997
FEDERAL:			
Current	\$52,902	\$113,575	\$63,826
Deferred	(58,256)	(41,311)	(18,515)
Total Federal	(5,354)	72,264	45,311
STATE:			
Current	216	21,224	11,950
Deferred	(5,160)	(5,633)	(3,203)
Total State	(4,944)	15,591	8,747
Foreign	39,541	13,874	18,116
Provision for income taxes	\$29,243	\$101,729	\$72,174

Significant components of net deferred tax assets at December 31 are as follows (in thousands):

Years Ended December 31,	1999	1998	1997
Deferred revenue	\$10,786	\$10,390	\$1,387
State taxes	546	2,082	1,740
Accrued liabilities and reserves	54,354	53,394	28,349
Depreciation and amortization	43,581	30,533	11,917
Tax credits	56,211	—	—
Net operating loss carryover	71,168	30,130	10,597
	236,646	126,529	53,990
Valuation allowance	(63,556)	(22,458)	(7,728)
	173,090	104,071	46,262
Deferred liability	10,575	13,000	2,100
Net deferred tax asset	\$162,515	\$91,071	\$44,162
Current portion	\$93,904	\$65,866	\$30,089
Non-current portion	68,611	25,205	14,073
	\$162,515	\$91,071	\$44,162

Realization of net deferred tax assets of \$162.5 million as of December 31, 1999 is dependent on generating sufficient future taxable income, which is not assured. The amount of the deferred tax asset realizable, however, could be reduced in the near term if estimates of future taxable income are reduced. The net deferred tax asset at December 31, 1999 includes recognition of approximately \$8 million of foreign deferred tax assets.

At December 31, 1999, the Company has available net operating loss carryforwards for U.S. federal income tax return purposes of \$201.4 million, which expire from 2009 to 2020. A valuation allowance of \$20.8 million is recorded primarily for operating losses attributed to certain subsidiaries. Valuation allowances recorded for 1998 and 1997 include net operating losses acquired in connection with certain acquisitions. The

operating losses are subject to annual limitations and may expire before utilization by the Company.

At December 31, 1999, the Company has available foreign tax credit carryforwards of \$42.7 million, which expire in 2020. In addition, the Company has federal R&D credit carryforwards of \$9.0 million, which expire in 2005, and California R&D credit carryforwards of \$4.5 million, with no expiration. A valuation allowance of \$42.7 million is recorded for foreign tax credits due to uncertainty of future utilization.

U.S. income taxes were not provided for on a cumulative total of approximately \$13.8 million of undistributed earnings for certain non-U.S. subsidiaries. The Company intends to reinvest these earnings indefinitely in operations outside the United States.

The Company's effective tax rate on income before income taxes differs from the U.S. Federal statutory regular tax rate as follows:

Years Ended December 31,	1999	1998	1997
U.S. Federal income tax provision (benefit) statutory rate	(35.0%)	35.0%	35.0%
State taxes (benefit)	(4.1)	4.4	4.7
Non-deductible acquisition and other costs	17.8	29.6	48.9
Tax exempt interest income	—	(1.1)	(3.4)
Foreign earnings taxed at rates different than the U.S. rate	6.5	(6.3)	(7.1)
Goodwill and other permanent differences	16.1	16.3	10.6
Change in valuation allowance	31.5	—	—
Tax credits	(10.3)	(4.3)	(1.5)
	22.5%	73.6%	87.2%

13. NET INCOME (LOSS) PER SHARE

In accordance with the disclosure requirements of SFAS 128, a reconciliation of the numerator and denominator of basic and diluted net income (loss) per share is provided as follows (in thousands, except per share amounts):

