

SECURE COMPUTING

ANNUAL REPORT

97

SECURE COMPUTING CORPORATION

9

is one of the leading developers of enterprise network security technology in the world. We offer a broad portfolio of scaleable, interoperable, standards-based products, which combined with our sophisticated consulting services, provide organizations with complete end-to-end security solutions for doing business on the Internet.

From our early days of developing security technology for the National Security Agency, Secure Computing has a long history of pioneering the most advanced security solutions on the market. Our products encompass all aspects of Internet security, including firewalls, Web filtering, identification, authentication, authorization, encryption and extranet technologies. With one of the largest assembled group of security experts in the industry, we offer a full suite of security consulting services, including Internet and internal penetration testing, security assessment and policy development.

Secure Computing has a worldwide presence in financial services, telecom, aerospace, manufacturing, and hi-tech industries, ranging from Fortune 1000 companies to service providers and government agencies.

This Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, beliefs, intentions or strategies regarding the future. All forward-looking statements included in this Annual Report are based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any such forward-looking statement. It is important to note that the Company's actual results could differ materially from those in such forward-looking statements as a result of a number of factors, including those set forth on pages 40-43 under the caption "Certain Factors That May Affect Future Results."

7

Net (Loss) Per Share		
95		(\$.08)
96		(1.76)
97		(.27)

Total Revenues (in millions)		
95		\$27.9
96		40.3
97		47.0

Total Assets (in millions)		
95		\$44.3
96		36.8
97		31.1

Financial Highlights	1
Report to Our Shareholders	2
Market Leadership	6
Security Foundation	8
Network Security Services	10
Next Generation Security	12
Product Portfolio	14

FINANCIAL REVIEW

Selected Financial Data	17
Management's Discussion and Analysis	17
Consolidated Balance Sheets	25
Consolidated Statements of Operations	26
Consolidated Statement of Stockholders' Equity	27
Consolidated Statements of Cash Flows	28
Notes to Consolidated Financial Statements	29
Report of Independent Auditors	39
Certain Factors That May Affect Future Results	40

financial

HIGHLIGHTS

Year Ended December 31

(in thousands except per share amounts and percentages)

	1997	1996	1995
Products and services revenue	\$ 33,203	\$ 23,290	\$ 13,081
Government contracts revenue	13,773	16,972	14,849
Total revenue	46,976	40,262	27,930
Gross profit	28,210	21,465	13,079
Selling and marketing expense	20,469	18,425	5,376
Research and development expense	8,736	9,575	4,869
General and administrative expense	3,839	6,869	3,467
Acquisition Costs —	—	13,069	-
Total operating expenses	33,944	47,938	13,712
Net (loss)	(4,251)	(25,094)	(632)

At December 31

	1997	1996
Cash and cash equivalents	\$ 4,880	\$ 12,130
Total assets	23,429	29,429
Total liabilities	6,254	10,543
Total stockholders' equity	24,800	26,232

LETTER to the

SHAREHOLDERS



NINETEEN-NINETY-SEVEN MARKED AN IMPORTANT TURNING POINT FOR SECURE COMPUTING.

In 1997, our strategy for transforming Secure into a market driven company came to fruition. It was a year of very hard – and very focused – work. But today, Secure has an integrated portfolio of innovative information security solutions and a network for delivering them to markets worldwide.

The defining achievement of the year – and for me, the most satisfying – was the fulfillment of our promise to investors that we would turn the company to profitability in the fourth quarter of 1997. Net income for that quarter was \$305,000 on record revenues of \$12.8 million.

Arriving at this milestone was the culmination of a year of continued strong financial performance, with consistent quarter over quarter revenue growth. Total revenue in 1997 was \$47.0 million, compared to \$40.3 million the previous year, a 16.6% increase. Net loss for the year was \$4.3 million, compared to a 1996 loss of \$25.1 million.

Our reliance on government contract revenues decreased as Secure continued its shift toward higher margin commercial product and services revenues, which accounted for 71% of total revenues in 1997, up from 56% in 1996. Gross margins for the year were at a record level of 60%, compared to 53% in 1996.

THE YEAR WAS HIGHLIGHTED BY A NUMBER OF SIGNIFICANT ACCOMPLISHMENTS.

We completed the integration of the three companies that we acquired in 1996, and with that, completed the transformation of Secure Computing from a firewall company into a true Internet security company. Secure now has a common R&D strategy, with teams from across the company working together to develop new products; a single, unified sales organization, with every member of the sales force and all of our resellers fully trained and authorized to sell our entire line of firewalls, filters and authentication systems; a unified and sharply focused marketing team; and most importantly, an integrated portfolio of enterprise-wide solutions that work together to address customer requirements.

Secure's leadership in the Internet security market rests on the technological strength of the solutions that we offer. Last year, we extended the capabilities and increased the channel readiness of our entire product portfolio. We integrated and enhanced our flagship product lines, responding to easily identified as well as emerging market requirements. This discipline focused on core security strengths – such as proxies, dynamic Virtual Private Networks and email filtering – plus differentiators in ease and cost of security management. We also introduced a broad, channel ready security portfolio for Microsoft Windows NT, laying the foundation for announcing the first Microsoft BackOffice compliant firewall in January 1998.

In 1997, we became the first security vendor to commercially deliver complete, interoperable enterprise-wide solutions for organizations ranging from smaller businesses to multinational corporations with complex, distributed computing environments – a significant competitive advantage in an industry dominated by companies that offer what is often little more than incompatible point products.

For marketing, innovation and integration garnered impressive results. We introduced a new branding system, from corporate logo to products and services, launched our first corporate advertising and direct marketing campaigns, doubled our lead generation results, centralized public relations, and established a modern and efficient collateral system for our aggressive channel strategy.

To capitalize on these technologies as more companies move mission-critical business operations online and the demand for network security increases, we have expanded our sales force worldwide and restructured it around three primary markets: International, Federal and the Americas. We are also moving away from direct sales and focusing primarily on channel partners, and we expect that their knowledge of particular industries, local markets and customers will allow us to extend the reach of our own internal sales force.

In 1997, we put much of this framework in place. We created the international sales organization essentially from scratch, opening offices in London, Paris, Munich, Amsterdam and Sydney. Their sales have increased steadily throughout the year, accounting for 40% of Secure's total revenues in the fourth quarter.

We also engaged more than 300 resellers and redirected sales through third party channels. We began the year selling mostly through our direct sales force. By the end of the year, 70% of our Federal sales, 75% of our Americas sales and 100% of our International sales were through our network of resellers.

Secure Computing is a global company, with customers that do business around the world. But certain aspects of Internet security must be tailored to meet the unique language and cultural needs of individual countries. This is particularly true for URL filtering. Last year, we entered into an agreement with ViRT Corporation, a leading Japanese information technology distributor, to translate and sell our SmartFilter Control list in Japan, currently the second largest market for server-based URL filtering products worldwide. As we expand our global sales infrastructure further, we will rely on similar collaborations with leading resellers in other countries to help us localize our products for other markets as well.

Industry alliances with platform vendors and networking suppliers who promote our products in conjunction with their own provide another critical source of sales leverage. Last year we established a number of such relationships, most notably with Cisco Systems, Stratus Computer and Digital Equipment.

Last year, we launched our Secure Professional Services program to provide business and government clients with such services as Internet penetration testing, security assessments and security policy development. This program will allow our resellers and their customers to better leverage Secure's portfolio of information security solutions by combining the plug-and-play ease of use of those solutions with the ability to customize them to meet each user's unique security requirements.

Internet security is an unforgiving business. It's also a very secretive one. Because of the nature of what we sell, our customers rarely permit us to publicize how they use our products and services – or for that matter, even the fact that they actually use them. A notable exception underscores the impact of our solutions. Last year, after extensive testing of several commercial firewall products, the U.S. Air Force ordered 41 Sidewinder systems.

It has been a challenging year, and one filled with accomplishments. I would like to thank our board, our management team, and every employee of the company, for their commitment to Secure Computing. To have turned a company of this complexity around in such a short period of time is a rare achievement, and one in which we should all take pride in.

The Internet is expanding at a phenomenal rate, and opportunities for growth in the network security market are substantial. We believe that Secure Computing is in an excellent position to capitalize on those opportunities.

A handwritten signature in black ink, reading "Jeffrey H. Waxman". The signature is fluid and cursive, with a long horizontal stroke at the end.

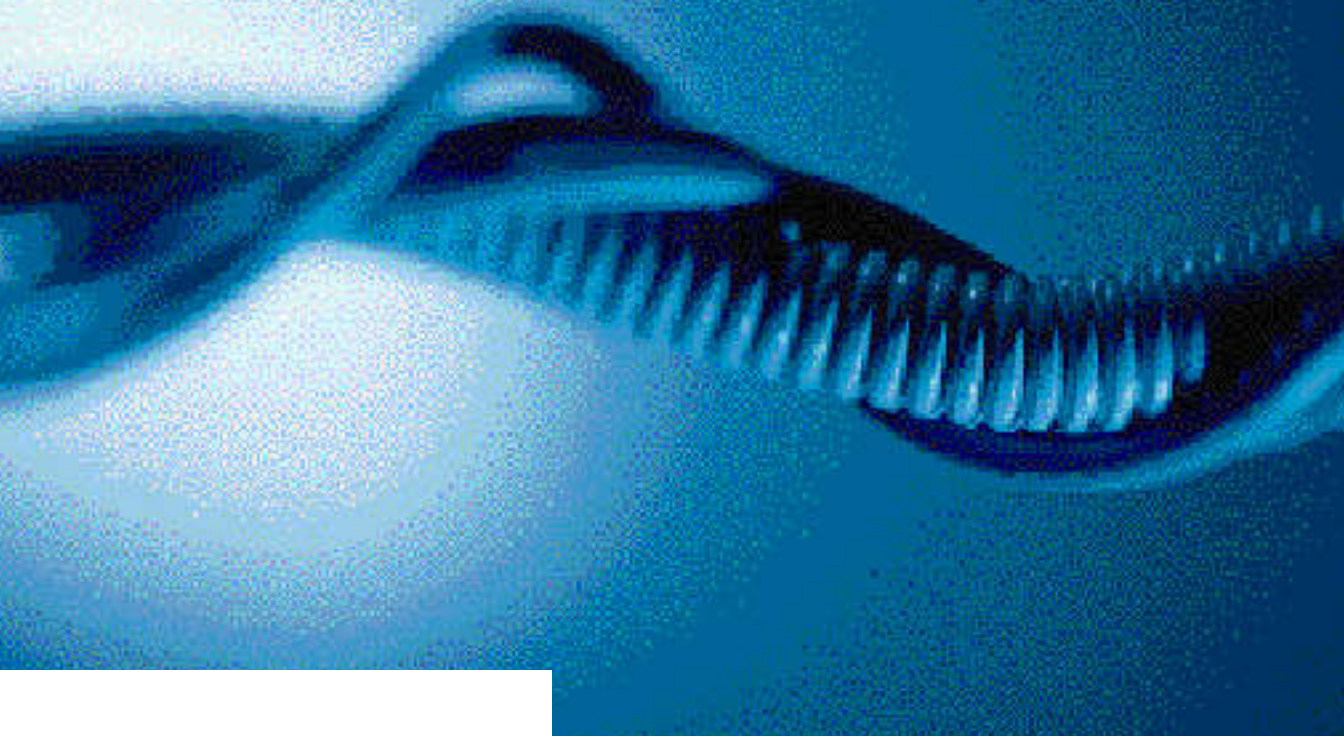
JEFFREY H. WAXMAN
Chairman & Chief Executive Officer

S E C U R E

t h e

WIRED

W O R L D



Organizations in every industry are increasing productivity and competitiveness by moving mission-critical business functions to new Internet-related applications. Numerous studies show that network security is a primary concern for organizations leveraging the wired world. To gain confidence and realize the full revenue potential of their Internet and applications investments, organizations are adopting new network security technologies and practices at a fast pace.

The demand for robust network security technology has created a market that is expected to exceed \$5 billion worldwide by the year 2000, with growth averaging over 50% per year. Secure Computing is a leader in many of the core segments of the Internet security market. We are the number one vendor, in revenue and market share, of firewalls to the Federal government; the leading vendor of Web filtering technology, a market category that we created; and the number two vendor of authentication solutions, technologies critical

for financial, telecommuting and other networked applications; and the number three vendor in the combined authentication / encryption market.

LEADING INTERNET SECURITY ANALYSTS
RECOGNIZED SECURE COMPUTING'S RAPID
PROGRESS IN 1997. FOR EXAMPLE, GARTNER
GROUP RATED SECURE COMPUTING AS ONE
OF THE MOST VISIONARY SECURITY VENDORS
WHILE BOOSTING OUR RELATIVE RANKING
ON MANAGEMENT STRENGTH BASED ON
FACTORS SUCH AS COST CONTROL, NEW
PRODUCTS AND INTEGRATION.

PARTNERS

SECURE COMPUTING SOLUTIONS REACH
CUSTOMERS THROUGH A GLOBAL NETWORK
OF AUTHORIZED VALUE ADDED RESELLERS
AND DISTRIBUTORS, ALLIANCES WITH
LEADING HIGH TECHNOLOGY COMPANIES, AND
CORPORATE/OEM SALES. REPRESENTATIVE
PARTNERS INCLUDE ANIXTER, AVENTAIL, CISCO,
COMPUSERVE, DIGITAL, MICROSOFT, NETSCAPE,
PEAPOD, SIEMENS NIXDORF, STRATUS
COMPUTER, SYMANTEC, TECH DATA AND VIRT.

The Internet is a hostile environment for sensitive information. Networks wholly owned by an organization also can become hostile as more users and information come online and computing resources expand and change. Secure Computing offers a flexible, modular and scaleable portfolio of standards-based interoperable products that protect networks from security risks inside and outside the organization.

Our Secure OS™ firewalls provide a high level of security for protecting network perimeters, for security-sensitive commercial, government and defense networks. For sites with higher risk tolerance, our firewall designed for Microsoft BackOffice integrates robust security with native Windows NT services, offering a combination of security, economy and ease of use. Our strong authentication product family protects the privacy and integrity of users and information alike, whether local or remote, by enforcing authorized-only access and protecting passwords. Fault tolerance permits non-stop operation. Our Web monitoring and filtering products help organizations manage productivity, preserve network bandwidth and reduce legal liability.

H I G H

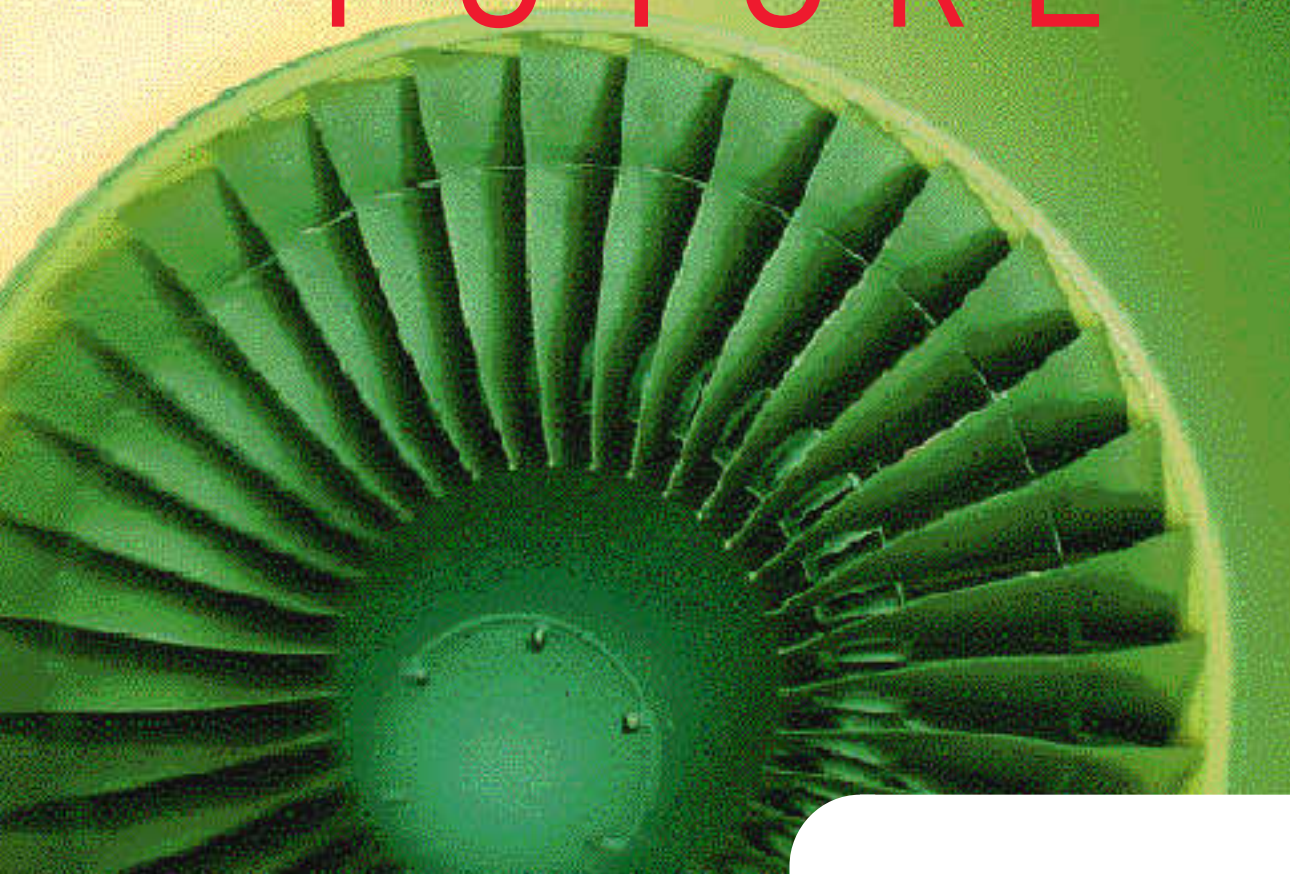
TECHNOLOGY

S E C U R I T Y

LAUNCHING

into the

FUTURE



Designing, maintaining and enhancing network security has become much more complex than simply purchasing and installing off-the-shelf point products. Secure Computing's comprehensive and growing array of custom and packaged services helps organizations understand and address their full network security needs.

Professional Services augment an organization's expertise in testing, evaluating and designing network security measures and practices. For example, penetration testing services employ non-destructive, ethical hacking techniques and proprietary tools to search out vulnerabilities exposing networks to intrusion threats from within and beyond the network perimeter. SecureSupport™ addresses product and solution lifecycle needs, from installation and configuration to integration and ongoing technical support. Education and Training spans security awareness training for management and employees to developing self-sufficiency on key concepts, technologies and products.

SECURE COMPUTING'S TEAM OF NETWORK

SECURITY EXPERTS BRINGS EACH CLIENT INSIDE

KNOWLEDGE OF THE PUBLIC, GOVERNMENT

AND UNDERGROUND SECURITY COMMUNITIES.

CLIENTS INCLUDE SOME OF THE MOST

SECURITY CONSCIOUS ORGANIZATIONS ON

THE PLANET, INCLUDING LEADERS IN

MANUFACTURING, HIGH TECHNOLOGY,

FINANCIAL SERVICES, TELECOMMUNICATIONS,

AEROSPACE AND GOVERNMENT.

security in the
FUTURE

While the costs of creating, sharing and storing information are declining, the costs and complexities associated with securing information are rising. Information technology and investment analysts point to fast growing needs for security products and solutions that simplify security management.