Years Ended December 31,	1999	1998	1997
NUMERATOR – BASIC			
Net income (loss)	\$(159,901)	\$36,438	\$10,639
NUMERATOR – DILUTED			
Net income (loss)	\$(159,901)	\$36,438	\$10,639
Interest on convertible debentures (1)	—	—	—
	\$(159,901)	\$36,438	\$10,639
DENOMINATOR – BASIC			
Basic weighted average common shares outstanding	138,695	133,075	126,662
DENOMINATOR – DILUTED			
Basic weighted average common shares outstanding	138,695	133,075	126,662
EFFECTIVE OF DILUTIVE SECURITIES			
Common Stock options	—	5,534	6,067
Diluted weighted average shares	138,695	138,609	132,729
Net income (loss) per share – Basic	\$(1.15)	\$0.27	\$0.08
Net income (loss) per share – Diluted	\$(1.15)	\$0.26	\$0.08

(1) Convertible debt interest and related as-if converted shares are excluded from the 1998 calculation as they are anti-dilutive.

14. BUSINESS SEGMENTS AND MAJOR CUSTOMER INFORMATION

The Company has adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," effective for fiscal years beginning after December 15, 1997. In fiscal year 1998, the Company determined that it had a single reporting segment consisting of the development, sale, and support of computer security and management software. Since then, the Company established one of its subsidiaries, McAfee.com, as a separate business entity. As of December 31, 1999, the Company evaluated its product segments in accordance with SFAS 131 and concluded that its reportable segments are computer security and management software ("Infrastructure"), and consumer PC

security and management software on the Internet ("McAfee.com"). The Infrastructure segment consists of anti-virus, network management, security and help desk software. These products are marketed and sold through a direct sales force to distributors, retailers and end users in the United States, Europe, Asia Pacific and Latin America.

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

Summarized pre-tax financial information concerning the Company's reportable segments in the years ended December 31, 1999 and 1998 is provided as follows (in thousands):

	1999	1998
INFRASTRUCTURE:		
Net revenues	\$659,170	\$983,753
Segment profit (loss)	(131,976)	38,431
MCAFEE.COM:		
Net revenues	24,497	6,292
Segment loss	(27,925)	(1,993)
INFRASTRUCTURE:		
Total assets	\$1,384,107	\$1,534,283
MCAFEE.COM:		
Total assets	\$95,287	\$2,438

The table below presents information about the revenues and long-lived assets by geographical area as of and for the years ended December 31:

	1999	1998	1997
(In thousands)			
REVENUE			
United States	\$406,805	\$629,450	\$479,224
Netherlands	\$208,583	\$217,177	\$64,449
Other International	\$68,280	\$143,418	\$192,019
Total	\$683,668	\$990,045	\$735,692
LONG LIVED ASSETS			
United States	\$33,569	\$39,429	\$30,434
United Kingdom	\$—	\$6,713	\$11,420
Other International	\$11,823	\$8,347	\$6,474
Total	\$45,392	\$54,489	\$48,328

At December 31, 1999, one customer had an accounts receivable balance representing 12% of our total accounts receivable balance. No other customer had an accounts receivable balance greater than 10% of the total December 31, 1999 accounts receivable balance. During 1999, one customer accounted for 30% of the total revenue for the year. No other customer accounted for more than 10% of the total revenue in 1999.

15. LITIGATION

Securities Cases

Knisley v. Network Associates. On April 7, 1999, a putative securities class action, captioned *Knisley v. Network Associates, Inc., et al.*, Civil Action No. C-99-1729-SBA, was filed against Network Associates and several of its officers in the United States District Court for the Northern District of California. The complaint alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and seeks unspecified damages on behalf of a purported class of purchasers of Common Stock between January 20, 1998 and April 6, 1999. Twenty-five similar actions asserting virtually identical allegations have been filed by other plaintiffs. The Court has consolidated these cases and has appointed Lead Plaintiff. Other lead plaintiff candidates have appealed the District Court's appointment of Lead Plaintiff to the Ninth Circuit. The Ninth Circuit has stayed proceedings in the District Court, pending its review. Once an amended consolidated complaint is filed, defendants intend to move to dismiss.

Dow Jones Investment Club v. Network Associates.