In 1997, Secure Computing began focusing its technologies and expertise on simplifying security management by enabling customers to move from deploying point products to creating an integrated shield of security across the enterprise network. Immediate results include our native Windows NT firewall and the integration of our highly secured firewalls with strong authentication, dynamic Virtual Private Networks and filtering capabilities. Industry and channel alliances, combined with our commitment to open industry standards, extend these shields to include complementary security measures such as anti-virus products, solutions localized for our key international markets, and solutions tailored for specific market segments such as education and government.

IN 1997, SECURE COMPUTING DEVELOPED
SECUREWIRE™, THE FIRST COMMERCIALY
AVAILABLE BUSINESS SOLUTION COMBINING THE
CAPABILITIES OF INTRANET AND EXTRANET
TECHNOLOGIES FOR SHARING INTERNAL WEB
DATA WITH AUTHORIZED EXTERNAL USERS, SUCH
AS CUSTOMERS, SUPPLIERS AND PARTNERS.
FORWARD-LOOKING RESEARCH PROJECTS
UNDERWAY AT SECURE COMPUTING HIGHLIGHT
THE RAPID EVOLUTION OF SECURITY: FROM
PERIMETER-FOCUSED POINT SECURITY TO
UBIQUITOUS SECURITY DISTRIBUTED AND
INTEGRATED THROUGHOUT THE ENTERPRISE.

SecureZone™

SecureZone delivers robust security, revolutionary ease of use, and lower cost of ownership to organizations requiring a high level of network security. The intuitive, visual interface simplifies all aspects of security administration, while SecureOS™, patented Type Enforcement™ and Strikeback™ are designed to ensure a highly secured environment.

Sidewinder™ Security Server

The network security solution of choice for the Fortune 500 and U.S. Federal agencies, Sidewinder employs SecureOS, Type Enforcement and Strikeback to deliver robust power and versatility for enforcing complex security policies and stringent security thresholds.

BorderWare™ Firewall Server

One of the world's best-selling application gateway firewalls, BorderWare combines turnkey plug-and-play installation, simplified management interfaces, hardened network perimeter defenses and secured, cost-effective remote connectivity options.

Secure Computing Firewall™ for NT

The only commercially available application gateway firewall designed for Microsoft BackOffice, Secure Computing Firewall for NT is a native Windows NT server application delivering cost effective, easy to use security.

1997 INDUSTRY HIGHLIGHTS**WINNER,**

VARBUSINESS FIREWALL VENDOR REPORT

HOT PRODUCT,

VARBUSINESS FIREWALL PRODUCT REPORT

*BEST AUTHENTICATION PRODUCT OF 1997,
SOFTWARE TOOLS REPORT*

*BEST FILTERING PRODUCT OF 1997,
SOFTWARE TOOLS REPORT*

MICROSOFT CERTIFIED SOLUTION PROVIDER

ICSA CERTIFIED FIREWALLS

ISO 9001 QUALITY CERTIFICATION

SafeWord™

The SafeWord family of strong authentication products provides server software, hard tokens and soft tokens for secured access to networks, plus built-in replication to enable load balancing, real-time mirroring and recovery. This one-time encrypted password protection runs on a wide choice of platforms.

SecureWire™

SecureWire is the first commercially available business solution combining the capabilities of intranet and extranet technologies for sharing internal Web data with external users, such as partners, customers, suppliers and agencies. SecureWire enables organizations to grant authorized access to specific servers or URLs on the internal network, while denying access to all other data.

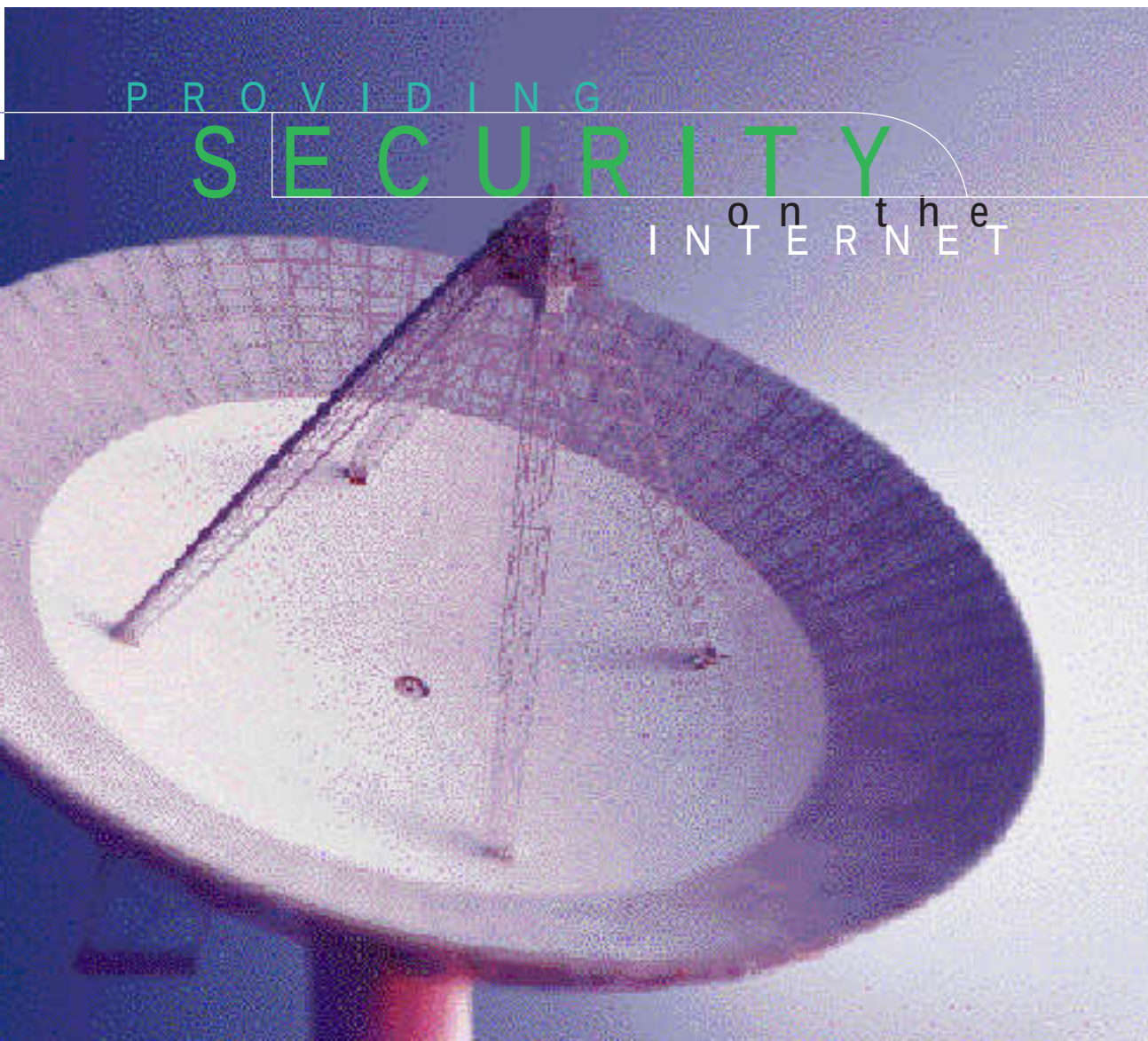
SmartFilter™

SmartFilter provides URL monitoring and filtering to block or discourage employee exposure to non-business Web sites. With weekly updates, the SmartFilter Control List offers the industry's most comprehensive database of URLs.

P R O V I D I N G

S E C U R I T Y

o n t h e
I N T E R N E T



F I N A N C I A L S

S E L E C T E D F I N A N C I A L D A T A

CONSOLIDATED STATEMENT OF OPERATIONS DATA

	Year Ended December 31				
	1997	1996	1995	1994	1993
Revenue:					
Products and services	\$ 33,203,000	\$ 23,290,000	\$ 13,081,000	\$ 4,051,000	\$ 1,598,000
Government contracts	13,773,000	16,972,000	14,849,000	13,744,000	9,389,000
Total revenue	46,976,000	40,262,000	27,930,000	17,795,000	10,987,000
Gross profit	28,210,000	21,465,000	13,079,000	7,120,000	4,244,000
Acquisition costs	—	13,069,000	—	—	—
Operating Income (loss)	(5,734,000)	(26,473,000)	(633,000)	1,220,000	215,000
Net Income (loss)	(4,251,000)	(25,094,000)	(632,000)	1,541,000	731,000
Net income (loss) per share:					
Basic	(.27)	(1.76)	(.08)	.17	.14
Diluted	(.27)	(1.76)	(.08)	.17	.10

CONSOLIDATED BALANCE SHEET DATA

	Year Ended December 31				
	1997	1996	1995	1994	1993
Working capital (deficit)	\$ 17,175,000	\$ 18,886,000	\$ 34,292,000	\$ 1,991,000	\$ (731,000)
Total assets	31,054,000	36,775,000	44,261,000	7,727,000	4,495,000
Long-term debt, less current portion and redeemable convertible preferred stock	—	—	1,879,000	10,659,000	8,630,000
Stockholder's equity (deficit)	24,800,000	26,232,000	36,208,000	(5,996,000)	(7,081,000)

M D & A

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

OVERVIEW

The Company produces and markets products designed to enable electronic commerce by protecting an organization's computer network from access by unauthorized users. Secure was organized in July 1989 to acquire certain assets of a division of Honeywell, Inc., then engaged in research and development of computer network security technology under a U.S. government contract. In August 1996, the Company acquired Border Network Technologies Inc. (Border) and Enigma Logic, Inc. (Enigma) in a transaction accounted for as a pooling of interests. All historical information presented in this Item 7 has been restated to reflect this combination. Also in 1996, the Company purchased Webster Network Strategies, Inc. (Webster).

PRODUCTS AND SERVICES | The Company sells its products and services to commercial and government customers. The Company's SafeWord identification and authentication server products were introduced prior to 1994. During 1994 and 1995, the Company invested significant resources in the development of the Sidewinder and BorderWare firewall products. Both firewalls first had significant sales in 1995. In 1996, the Company's SmartFilter Internet filtering product (formerly known as WebTrack) was introduced. The Company expects that the percentage of its revenues derived from products and related services will increase in future years, as the Company increasingly focuses on product sales.

During 1998, the Company plans to continue its research and development investment and general and administrative spending at current levels and to increase its sales and marketing expenditures over 1997 levels. The Company expects that operating expenses as a percentage of revenues will decline in 1998. The Company has planned for increased costs associated with selling and marketing in connection with the release of new products.

GOVERNMENT CONTRACTS | From the time of its organization, Secure has been engaged in research and development of computer network security technology under contracts with departments and agencies of the U.S. government.

The Company's Secure Network Server development contract with the National Security Agency (NSA) accounted for approximately 18 percent, 33 percent and 43 percent of the Company's total revenue for the years ended December 31, 1997, 1996 and 1995, respectively. The Company estimates that the aggregate fee to be received over the course of the contract will be approximately 6 percent and is currently using a rate of 5.5 percent in recognizing revenue in 1997 based on its current estimate of the remaining fee to be earned under the contract. The NSA contract now extends to August 1998.

Most of the Company's government research and development contracts provide for compensation to the Company in the form of reimbursement of costs plus a fee. The Company typically bills government agencies, including the NSA, monthly for a ratable portion of the fee expected to be received over the life of the contract and current expenses. Under these government contracts, the Company is entitled to recover direct labor costs, engineering overhead and certain general and administrative expenses.

Under its government contracts, the Company bears the risk that increased or unexpected costs required to perform specified services may reduce the amount of the Company's fee and are subject to audit. Pursuant to their terms, these contracts are generally also subject to termination for the convenience of the applicable government agency. If the contract is terminated, the Company typically would be reimbursed for its costs to the date of its termination, plus the costs of an orderly termination, and paid a portion of the fee.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain items from the statements of operations of the Company expressed as a percentage of revenue:

	Year Ended December 31		
	1997	1996	1995
Revenue:			
Products and services	70.7%	57.8%	46.8%
Government contracts	29.3	42.2	53.2
Total revenue	100.0	100.0	100.0
Cost of revenue	39.9	46.7	53.2
Gross profit	60.1	53.3	46.8
Operating expenses:			
Selling and marketing	43.6	45.8	19.3
Research and development	18.6	23.8	17.4
General and administrative	8.2	17.1	12.4
Acquisition costs	—	32.4	—
Stock option compensation expense	1.9	—	—
Total operating expenses	72.3	119.1	49.1
Operating loss	(12.2)	(65.8)	(2.3)
Interest and other income	1.1	3.8	0.9
Interest expense	—	(0.3)	(0.8)
Loss before income taxes	(11.1)	(62.3)	(2.2)
Income tax (benefit) expense	(2.1)	—	0.1
Net loss	(9.0)%	(62.3)%	(2.3)%

COMPARISON OF YEARS ENDED DECEMBER 31, 1997 AND 1996

REVENUE | The Company's revenue increased 16.7 percent to \$47.0 million in 1997, up from \$40.3 million in 1996. Products and services revenue was \$33.2 million in 1997, an increase of 42.6 percent over 1996, and was attributable mainly to increased sales of authentication products and related services. The decrease in government contracts revenue in 1997 reflects the continuation of efforts to reduce reliance on government contracts.

GROSS PROFIT | Gross profit as a percentage of revenue increased to 60.1 percent in 1997 from 53.3 percent in 1996. The increase in 1997 was primarily the result of increased products and services revenue which carries a higher gross margin than government contracts.

SELLING AND MARKETING | Selling and marketing expenses increased 11.1 percent to \$20.5 million in 1997, from \$18.4 million in 1996. The increase was due primarily to additions to the Company's sales and marketing staff and higher expenditures for advertising, trade shows and product literature.

RESEARCH AND DEVELOPMENT | Research and development expenses decreased by 8.8 percent to \$8.7 million in 1997 from \$9.6 million in 1996. The decrease resulted primarily from improved efficiencies due to consolidation of the Company's operations.

GENERAL AND ADMINISTRATIVE | General and administrative expenses decreased by 44.1 percent to \$3.8 million in 1997 from \$6.9 million in 1996. The decrease was primarily the result of improved efficiencies from the consolidation of the Company's operations.

ACQUISITION COSTS | Certain acquisition costs were recognized in the second quarter of 1996 relating to the Webster, Border and Enigma acquisitions. Purchased research and development in process of \$3.9 million was expensed in connection with the Webster acquisitions. Also, \$9.2 million of acquisition costs were recorded for investment banking, professional fees and other expenses for the Border and Enigma acquisitions.

INTEREST AND OTHER INCOME | The difference in interest and other income between the periods reflects interest earned in 1997 by the Company on declining cash and investment balances.

STOCK OPTION COMPENSATION EXPENSE | The stock option compensation expense in 1997 reflects vesting by a certain portion of options triggered by stock price performance.

INCOME TAX BENEFIT | The Company recognized an income tax benefit in 1997 compared to no income tax expense or benefit in 1996. The income tax benefit recognized in 1997 related to a reduction in the valuation allowance against the Company's deferred tax assets. The allowance was reduced based on the Company's estimate of the amount of net operating loss carryforwards more likely than not to be utilized to offset future taxable income. Management believes it is more likely than not that net deferred tax assets, which total \$2.4 million at December 31, 1997, will be realized. The

computation of the Company's deferred tax assets and valuation allowance are based in part on taxable income expected to be earned on existing government contracts and projected interest income. The amount of the deferred tax assets considered realizable could be reduced in the near term if estimates of future taxable income are reduced. The Company had total net operating loss carryforwards of approximately \$38.9 million at December 31, 1997. Of these carryforwards, \$9.9 million relates to stock option exercises. As these deductions are realized, the benefit will not reduce income tax expense, rather it will be recorded as additional paid-in-capital. Of the remaining benefit associated with the carryforwards, approximately \$23.0 million had yet to be recognized as a benefit in the statement of operations. However, there can be no assurance that these carryforwards will be available to offset future income tax expense when taxable income is realized.

COMPARISON OF YEARS ENDED DECEMBER 31, 1996 AND 1995

REVENUE | The Company's revenue increased 44.2 percent to \$40.3 million in 1996, up from \$27.9 million in 1995. Products and services revenue was \$23.3 million in 1996, an increase of 78.0 percent over 1995, and was attributable mainly to increased sales of firewall products and related services. The increase in government contracts revenue in 1996 reflects the continuation of increased efforts on the Secure Network Server program for the NSA.

GROSS PROFIT | Gross profit as a percentage of revenue increased to 53.3 percent in 1996 from 46.8 percent in 1995. The difference between periods was the result of increased products and services revenue which carries higher margins than government contracts.

SELLING AND MARKETING | Selling and marketing expenses increased by 242.7 percent to \$18.4 million in 1996 from \$5.4 million in 1995. The increase was due primarily to additions to the Company's sales and marketing staff and higher expenditures for advertising, trade shows and product literature.

RESEARCH AND DEVELOPMENT | Research and development expenses increased by 96.7 percent to \$9.6 million in 1996 from \$4.9 million in 1995. The increase resulted primarily from increased development efforts on the Company's firewall and identification and authentication products.

GENERAL AND ADMINISTRATIVE | General and administrative expenses increased by 98.1 percent to \$6.9 million in 1996 from \$3.5 million in 1995. The increase was due primarily to additions to administration staff and increased professional and other outside fees.

ACQUISITION COST | Certain acquisition costs were recognized in the second quarter of 1996 relating to the Webster, Border and Enigma acquisitions. Purchased research and development in process of \$3.9 million was expensed in connection with the Webster acquisition as well as \$9.2 million of acquisition costs recorded for investment banking, professional fees and other expenses for the Border and Enigma acquisitions.

INTEREST AND OTHER INCOME | The difference in interest and other income between the periods reflects interest earned in 1996 by the Company on cash and investments generated from its initial public offering in November, 1995 and sales of common stock in early 1996.

INTEREST EXPENSE | Interest expense decreased to \$129,000 in 1996 from \$239,000 in 1995, due to the repayment of all outstanding debt in 1996.

INCOME TAX EXPENSE | The Company recognized no income tax expense for 1996 compared to \$21,000 in 1995. Management's evaluation of the realizability of the deferred tax assets remained constant in 1996 and 1995, resulting in a net deferred tax asset of \$1.4 million in both years.

LIQUIDITY AND CAPITAL RESOURCES

Since its organization, the Company has financed its operations through the issuance of equity securities and notes to stockholders, long-term debt, short-term borrowings and cash generated from operations. The Company's cash and cash equivalents decreased by approximately \$7.3 million from 1996 to 1997. The decrease resulted primarily from recurring operating losses and \$2.3 million of purchases of capital equipment. The decrease was partially offset by approximately \$2.0 million of proceeds from sales of common stock, primarily from employees upon exercise of stock options. As of December 31, 1997, the Company had working capital of \$17.2 million. In 1998, the Company has received a commitment from a bank to enter into a \$5 million line of credit. The Company expects the terms of the line to be finalized in April 1998. The Company anticipates using available cash to fund growth in operations, invest in capital equipment and to acquire businesses or license technology or products related to the Company's line of business.

Capital expenditures for property and equipment were \$2.3 million, \$5.0 million and \$2.3 million for the years ended December 31, 1997, 1996 and 1995, respectively. These expenditures have generally consisted of computer workstations, office furniture and equipment, and leasehold improvements.