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

Gage v. Network Associates. A similar case, captioned *Gage v. Network Associates, Inc., et al.*, Civil Action No. B C211552, has been filed in the Superior Court of California, County of Los Angeles. Plaintiffs allege violations of Sections 25400 et seq. of the California Corporations Code, Section 17200 of the California Business and Professions Code, and breach of fiduciary duty. The parties stipulated to transfer the action to Santa Clara County Superior Court, where it is now pending under Civil Action No. CV-785715. The complaint was dismissed with prejudice. Gage has until March 18, 2000 to file an amended complaint asserting individual claims. Discovery is ongoing.

Ong, et al. v. CyberMedia, et al. On September 14, 1998, CyberMedia and certain of its former officers and directors were named as defendants in a consolidated amended securities class action complaint filed in the United States District Court for the Central District of California. The consolidated amended complaint consolidated the following previously filed cases: *Ong v. CyberMedia, Inc., et al.*, No. 98-1811 CBM (Ex), filed on March 12, 1998, *St. John v. CyberMedia, Inc., et al.*, No. 98-2085 MRP (SHx), filed on March 24, 1998, *Zier v. CyberMedia, Inc., et al.*, No. 98-2210 CM (MCx), filed on March 26, 1998, *Liu v. CyberMedia, Inc., et al.*, No. 98-2617, filed on April 8, 1998, *Kerr, et al. v. CyberMedia, Inc., et al.*, No. 98-3104 RJK (ANx), filed on April 23, 1998, and *Barker v. CyberMedia, Inc., et al.*, No. SA CV-98-401 AHS (ANx), filed on May 6, 1998. Plaintiffs filed a second consolidated amended complaint on March 8, 1999. It alleges that the defendants violated federal securities laws by artificially inflating the price of CyberMedia stock to the detriment of a purported class of investors who purchased or otherwise acquired CyberMedia stock between March 31, 1997 and March 12, 1998. CyberMedia and certain of its former officers and directors were also named as defendants in three securities class action lawsuits filed in the Superior Court of Los Angeles County. Such complaints have been ordered consolidated, although a consolidated amended complaint has not yet been filed. The consolidated complaints include: *Brown v. CyberMedia, Inc., et al.*, No. B C187898, filed on March 19, 1998, *Smith v. CyberMedia, Inc., et al.*, No. B C188527, filed on March 31, 1998, and *Stockwell v. CyberMedia, Inc., et al.*,

No. B C189020, filed on April 8, 1998. The complaints allege that defendants violated California state securities laws and common law by artificially inflating the price of CyberMedia stock to the detriment of a purported class of investors who purchased or otherwise acquired CyberMedia stock between March 31, 1997 and March 13, 1998. Network Associates has reached an agreement with plaintiffs to settle the state and federal securities class actions. The settlement provides for a payment of \$11.5 million plus interest from approximately May 6, 1999, \$1.5 million (and interest on that amount) of which is to be paid by Network Associates and the remainder of which is to be paid by the Company's insurers. The parties memorialized the agreement in a Stipulation of Settlement lodged with the District Court on November 12, 1999. The Court preliminarily approved the settlement on December 15, 1999, and a hearing is currently set for March 27, 2000 to determine whether final approval will be granted. Consummation of the settlement is contingent upon final judicial approval.

Other Litigation

Trend Micro, Inc. v. Network Associates. On May 13, 1997, Trend Micro, Inc. ("Trend") filed suit in United States District Court for the Northern District of California against both Network Associates and Symantec. Trend currently alleges that Network Associates' "WebShield" and "GroupShield" products infringe a Trend patent which was issued on April 22, 1997. Trend's complaint seeks injunctive relief and unspecified money damages. On June 6, 1997, Network Associates filed its answer denying any infringement. Network Associates also filed counterclaims against Trend alleging unfair competition, false advertising, trade libel, and interference with prospective economic advantage.

The Court held a patent claim interpretation hearing on September 1, 1998. The Court issued a ruling on claim interpretation on or about December 29, 1998. In addition, Trend filed a supplemental complaint on October 5, 1998, adding the "Gauntlet" product to the list of products that allegedly infringe Trend's patent. At a case management conference held on October 2, 1998, the Court set a new trial date of November 8, 1999. The trial has since been postponed and is

now scheduled for May 1, 2000. The parties are engaged in completing expert discovery and preparing for trial.