At its current level of operations, the Company believes that its existing cash and cash equivalents are sufficient to meet the Company's current working capital and capital expenditure requirements through at least the next 12 months.

INFLATION

To date, the Company has not been significantly affected by inflation.

FORWARD LOOKING STATEMENTS

Certain statements made above, which are summarized below, are forward-looking statements that involve risks and uncertainties, and actual results may be materially different. Factors that could cause actual results to differ include those identified below:

- **The Company expects that the percentage of its revenues derived from products and related services will increase in future years, as the Company increasingly focuses on product sales.** Meeting this expectation depends upon the Company's ability to achieve a higher level of products and services revenue, which may not occur for a variety of reasons, including general market conditions for the Company's products and services, delays or difficulties in the development, and inability to obtain market acceptances of new products offered by the Company, and introduction of products by competitors.

- **During 1998, the Company plans to continue its research and development investment and general and administrative spending at current levels and to increase its sales and marketing expenditures over 1997 levels. The Company expects that operating expenses as a percentage of revenues will decline in 1998.** This expectation depends on the Company maintaining the current anticipated level of product development, which may not occur due to unexpected increases in such costs or because of a need to accelerate or begin new product development and also may be affected by current plans for a full scale product marketing and branding campaign being curtailed or delayed or decreased products and services revenue resulting in lower selling expense. Fluctuations in revenue from quarter to quarter will likely have an increasingly significant impact on the Company's results of operations. Additionally, meeting this expectation depends upon the Company's ability to control costs and achieve a higher level of revenue, which may not occur for a variety of reasons, including general market conditions for the Company's products and services, development and acceptance of new products offered by the Company, and introduction of products by competitors.

- **Year 2000 Compliance.** Many currently installed computer systems and software products are coded to accept only two digit entries in the date code field. These date code fields will need to accept four digit entries to distinguish 21st century dates. As a result, in less than two years, computer systems and software used by many companies may need to be upgraded to comply with such Year 2000 requirements. Although the Company believes that its products and internal systems are Year 2000 compliant, the Company believes that the purchasing patterns of customers and potential customers may be affected by Year 2000 issues as companies expend significant resources to upgrade their current software systems for Year 2000 compliance. These expenditures may result in reduced funds available to purchase products such as those offered by the Company, which could have a material adverse effect on the Company's business and results of operations.

› **Management believes it is more likely than not that deferred tax assets, which total \$2.4 million at December 31, 1997, will be realized.** This expectation depends mainly on the Company maintaining, at current levels, its existing government contract business. If these contracts were lost or adjusted downward, deferred tax assets would be expected to be written down with a corresponding charge to income tax expense recorded.

At its current level of operations, the Company believes that its existing cash and cash equivalents are sufficient to meet the Company's current working capital and capital expenditure requirements through at least the next 12 months. The Company's ability to generate revenue as currently expected, unexpected expenses and the need for additional funds to react to changes in the marketplace, including unexpected increases in personnel costs and selling and marketing expenses or currently unplanned acquisitions may impact whether the Company has sufficient cash resources to fund its product development and marketing and sales plans for 1998 and early 1999.

CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

ASSETS	December 31	
	1997	1996
Current assets		
Cash and cash equivalents	\$ 4,880	\$ 12,130
Investments	—	5,935
Accounts receivable (net of allowance for doubtful accounts of 1997 - \$417; 1996 - \$290)	13,553	7,098
Deferred income taxes	2,113	1,083
Inventory	1,123	1,908
Other current assets	1,760	1,275
Total current assets	23,429	29,429
Property and equipment		
Equipment	8,008	7,843
Furniture and fixtures	2,595	2,067
Leasehold improvements	1,301	929
	11,904	10,839
Accumulated depreciation	(6,286)	(4,993)
	5,618	5,846
Intangible assets (net of accumulated amortization of 1997 - \$561; 1996 - \$425)	1,221	1,082
Other assets	786	418
Total assets	\$ 31,054	\$ 36,775
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	\$ 2,175	\$ 3,727
Accrued payroll liability	1,170	2,031
Accrued acquisition liabilities	—	1,083
Other accrued liabilities	1,094	1,947
Deferred revenue	1,815	1,755
Total current liabilities	6,254	10,543
Stockholders' equity		
Common Stock, par value \$.01 per share:		
Issued and outstanding shares Ñ December 31, 1997 - 15,762,820 and December 31, 1996 - 15,101,152	158	151
Additional paid-in capital	68,131	65,208
Accumulated deficit	(43,378)	(39,127)
Foreign currency translation	(111)	—
Total stockholders' equity	24,800	26,232
Total liabilities and stockholders' equity	\$ 31,054	\$ 36,775

See accompanying notes.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Year ended December 31		
	1997	1996	1995
Revenue			
Products and services	\$ 33,203	\$ 23,290	\$ 13,081
Government contracts	13,773	16,972	14,849
	46,976	40,262	27,930
Cost of revenue	18,766	18,797	14,851
Gross profit	28,210	21,465	13,079
Operating expenses			
Selling and marketing	20,469	18,425	5,376
Research and development	8,736	9,575	4,869
General and administrative	3,839	6,869	3,467
Acquisition costs	—	13,069	—
Stock option compensation expense	900	—	—
	33,944	47,938	13,712
Operating loss	(5,734)	(26,473)	(633)
Interest expense	—	(129)	(239)
Interest and other income	506	1,508	261
Loss before income taxes	(5,228)	(25,094)	(611)
Income tax (benefit) expense	(977)	—	21
Net Loss	\$ (4,251)	\$ (25,094)	\$ (632)
Net loss per share-basic and diluted	\$ (.27)	\$ (1.76)	\$ (.08)
Weighted average shares outstanding	15,480	14,222	7,665

See accompanying notes.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands, except share amounts)

	Common		Additional	Accumulated	Foreign	
	Shares	Amount	Paid-In Capital	Deficit	Currency Translation	Total
Balance at December 31, 1994	6,431,851	\$ 64	\$ 7,234	\$ (13,294)	\$ —	\$ (5,996)
Exercise of incentive stock options	223,820	2	99	—	—	101
Exercise of Common Stock warrants	164,619	2	367	—	—	369
Common Stock issued for services	11,271	—	50	—	—	50
Initial public offering of Common Stock, net of expenses	2,250,000	22	32,687	—	—	32,709
Preferred Stock conversion	3,460,635	35	10,119	—	—	10,154
Preferred Stock accretion	—	—	(11)	—	—	(11)
Dividends accrued on Preferred Stock	—	—	(429)	(107)	—	(536)
Net loss for the year	—	—	—	(632)	—	(632)
Balance at December 31, 1995	12,542,196	125	50,116	(14,033)	—	36,208
Exercise of incentive stock options	426,394	4	991	—	—	995
Common Stock issued under Employee Stock Purchase Plan	34,155	—	277	—	—	277
Compensation expense on options	—	—	197	—	—	197
Common Stock issued	1,142,908	12	6,350	—	—	6,362
Exercise of Common Stock warrants	955,499	10	7,277	—	—	7,287
Net loss for the year	—	—	—	(25,094)	—	(25,094)
Balance at December 31, 1996	15,101,152	151	65,208	(39,127)	—	26,232
Exercise of incentive stock options	552,111	6	1,447	—	—	1,453
Common Stock issued under Employee Stock Purchase Plan	109,557	1	576	—	—	577
Compensation expense on options	—	—	900	—	—	900
Foreign currency translation	—	—	—	—	(111)	(111)
Net loss for the year	—	—	—	(4,251)	—	(4,251)
Balance at December 31, 1997	15,762,820	\$ 158	\$ 68,131	\$ (43,378)	\$ (111)	\$ 24,800

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year ended December 31		
	1997	1996	1995
Operating activities			
Net loss	\$ (4,251)	\$ (25,094)	\$ (632)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Purchased research and development in process and goodwill write-off	—	4,994	—
Depreciation	2,373	2,030	1,037
Loss on disposals of property and equipment	159	—	—
Amortization	731	187	39
Deferred income tax	(1,030)	409	104
Stock option expense	900	—	—
Changes in operating assets and liabilities:			
Accounts receivable	(6,455)	(1,348)	(3,050)
Inventory	785	(1,302)	(337)
Other current assets	(485)	(1,315)	(128)
Accounts payable	1,552	1,608	1,468
Accrued liabilities and reserves	(2,797)	2,009	1,031
Deferred revenue	60	290	793
Net cash (used in) provided by operating activities	(11,562)	(17,532)	325
Investing activities			
Purchases of investments	—	(8,645)	—
Proceeds from sales of investments	5,935	3,000	—
Cash paid in purchase of Webster Network Strategies, Inc.	—	(759)	—
Cash paid in purchase of remaining interest in Border Network Technologies Europe Ltd.	—	(989)	—
Purchase of property and equipment	(2,304)	(5,030)	(2,314)
Increase in intangible and other assets	(1,238)	(885)	(121)
Net cash provided by (used in) investing activities	2,393	(13,308)	(2,435)
Financing activities			
Payments on notes payable and long-term debt	—	(1,943)	(1,259)
Proceeds from notes and long-term debt	—	—	189
Proceeds from issuance of Common Stock	2,030	11,989	33,179
Proceeds from issuance of Preferred Stock	—	—	1,661
Net cash provided by financing activities	2,030	10,046	33,770
Effect of foreign currency translation	(111)	—	—
(Decrease) increase in cash and cash equivalents	(7,250)	(20,794)	31,660
Cash and cash equivalents at beginning of year	12,130	32,924	1,264
Cash and cash equivalents at end of year	\$ 4,880	\$ 12,130	\$ 32,924

See accompanying notes

SECURE COMPUTING CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except share and per share amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Secure Computing Corporation (the "Company") designs and assembles products to enable electronic commerce by protecting an organization's computer network and its computers from access by unauthorized users. The Company's principal markets are commercial companies and the United States government for its network security products and the United States government under development contracts.