Hilgraeve v. Network Associates. On September 15, 1997, Network Associates was named as a defendant in a patent infringement action filed by Hilgraeve Corporation ("Hilgraeve") in the United States District Court, Eastern District of Michigan. Hilgraeve alleges that Network Associates' VirusScan product infringes a Hilgraeve patent which was issued on June 7, 1994. Hilgraeve's action seeks injunctive relief and unspecified money damages. All discovery has been completed. The Court heard Network Associates' motions for summary judgment of non-infringement on May 20, 1999 and granted the motion in a written opinion dated June 10, 1999. The Court entered judgment in favor of Network Associates on July 7, 1999. Hilgraeve has filed an appeal from the judgment to the United States Court of Appeals for the Federal Circuit. That appeal is pending.

Foremost Systems v. Network Associates,

No. CV 777301 (Santa Clara County). A former agent of Network Associates in India, Foremost Systems Pvt. Ltd., filed this action on October 14, 1998, in California State court and filed a Second Amended Complaint on February 18, 2000. Network Associates removed the action to the United States District Court, Northern District of California, San Jose Division. The Second Amended Complaint alleges that Network Associates wrongly terminated Foremost Systems in breach of their agency agreement and, in addition, contains counts for breach of oral contract, promissory estoppel, intentional and negligent misrepresentation, breach of fiduciary duty, tortious interference with contractual relations, unfair competition, and racketeering in violation of 18 U.S.C 1962 et seq.

Homenexus Inc. f/k/a HomeRun Network, Inc. v. DirectWeb, Inc., et al, No. 99-CV-2316 (CRW) (E.D. Pa.). In this action, filed in federal court in the Eastern District of Pennsylvania on May 5, 1999, plaintiff Homenexus alleges that DirectWeb successfully conspired with all defendants, including Network Associates and William Larson, to wrongly misappropriate plaintiff's purported proprietary business plan

and to deliberately infringe plaintiff's purported trade dress in its alleged Web site. The complaint further alleges that all defendants conspired to commit, and did commit, the torts of conversion and unfair competition. Plaintiff has indicated that it intends to amend the complaint to add a new defendant. Network Associates and William Larson deny the charges against them. To date, the parties have taken limited discovery.

Symantec Litigation

On December 20, 1999, Network Associates entered into a settlement agreement resolving the Symantec I, Symantec II, and CyberMedia/Symantec cases as well as the Symantec State Action (such terms are defined below). Dismissals of each of these actions have been, or are in the process of being, filed. The *CyberMedia v. Symantec* litigation, as described below, remains on file as to defendant ZebraSoft.

Symantec v. Network Associates (USDC). On April 24, 1997, Network Associates was served by Symantec with a suit filed in the United States District Court, Northern District of California, San Jose Division, alleging copyright infringement and unfair competition by Network Associates ("Symantec I"). Symantec alleges that Network Associates' computer software program called "PC Medic" copied portions of Symantec's computer software program entitled "CrashGuard." Symantec's complaint sought injunctive relief and unspecified money damages. On July 20, 1997, Symantec sought leave to amend its complaint to include additional allegations of copyright infringement and trade secret misappropriation pertaining to Network Associates' "VirusScan" product. Symantec sought injunctive relief and unspecified money damages. On October 6, 1997, the Court issued an order granting Symantec's motion to amend its complaint and enjoining Network Associates from shipping any product containing either an approximately 30-line routine found in CrashGuard or an approximately 100-line routine found in Symantec DLL. The Court's order expressly stated that "the court is not enjoining the sale or distribution of [McAfee's] current product." On December 19, 1997, the Court denied Symantec's motion to enjoin sale or distribution of Network Associates' current PC Medic product. On April 1, 1998,