BASIS OF PRESENTATION

The consolidated financial statements are presented giving retroactive effect to the Company's mergers with Border Network Technologies Inc. (now known as Secure Computing Canada Ltd.) and Enigma Logic, Inc. which have been accounted for under the pooling of interests method (see Note 2.).

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

REVENUE RECOGNITION

Products and Services | The Company recognizes product revenues at the time of shipment. The Company has entered into customer support and maintenance agreements with various customers. The Company recognizes the obligations either ratably as the obligations are fulfilled or upon completion of performance.

Government Contracts | Government contract revenues for cost-plus-fixed-fee contracts are recognized on the basis of costs incurred during the period plus the fee earned. Award fees are recognized based upon the percentage of completion and forecasted profit. A provision is made for the estimated loss, if any, on government contracts.

Under its government contracts, the Company bears the risk that increased or unexpected costs required to perform specified services may reduce the amount of the Company's fee. In addition, recoverable expenses billed by the Company are subject to review and audit by the Defense Contract Audit Agency, which could result in amounts previously billed being renegotiated. Pursuant to their terms, these contracts are generally also subject to termination at the convenience of the applicable government agency. If the contract is terminated, the Company typically would be reimbursed for its costs to the date of its termination plus the cost of an orderly termination, and paid a portion of the fee.

At December 31, 1997 and 1996, the Company had deferred revenue of \$144 and \$178, respectively, related to government contracts.

CASH EQUIVALENTS

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

INVENTORY

Inventory consists mainly of purchased components and is valued at the lower of cost (first-in, first-out method) or market.

PROPERTY AND EQUIPMENT

Property and equipment are carried at cost. Depreciation is computed using accelerated methods over the estimated useful lives of the assets ranging from 3-10 years.

INTANGIBLE ASSETS

Intangible assets consist of patents and trademarks and are amortized using the straight-line method over the estimated useful lives of the assets, which range up to ten years.

FOREIGN CURRENCY TRANSLATION AND TRANSACTIONS

Foreign assets and liabilities are translated using the year-end exchange rate. Results of operations are translated using the average exchange rates throughout the period. Translation gains or losses, net of applicable deferred taxes, are accumulated as a separate component of stockholders' equity. In 1996 the effect of foreign currency translation was immaterial, and accordingly, has not been separately disclosed.

RESEARCH AND DEVELOPMENT

Research and development expenditures are charged to operations as incurred. Statement of Financial Accounting Standards No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed" requires capitalization of certain software development costs subsequent to the establishment of technological feasibility.

Based on the Company's product development process, technological feasibility is established upon completion of a working model. Costs incurred by the Company between completion of the working model and the point at which the product is generally available for sale are capitalized and amortized over their estimated useful life of one year. The Company Software development costs net of accumulated amortization of \$547 and \$450 at December 31, 1997 and 1996, respectively. Amortization expense was \$682, \$187, and \$ — for the years ended December 31, 1997, 1996, and 1995, respectively.

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 amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

NET LOSS PER SHARE

In 1997, the Financial Accounting Standards Board issued Statement No. 128, Earnings per Share, (Statement 128). Statement 128 replaced the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share. Unlike primary earnings per share, basic earnings per share excludes any dilutive effects of options, warrants and convertible securities. Diluted earnings per share is very similar to fully diluted earnings per share under the previous rules. All earnings per share amounts for all periods have been presented, and where necessary, restated to conform to the Statement 128 requirements. Diluted earnings per share is not presented as the effect of outstanding options, warrants and preferred stock are antidilutive.

STOCK OPTIONS

The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* regarding disclosure of pro-forma information for stock compensation. As is allowed by Statement No. 123, the Company will continue to measure compensation cost using the methods described in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*

RECLASSIFICATIONS

Certain amounts presented in the 1996 and 1995 financial statements have been reclassified to conform with the 1997 presentation.

RECENTLY ISSUED ACCOUNTING STANDARDS

In June 1997, the FASB issued No.130, *Reporting Comprehensive Income*. Statement No. 130 is effective for fiscal years beginning after December 15, 1997. This standard defines comprehensive income as the changes in equity of an enterprise income are required to be reported in a new financial statement. Management believes the adoption of Statement No. 130 will not have a material effect on the Company's financial statement.

Also in June 1997, the FASB issued Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Statement No. 131 is effective for years beginning after December 15, 1997. Statement No. 131 establishes standards for disclosures about operating segments, products and services, geographic areas and major customers. Management has not completed its review of Statement No. 131, but does not anticipate that the adoption will have a significant effect on the Company's reported segments.

In October 1997, the American Institute of Certified Public Accountants issued Statement of Position 97-2 (*SOP 97-2*). *Software Revenue Recognition*. This Statement establishes revenue recognition requirements for companies that sell software for fiscal years beginning after December 15, 1997. Management is currently evaluating the impact of SOP 97-2 and has not determined the result, if any, on the Company's financial position, results of operations or cash flows.

2. ACQUISITIONS

In May 1996, the Company acquired Webster Network Strategies, Inc. (Webster), a Florida based Internet software developer, for 102,000 shares of Common Stock and \$749 cash, which includes expenses of \$249, in exchange for all outstanding common stock of Webster. The acquisition has been accounted for using the purchase method. Subsequent to the acquisition, the Company expensed all purchased research and development in process of \$3,894 based upon an independent appraisal.

In August 1996, the Company acquired network security software developers Border Network Technologies, Inc. (Border) and Enigma Logic, Inc. (Enigma). Both Border and Enigma were merged directly into the Company in a pooling of interests. As a result of the mergers, the Company exchanged approximately 6,000,000 shares of Common Stock for all of the outstanding common stock of Border and approximately 2,060,000 shares of Common Stock for all of the outstanding common stock of Enigma. In addition, outstanding Border and Enigma stock options were converted into options to purchase approximately 1,160,000 shares of the Company's Common Stock. Separate results of operations for the periods prior to the mergers are as follows:

	Six Months Ended June 30, 1996	Year Ended December 31, 1995
	(Unaudited)	
Revenue:		
Secure	\$ 13,438	\$ 20,712
Border	4,506	3,317
Enigma	2,478	3,901
Combined	\$ 20,422	\$ 27,930
Net income (loss):		
Secure	\$ (9,189)	\$ (974)
Border	(4,474)	50
Enigma	(2,857)	292
Combined	\$ (16,520)	\$ (632)

Also in May 1996, the Company acquired the remaining 68% interest it did not own in Border Network Technologies Europe Limited for 40,908 shares Common Stock and \$989 in cash. Goodwill of \$1,100 that was recorded in this transaction was subsequently expensed as acquisition costs.

3. INVESTMENTS

At December 31, 1996, investments consist of United States treasury bills with original maturities of less than one year. The investments are considered available for sale and are stated at cost plus accrued interest which approximates fair market value.

4. ACCOUNTS RECEIVABLE

Approximately 9% and 26% of accounts receivable were due from the United States government at December 31, 1997 and 1996, respectively. Unbilled accounts receivable from all customers were \$644 and \$202 at December 31, 1997 and 1996, respectively.

5. STOCKHOLDER DEBT

In 1995, a stockholder of the Company had made cash advances in exchange for notes bearing interest at rates ranging from 9.5% to 12%. The notes were fully repaid in 1996. Accrued interest of \$562 is included in the balance at December 31, 1995.

6. LEASES

The Company leases office space for all of its locations. Future lease payments for all operating leases, excluding executory costs such as management and maintenance fees, are as follows:

1998	\$	2,244
1999		2,395
2000		2,305
2001		1,799
2002		1,727
Thereafter		5,508
	\$	<u>15,978</u>

Rent expense was \$2,191, \$2,488 and \$916 for the years ended December 31, 1997, 1996 and 1995, respectively.

7. CAPITAL STOCK

1995 REORGANIZATION AND STOCK SPLIT

On September 30, 1995, the Company effected a reorganization (the 1995 Reorganization) which included a 1.25-for-1 split of the Company's Common Stock. Accordingly, all share, per share, weighted average share information and redeemable convertible preferred stock have been restated to reflect the split.

Following the 1995 Reorganization, the Company had 30,460,635 shares of authorized capital stock, consisting of 25,000,000 shares of Common Stock and 5,460,635 shares of Preferred Stock, of which 3,127,302 shares were designated Series A Convertible Preferred Stock, 333,333 were designated Series B Convertible Preferred Stock and 2,000,000 shares of Preferred Stock undesignated as to its series. In December 1995, the Board of Directors elected to decrease the amount of authorized Preferred Stock to 2,000,000 undesignated shares.

INITIAL PUBLIC OFFERING

In November 1995, the Company sold 2,250,000 shares of Common Stock in an initial public offering from which the Company received \$33,480 before deducting expenses.

PREFERRED STOCK

Upon the conclusion of the Company's initial public offering, all outstanding shares of preferred stock were converted on a one for one basis to Common Stock. Prior to that date, the Company had issued 3,127,302 shares of \$2.24 Series A Cumulative Redeemable Convertible Preferred Stock and 333,333 shares of \$3.00 Series B Cumulative Redeemable Convertible Preferred Stock.

Series A and B Preferred Stock accrued cumulative dividends at \$.20 and \$.24 per share per annum, respectively. Dividends in arrears prior to conversion for Series A Convertible Preferred Stock at November 17, 1995 and December 31, 1994 were \$2,093 and \$1,624, respectively, and for Series B Cumulative Redeemable Convertible Preferred Stock at November 17, 1995 and December 31, 1994 were \$90 and \$23, respectively. Upon conversion, all rights to receive the dividends in arrears ceased.

8. STOCK OPTIONS

In September 1995, the Board of Directors and the stockholders approved the Company's 1995 Omnibus Stock Plan (the "Stock Plan"). Under the terms of the Stock Plan, key employees and non-employees may be granted options to purchase up to 5,244,131 shares of the Company's Common Stock. Options granted typically have ten year terms and vest annually over three years.

A summary of changes in outstanding options and common shares reserved under the Plan are as follows:

(in thousands, except share and per share amounts)

	Shares Available for Grant	Options Outstanding	Weighted Average Exercise Price Per Share
Balance at December 31, 1994	216,088	1,003,165	\$.73
Shares authorized	379,390	—	—
Granted	(445,790)	445,790	4.10
Exercised	—	(225,445)	.39
Canceled	90,957	(92,044)	.73
Balance at December 31, 1995	240,645	1,131,466	2.14
Shares authorized	2,084,570	—	—
Granted	(2,397,152)	2,397,152	10.29
Exercised	—	(426,394)	2.33
Canceled	188,188	(188,188)	6.88
Balance at December 31, 1996	116,251	2,914,036	\$ 9.01
Shares authorized	1,300,000	—	—
Granted	(3,282,073)	3,282,073	6.44
Exercised	—	(552,111)	2.71
Canceled	1,866,233	(1,866,233)	11.96
Balance at December 31, 1997	411	3,777,765	\$ 6.24

The following table summarizes information about the stock options outstanding at December 31, 1997:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted- Average Remaining Contractual Life	Weighted- Average Exercise Price	Number Exercisable	Weighted- Average Exercise Price
\$.01 - 1.60	224,562	6.5 years	\$.89	41,225	\$.88
\$ 2.22 - 3.66	202,612	7.5 years	2.61	37,196	2.59
\$ 5.06 - 6.63	2,849,626	9.5 years	6.12	522,952	6.35
\$ 6.66 - 8.50	286,573	8 years	7.07	52,609	7.07
\$ 10.50 - 30.00	214,392	8.5 years	15.59	39,538	13.78
\$.01 - 30.00	3,777,765	8 years	\$ 6.24	693,520	\$ 6.31

Options outstanding under the Stock Plan expire at various dates from 2002 to 2007. The number of options exercisable as of December 31, 1997, 1996, 1995 and 1994 were 693,520, 1,062,920, 565,496 and 482,181, respectively. The weighted average fair value of options granted and the weighted average remaining contractual life of options granted during 1997, 1996 and 1995 are \$5.05, \$10.29 and \$4.26 and 10.5, 9.5 and 8.5 years, respectively.

The Company also has an Executive Stock Option Plan under which 780,000 shares are subject to accelerated vesting based on the performance of the Company's stock price over the next three years. The number of shares exercisable under this Plan, as of December 31, 1997 was 180,000 and are valued at \$6,125. For the year ended December 31, 1997, the Company recognized \$900,000 of compensation expense related to the accelerated vesting of options under this plan.

The Company also has an Employee Stock Purchase Plan under which 400,000 shares have been reserved for purchase by employees. The purchase price of the shares under the plan is the lesser of 85% of the fair market value on the first or last day of the offering period. Offering periods are each three months. Employees may designate up to 10% of their compensation for the purchase of stock under the Plan.

Pro forma information regarding net loss and loss per share is required by Statement No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 1997, 1996 and 1995, respectively: risk-free interest rates of 6.0%; volatility factors of the expected market price of the Company's Common Stock of .80, .80 and 3.51; and a weighted average expected life of the option of 5 years.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma information is as follows:

(in thousands, except share and per share amounts)

	Year ended December 31		
	1997	1996	1995
Pro forma net loss	\$ (9,105)	\$ (30,217)	\$ (956)
Pro forma basic and diluted loss per share	\$ (.59)	\$ (2.12)	\$ (.12)

The pro forma effect on the net loss for all years shown is not representative of the pro forma effect on net income (loss) in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

9. INCOME TAXES

The Company's income tax benefit of \$977 for the year ended December 31, 1997 consists of current foreign income taxes of \$53 and a deferred federal benefit of \$1,030. The entire tax expense for the year ended December 31, 1995 represents current foreign income taxes.

The effective tax rate differs from the statutory tax rate primarily as a result of the following:

	Year ended December 31		
	1997	1996	1995
Income taxes at statutory rate	\$ (1,778)	\$ (8,785)	\$ (239)
State taxes, net of federal benefit	(223)	(1,255)	(34)
Foreign taxes	(180)	—	21
Change in valuation allowance	1,110	5,539	391
Use of net operating loss carryforwards	—	—	(102)
Non-deductible acquisition costs	—	4,470	—
Other	94	31	(16)
Income tax (benefit) expense	\$ (977)	\$ —	\$ 21

Deferred income tax assets and liabilities result from temporary differences between the carrying values of assets and liabilities for financial statement and the income tax purposes. Significant components of the Company's net deferred tax assets are as follows:

	December 31	
	1997	1996
Deferred tax assets:		
Accrued liabilities	\$ 492	\$ 823
Stock option compensation expense	360	—
Contract loss reserve	70	100
Payroll liabilities	187	187
Book over tax amortization	124	55
Book over tax depreciation	114	112
Income tax credits	478	312
Net operating loss carryforward	15,675	12,117
Total deferred tax assets before valuation allowance	17,252	13,706
Less valuation allowance	(14,849)	(12,333)
Total deferred tax assets	2,403	1,373
Net deferred tax assets	\$ 2,403	\$ 1,373

SFAS 109 "Accounting for Income Taxes" requires the consideration of a valuation allowance for deferred tax assets if it is more likely than not that benefits of deferred tax assets will not be realized. Management believes it is more likely than not that the net deferred tax assets of \$2,403 at December 31, 1997 will be realized. However, the amount of the deferred tax assets considered realizable could be reduced in the near term if estimates of future taxable income are reduced.

At December 31, 1997, the Company had net operating loss carryforwards (NOL) of approximately \$38,878 which are available to offset taxable income through 2012. These carryforwards are subject to the limitations of Internal Revenue Code Section 382. This section provides limitations on the availability of net operating losses to offset current taxable income if significant ownership changes have occurred for federal tax purposes. Included in the NOL is approximately \$9,900 related to stock option exercises. These deductions currently have a full valuation allowance and, when realized for financial statement purposes, they will not result in a reduction in income tax expense. Rather, the benefit will be recorded as an increase to additional paid-in-capital.

Income taxes were paid only in 1995 and amounted to \$25.

10. EMPLOYEE BENEFIT PLAN

The Company has a voluntary defined contribution plan under Section 401(k) of the Internal Revenue Code which covers substantially all U.S. employees of the Company. The Company also has voluntary defined contribution plans which cover substantially all employees of the Company. Contributions to the latter are limited to the employer's discretionary annual contribution.

The Company recognized expense for contributions to the plans as follows:

	Year ended December 31		
	1997	1996	1995
Defined contribution plan (401K)	\$ 50	\$ 61	\$ 44
Voluntary contribution plans	—	367	451
	\$ 50	\$ 428	\$ 495

11. FOREIGN SALES

Sales to foreign customers accounted for 35%, 21% and 14% of total revenue in the years ended December 31, 1997, 1996 and 1995, respectively.

12. CONTINGENCIES

The Company is engaged in certain legal proceedings and claims arising in the ordinary course of its business. The ultimate liabilities, if any, which may result from these or other pending or threatened legal actions against the Company cannot be determined at this time. However, in the opinion of management, the facts known at the present time do not indicate that there is a probability that such litigation will have a material effect on the financial position of the Company.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Secure Computing Corporation

We have audited the accompanying consolidated balance sheets of Secure Computing Corporation as of December 31, 1997 and 1996, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1997. These consolidated 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 did not audit the financial statements of Enigma Logic, Inc. and Border Network Technologies Inc., which statements reflect total revenues constituting 26% in 1995 of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to data included for Enigma Logic, Inc. and Border Network Technologies, Inc., is based solely on the report of other auditors.

We conducted our audits in accordance with generally accepted auditing standards. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Secure Computing Corporation at December 31, 1997 and 1996, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

Ernst & Young LLP

Minneapolis, Minnesota
January 26, 1998

CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Annual Report on Form 10-K and presented elsewhere by management from time to time.

A number of uncertainties exist that could affect the Company's future operating results, including, without limitation, general economic conditions, the Company's continued ability to develop and introduce products, the introduction of new products by competitors, pricing practices of competitors, expansion of the Company's sales distribution capability, the cost and availability of components and the Company's ability to control costs.

The Company's success is highly dependent on its ability to enhance its existing products and to develop and introduce new products in a timely manner. If the Company were to fail to introduce new products on a timely basis, the Company's operating results could be adversely affected. To date, substantially all of the Company's revenues have been attributable to sales of its enterprise network and data security products and the provision of related services, and existing and new versions of such products are expected to continue to represent a high percentage of the Company's revenue for the foreseeable future. As a result, any factor adversely affecting sales of these products and services could have a material adverse effect on the Company's financial condition and results of operations.

Certain components of the Company's products are currently purchased from a single or limited sources and any interruption in the supply of such components could adversely affect the Company's operating results.

The Company's quarterly operating results may vary significantly depending on a number of factors, including the timing of the introduction or enhancement of products by the Company or its competitors, the sizes, timing and shipment of individual orders, market acceptance of new products, changes in the Company's operating expenses, personnel changes, mix of products sold, changes in product pricing, development of the Company's direct and indirect distribution channels and general economic conditions.

Dependence on Principal Products | The Company currently derives substantially all of its revenue from sales of its enterprise network and data security products, the provision of related services, and existing and new versions of such products are expected to continue to represent a high percentage of the Company's revenue for the foreseeable future. As a result, any factor adversely affecting sales of these products and services, or any factor impeding or delaying the Company's ability to diversify its products offerings to lessen its dependency on those products, would have a material adverse effect on the Company's financial condition and results of operations.