Symantec filed an amended complaint including additional allegations of trade secret misappropriation, unfair competition, interference with economic advantage and contractual relations, and violations of the Racketeer Influenced and Corrupt Organization Act ("RICO"), in connection with the alleged use by Network Associates employees of a proprietary Symantec customer database. On June 9, 1998, the Court dismissed Symantec's RICO claims without prejudice and dismissed Symantec's unfair competition claims relating to alleged use of source code with prejudice. On June 15, 1998, the Court entered a stipulated preliminary injunction prohibiting Network Associates from making use of any Symantec customer list data. On September 4, 1998, Symantec's time for amending its complaint expired; Symantec did not refile its RICO claims. On October 8, 1998, the Court granted partial summary judgment in Network Associates' favor dismissing with prejudice Symantec's claims for interference with economic and contractual relations, Symantec's trade secret claims relating to alleged misappropriation of source code and portions of Symantec's copyright claims.

On October 22, the Court consolidated this case for purposes of trial with an action originally brought on February 4, 1998 by CyberMedia Inc. (acquired by Network Associates in September 1998) against Symantec (described below) and the action brought by Symantec against Network Associates on September 4, 1998 (described below).

Symantec v. Network Associates (USDC). On September 4, 1998, Symantec filed suit in United States District Court for the Northern District of California, San Jose Division, against Network Associates, alleging copyright infringement, unfair competition, and trade secret misappropriation ("Symantec II"). Symantec alleges that an unidentified Network Associates employee copied and transported to Network Associates certain proprietary Symantec files, including files containing Norton Antivirus software. On January 20, 1999, the Court dismissed those portions of Symantec's claims relating to Network Associates' PC Medic and VirusScan products. Symantec also alleges that another unidentified Network Associates employee located in

Canada copied and transported to Network Associates certain other unidentified files containing Symantec confidential information.

CyberMedia v. Symantec. On February 4, 1998, CyberMedia filed a lawsuit against Symantec in United States District Court for the Northern District of California ("CyberMedia"). Also named as defendants in the complaint are ZebraSoft, Inc. ("ZebraSoft") and three individual officers and directors of ZebraSoft. The complaint alleges that the defendants violated federal copyright laws and misappropriated CyberMedia's trade secrets in developing and distributing a computer software program, known as Norton Uninstall Deluxe, that is competitive with CyberMedia's UnInstaller program. The complaint seeks money damages and injunctive relief against the defendants.

On September 3, 1998, the United States District Court for the Northern District of California issued a preliminary injunction preventing the defendants from manufacturing, marketing or distributing any existing version of their competing program, and requiring defendants to issue a "Notice of Recall" to all distributors regarding the existing versions of the program. The injunction was effective throughout the United States. On November 30, 1998, the Court issued a further order, pursuant to an agreement of the parties, prohibiting Symantec from manufacturing, distributing or advertising Norton Uninstall Deluxe anywhere in the world.

The defendants have filed counterclaims against CyberMedia for slander, libel, product disparagement and related state law claims, seeking unspecified money damages.

Symantec v. Network Associates (Superior Court). On April 27, 1999, Network Associates was served by Symantec with a suit filed in the Superior Court of California, County of Santa Clara ("Symantec State Action"). The suit alleges malicious prosecution in connection with an earlier suit Network Associates brought against Symantec for defamation and related claims, which was dismissed in December 1997.

16. RECENT ACCOUNTING PRONOUNCEMENTS

Effective January 1, 1998, the Company adopted Statement of Position ("SOP") No. 97-2, "Software Revenue Recognition" and SOP No. 98-4, "Deferral of the Effective Date of a Provision of SOP No. 97-2." Prior to 1998, the Company recognized revenues in accordance with SOP No. 91-1, "Software Revenue Recognition." In December 1998, the American Institute of Certified Public Accountants ("AICPA") issued SOP No. 98-9, "Modification of SOP No. 97-2, Software Revenue Recognition, with Respect to Certain Transactions." SOP No. 98-9 clarifies certain provisions of SOP No. 97-2 that were previously deferred by SOP No. 98-4, and effectively defers the required adoption of those provisions until the Company's fiscal year beginning January 1, 2000. The adoption of SOP No. 98-9 is not expected to have a material impact on the Company's results of operations, financial position or cash flows.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 requires the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through net income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of the derivative are either offset against the change in fair value of assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. SFAS 133, as amended, is effective for quarters beginning after June 15, 2000.

In February 1998, the Accounting Standards Executive Committee ("AcSEC") issued Statement of Position No. 98-1 (SOP 98-1), "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." SOP 98-1 establishes the accounting for costs of software products developed or purchased for internal use, including when such costs should be capitalized. Adoption of this pronouncement, which is effective for fiscal 1999, did not materially impact the Company's results of operations.

In July 1999, the FASB issued Statement of Financial Accounting Standards No. 137, or SFAS No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB No. 133." SFAS 137 deferred the effective date of SFAS 133 until the first fiscal quarter beginning after June 15, 2000.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 (SAB 101), "Revenue Recognition in Financial Statements." SAB 101 provides guidance for revenue recognition under certain circumstances. The Company is currently evaluating the impact of SAB 101 on its financial statements and related disclosures, but does not expect that such impact, if any, will be material. The accounting and disclosures prescribed by 101 will be effective for our fiscal year ended December 31, 2000.

17. RELATED PARTY TRANSACTIONS

The Company purchased 3,948,199 shares of Series A preferred stock of DirectWeb, Inc. for \$2.5 million, and 4,615,385 shares of Series B preferred stock for \$6.0 million in 1999. DirectWeb, Inc. is a subscription-based online service offering a complete turnkey Windows-98 based PC, unlimited Internet access and technical support for a fixed user-only fee. In connection with the formation of DirectWeb, the Company received a warrant to acquire 3,175,000 shares of DirectWeb common stock for total consideration of \$317.50. Prior to the transactions described below, on an as converted basis and excluding shares that may be acquired upon exercise of its warrant, the Company's total DirectWeb investment represented approximately 12.3% of DirectWeb's outstanding capital stock. With respect to this balance, approximately 35.2% is owned by William L. Larson, a DirectWeb founder and the Company's Chief Executive Officer; 35.4% is owned by Dennis Cline, a DirectWeb founder and the Company's former Vice President of Worldwide Sales; and 17.1% is owned by unrelated third-party investors who, along with the Company, invested in DirectWeb's Series A and Series B preferred stock.

In November 1999, the Company sold its 12.3% ownership to Dennis Cline, resulting in a net loss of \$2.5 million to the Company. At that time, the Company also agreed to exchange its

warrant to acquire 3,175,000 shares of DirectWeb common stock for a warrant to acquire \$2 million worth of DirectWeb Series C preferred stock at the same price per share as paid by the series C preferred stock investors. William L. Larson sold approximately 83.0% of his stake in DirectWeb to Dennis Cline in November 1999. He retains an approximately 5.9% ownership interest in DirectWeb.

18. STOCK OPTION REPRICING AND STOCK REPURCHASE PLAN

On April 22, 1999, the Company offered to substantially all of its employees, excluding executive officers, the right to cancel certain outstanding stock options and receive new options with exercise prices at the current fair market value of the stock. Options to purchase a total of 10.3 million shares were canceled, and the same number of new options were granted at an exercise price of \$11.063, which was based on the closing price of the Company's Common Stock on April 22, 1999. The new options vest at the same rate that they would have vested under previous option plans. As a result, options to purchase approximately 3.3 million shares at \$11.063 were vested at December 31, 1999; however the new options cannot be exercised for a period of twelve months from the date the options were repriced, regardless of vesting status.

In accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," the Company incurred an initial stock based compensation charge in connection with this repricing. This charge was calculated based on the difference between the exercise price of the new options and their market value on the date of acceptance by employees. Approximately \$0.7 million and \$8.8 million were expensed in the three months and year ended December 31, 1999, respectively; and approximately \$11.6 million will be expensed over the remaining vesting period.