Risks Associated with Enterprise Network and Data Security Market | The rapid development of enterprise-wide and remote computing as well as increased use of the Internet, intranets and extranets has enhanced the ability of users to access proprietary information and resources and has in recent years increased demand for enterprise network

and data security products. Declines in demand for the Company's products, whether as a result of competition, technological change, the public's perception of the need for security products, developments in the hardware and software environments in which these products operate, general economic conditions or other factors, could have a material adverse effect on the Company's financial condition and results of operations.

A well-publicized actual or perceived breach of enterprise network or data security could trigger a heightened awareness of computer abuse, resulting in an increased demand for security products such as those offered by the Company. Similarly, an actual or perceived breach of enterprise network or data security at one of the Company's customers, regardless of whether such breach is attributable to the Company's products, could adversely affect the market's perception of the Company and the Company's financial condition or results of operations. In addition, although the effectiveness of the Company's identification and authentication products is not dependent upon the secrecy of its proprietary algorithm, the public disclosure or "breaking" of this algorithm could result in a perception of breached security which could have an adverse effect on the Company's financial condition and results of operations.

Technological Change and New Products | The market for security products, especially in the Internet, intranet and extranet markets, is characterized by rapidly changing technology, emerging and evolving industry standards, new product introductions, relatively short product life cycles and rapid and constant changes in customer requirements and preferences. To the extent that specific methods other than those employed by the Company are adopted as standards for implementing enterprise network data security, sales of the Company's existing and planned products in those market segments may be adversely impacted, which could have a material adverse effect on the Company's financial condition and results of operations.

Software products may also contain undetected errors or bugs when first introduced or as new versions are released, and software products or media may contain undetected viruses. Errors or bugs may also be present in software licensed by the Company from third parties and incorporated into the Company's products. Errors, bugs or viruses may result in loss of or delay in market acceptance, recalls of hardware products incorporating the software or loss of data. Delays or difficulties associated with new product introductions or product enhancements could have a material adverse effect on the Company's financial condition and results of operations.

Competition | The market for enterprise network and data security products is highly competitive and subject to rapid change. The Company believes that the principal competitive factors affecting the market for enterprise network and data security products include technical features, ease of use, quality/reliability, level of security, customer service and support, distribution channels and price. The Company's competitors and potential competitors include organizations that provide or may seek to provide enterprise network and data security products based upon approaches similar to and different from those employed by the Company, and could in the future include operating systems or network suppliers not currently offering competitive enterprise-wide security products. There can be no assurance that the market for enterprise network and data security products will not ultimately be dominated by approaches other than the approach marketed by the Company.

Certain of the Company's potential competitors have significantly greater financial, marketing, technical and other competitive resources than the Company. As a result, they may be able to leverage an installed customer base and/or other existing or future enterprise-wide products, adapt more quickly to new or emerging technologies and changes in customer requirements, or devote greater resources to the promotion and sale of their products than can the Company. Competition could increase if new companies enter the market or if existing competitors expand their product lines. Any reduction in gross margins resulting from competitive factors could have a material adverse effect on the Company's financial condition and results of operations.

Potential Volatility of Stock Price | The trading of the Company's Common Stock has been and may continue to be subject to wide fluctuations in response to quarter to quarter variations in operating results, announcements of technological innovations or new products by the Company or its competitors, developments with respect to patents or proprietary rights, general conditions in the information security systems and wireless communications industries, changes in earnings estimates by analysts, or other events or factors. In addition, the stock market has experienced extreme price and volume fluctuations, which have particularly affected the market prices of many technology companies and which have often been unrelated to the operating performance of such companies. The Company's sales or operating results in future quarters may be below the expectations of public market securities analysts and investors. In such event, the price of the Company's Common Stock would likely decline, perhaps substantially. These Company-specific factors or broad market fluctuations may have a material adverse effect on the market price of the Company's Common Stock.

Lengthy Sales Cycle | Sales of the Company's products generally involve a significant commitment of capital by customers, with the attendant delays frequently associated with large capital expenditures. For these and other reasons, the sales cycle associated with the Company's product is typically lengthy and subject to a number of significant risks over which the Company has little or no control. The Company is often required to ship products shortly after it receives orders and consequently, order backlog at the beginning of any period has in the past represented only a small portion of that period's expected revenue. As a result, product revenue in any period is substantially dependent on orders booked and shipped in that period. The Company typically plans its production and inventory levels based on internal forecasts of customer demand, which are highly unpredictable and can fluctuate substantially. If revenue falls significantly below anticipated levels, the Company's financial condition and results of operations would be materially and adversely affected. In addition, the Company's operating expenses are based on anticipated revenue levels and a high percentage of the Company's expenses are generally fixed in the short term. Based on these factors, a small fluctuation in the timing of sales can cause operating results to vary significantly from period to period.

Product Liability Risks | Customers rely on the Company's information security products to prevent unauthorized access to their networks and data transmissions. A malfunction or the inadequate design of the Company's products could result in tort or warranty claims. Although the Company seeks to reduce the risk of such losses by attempting to negotiate warranty disclaimers and liability limitation clauses in its sales agreements and by maintaining product liability insurance, there can be no assurance that such measures will be effective in limiting the Company's liability for such

damages. Any liability for damages resulting from security breaches could be substantial and could have a material adverse effect on the Company's financial condition and results of operations.

Evolving Information Security Market | The market for the Company's information security products is only beginning to emerge. This market is characterized by rapidly changing technology, emerging industry standards, new product introductions and changes in customer requirements and preferences. The Company's future success will depend in part upon end users' demand for information security products in general and upon the Company's ability to enhance its existing products and to develop and introduce new products and technologies that meet customer requirements. To the extent that a specific method other than the Company's is adopted as the standard for implementing information security in any segment of the information security market, sales of the Company's existing and planned products in that market segment may be adversely impacted, which could have a material adverse effect on the Company's financial condition and results of operations. There can be no assurance that information security-related products or technologies developed by others will not adversely affect the Company's competitive position or render its products or technologies noncompetitive or obsolete.

In addition, a portion of the sales of the Company's information security products will depend upon a robust industry and infrastructure for providing access to public switched networks, such as the Internet. There can be no assurance that the infrastructure or complementary products necessary to make these networks into viable commercial marketplaces will be developed, or, if developed, that these networks will become viable commercial marketplaces.

BOARD OF DIRECTORS

Jeffrey H. Waxman

Chairman of the Board and Chief Executive Officer

Betsy Atkins

Private Investor

Robert J. Frankenberg

CEO, Encanto

Stephen M. Puricelli

General Partner, Corporate Venture Partners
Costine Associates, L.P.

Eric P. Rundquist

President and Chief Executive Officer
Eric Thomas, Inc.

Dennis J. Shaughnessy

Managing Director, GroTech Capital Group

Robert G. Smith

Managing Director, RGS Associates

Patrick W. Regester

Vice President, International Operations

Howard Smith

Executive Vice President, Products and Engineering

Gary D. Taggart

Vice President, Worldwide Sales

Jeffrey D. Saper

Secretary - Wilson Sonsini Goodrich & Rosati

DIVISION OFFICERS

William Bosen

Vice President, Engineering, Authentication Division

Barbara French

Vice President, Marketing Programs

Jay S. Goldlist

Vice President, Engineering, Firewall Division

Donald Hughes

Vice President and General Manager, Firewall Division

Joseph Perez

Vice President and General Manager,
Customer Service Division

John Sekevitch

Vice President and General Manager,
Professional Services Division

Joseph Stockwell

Vice President, Business Development

Richard Viets

Vice President and General Manager,
Web Tools Division

EXECUTIVE OFFICERS

Jeffrey H. Waxman

Chairman of the Board and Chief Executive Officer

Christine G. Hughes

Senior Vice President, Worldwide Marketing and
Business Development

Timothy P. McGurran

Senior Vice President of Operations and
Chief Financial Officer

IN MEMORY OF

Robert G. Smith

July 20, 1935 - April 18, 1998

We will miss his wisdom, advice and counsel.

Common Stock

The Company's Common Stock trades on the NASDAQ National Market under the symbol SCUR. As of March 26, 1998 the Company had 285 stockholders of record and approximately 4,625 beneficial holders of its Common Stock.

The Company has never declared or paid any dividends on its Common Stock and does not anticipate paying any dividends in the foreseeable future.

The following table sets forth, for the fiscal quarters indicated, the high and low closing prices of the Common Stock as reported by the NASDAQ National Market.

Quarter	High	Low
1997		
First Quarter	\$ 9.13	\$ 5.00
Second Quarter	\$ 8.88	\$ 5.00
Third Quarter	\$ 7.38	\$ 5.63
Fourth Quarter	\$ 14.82	\$ 9.06

Register and Transfer Agent
Norwest Bank
Shareowner Services
161 North Concord Exchange
P.O. Box 738
South St. Paul, Minnesota 55075-0738
+1.612.450.4062

Annual Meeting

The 1998 annual meeting of shareholders will be held at 2:00 p.m. Central Time on Thursday May 14th 1998, at Windows on Minnesota, 5000 IDS Center, 80 South 8th Street, Minneapolis, Minnesota.

Request for Additional Information

To request a copy of the Annual Report on Form 10-K please contact:
Investor Relations
Secure Computing Corporation
One Almaden Boulevard
Suite 400
San Jose, CA 95113
+1.408.918.6182

All trademarks or tradenames referenced in this annual report are the property of their respective owners.
© Secure Computing Corporation 1998.



Nobody Comes Close.™

CORPORATE HEADQUARTERS

Secure Computing Corporation

One Almaden Blvd., Suite 400

San Jose, CA 95113 USA

+1.408.918.6100

www.securecomputing.com

SALES AND MARKETING WORLD

HEADQUARTERS

One Almaden Blvd., Suite 400

San Jose, CA 95113 USA

+1.800.379.4944

+1.408.918.6100

INTERNATIONAL HEADQUARTERS

9 Shaftesbury Court

Chalvey Park

Slough

Berkshire SL1 2ER

United Kingdom

+1.44.1753.826000