On March 31, 1999, the Financial Accounting Standards Board ("FASB") issued an exposure draft of its Proposed Interpretation, "Accounting for Certain Transactions Involving

Stock Compensation — an interpretation of APB Opinion No. 25" (the "Proposed Interpretation"). Under the Proposed Interpretation, stock options repriced after December 15, 1998 will be subject to variable plan accounting treatment. If adopted, this proposed guidance will require the Company to remeasure compensation cost for outstanding repriced options each reporting period, based on changes in the market value of the underlying Common Stock after the date of adoption. The FASB currently expects to approve the release of this interpretation in the second quarter of 2000. Depending upon movements in the market value of the Company's Common Stock, this proposed accounting treatment may result in significant additional compensation charges in future periods.

In May 1999, the Board of Directors authorized the Company to repurchase up to \$100 million of its Common Stock in the open market. In the year ended December 31, 1999, the Company repurchased 685,000 shares of its Common Stock for a total cash outlay of approximately \$12.4 million. The timing and size of any future stock repurchases are subject to market conditions, stock prices, the Company's cash position, and other cash requirements.

On August 3, 1999, Network Associates sold "European style" put options for 1,000,000 shares of the Company's Common Stock as part of its stock repurchase plan. European style put options can only be exercised on the expiry date, which is August 3, 2000. The strike price for these put options is \$20.00, and the Company received total proceeds of \$5,250,000 from that sale.

19. FIXED ASSETS SALE-LEASEBACK

On September 20, 1999, the Company sold approximately \$6.6 million of fixed assets, consisting mostly of computer equipment, to a third party and leased them back under an operating lease. The initial term of the lease is 12 months, with an option to renew the lease for an additional 12 months.

20. SUBSEQUENT EVENTS (UNAUDITED)

On February 4, 2000, several companies acquired a less than 4% minority equity interest in NAI KK, our Japanese subsidiary, for a combined total of approximately \$11.9 million.

On February 16, 2000, Network Associates sold "European style" put options for 1,000,000 shares of the Company's Common Stock as part of its stock repurchase plan. European style put options can only be exercised on the expiry date, which is February 16, 2001. The strike price for these put options is \$30.00, and the Company received total proceeds of \$7,890,000 from the sale.

On March 10, 1999, the Company acquired 597,062 shares of Tesseract Information Systems, Inc. for approximately \$10 million. Shortly thereafter, Tesseract was acquired by Cadabra, Inc. and, in January 2000, Cadabra Inc. was acquired by Goto.com. The Company's Cadabra shares were converted into 554,093 shares of Goto.com, and the Company received \$1.2 million in cash. In February 2000, the Company sold the majority of its Goto.com shares for a net realized gain of approximately \$28.4 million.

FINANCIAL REGISTRAR

TRANSFER AGENT AND REGISTRAR

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c/o Boston EquiServe
P.O. Box 8040
Boston, Massachusetts 02266-8040

INDEPENDENT ACCOUNTANTS

PricewaterhouseCoopers
San Jose, California

GENERAL COUNSEL

Wilson Sonsini Goodrich & Rosati
Palo Alto, California

BOARD OF DIRECTORS

WILLIAM L. LARSON

Chairman and Chief Executive Officer

LESLIE L. DENEND

Former President of the Company

VIRGINIA GEMMELL

President, GlidePath, Inc.

EDWIN L. HARPER

President, Manufacturing Technology, Inc.
Also on the boards of Apex, Inc., MT and UltraCo, Inc.

ENZO TORRESI

Founding Partner, Eurofund Partners
Also on the boards of PictureTel and Optibase

CORPORATE REPORTS

A copy of the 1999 Network Associates Form 10-K may be obtained without charge by calling or writing the Corporate Secretary at Corporate Headquarters.

ANNUAL MEETING

The annual meeting of stockholders will be held at 1:00PM on May 25, 2000, at the Santa Clara Marriott.

EXECUTIVE MANAGEMENT

WILLIAM L. LARSON

Chairman and Chief Executive Officer

PRABHAT GOYAL

Chief Financial Officer

PETER WATKINS

President and Chief Operating Officer

ZACHARY NELSON

President and Chief Executive Officer, myCIO.com

SRIVATS SAMPATH

President and Chief Executive Officer, McAfee.com