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NORTHERN DISTRICT OF CALIFORNIA

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14 UNITED STATES DISTRICT COURT
15 FOR THE NORTHERN DISTRICT OF CALIFORNIA
16 SAN FRANCISCO DIVISION

PJH

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17 SECURITIES AND EXCHANGE)
18 COMMISSION,)
19)
20 Plaintiff,)
21 v.)
22 McAfee, INC.)
23 (f/k/a NETWORK ASSOCIATES, INC.),)
24 Defendant.)

Case No.

COMPLAINT

25 Plaintiff Securities and Exchange Commission ("Commission") alleges:

26 SUMMARY

27 1. McAfee, Inc., formerly known as Network Associates, Inc. (hereinafter referred
28 to as "McAfee"), a publicly-traded manufacturer and supplier of computer programs and
hardware based in Santa Clara, California, carried out a multimillion dollar financial fraud
between 1998 and 2000. During that period, McAfee overstated its revenues by \$622 million in
order to meet revenue and earnings targets and understated its cumulative net losses by \$353

1 million. McAfee stuffed its distribution channel and improperly recorded hundreds of millions
2 of dollars of revenue on sales transactions with distributors in violation of the antifraud and other
3 provisions of the federal securities laws. In a fraudulent scheme to oversell its products and
4 immediately record the revenue from those transactions, McAfee secretly gave its distributors
5 substantial cash payments, price discounts, rebates, and other concessions as inducements to
6 continue buying, as well as to not return, McAfee products that the distributors had no
7 reasonable expectation of selling to customers.

8 2. McAfee also inflated its revenues in certain quarters during the relevant period by
9 engaging in sham sales transactions that lacked economic substance and by improperly selling its
10 accounts receivables in certain quarters, in order to perpetuate the misleading impression that
11 McAfee had robust, non-discounted product sales.

12 3. McAfee concealed the revenue fraud from investors through various ploys. For
13 example, (1) McAfee falsely recorded in its books and records certain of the payments and
14 concessions to distributors as expenses rather than as reductions in revenue; (2) McAfee
15 impermissibly used tax reserve accounts to offset the undisclosed payments and concessions; and
16 (3) McAfee improperly inflated acquisitions and other expense reserve accounts. In the course
17 of this fraud, McAfee misled investors by filing with the Commission materially false and
18 misleading annual and quarterly reports and securities registration statements. In those filings,
19 McAfee stated that it was recognizing revenue on product sales only after product had been
20 delivered, the fee was fixed and determinable, and collection of the resulting account receivable
21 was probable. McAfee omitted material information that its accounting practices, as noted
22 above, did not conform to its stated revenue recognition policies. In so doing, McAfee deceived
23 investors about its actual earnings and revenues.

24 4. McAfee's accounting scheme began to unravel in the fourth quarter of 2000
25 when, after eleven consecutive quarters of McAfee's distribution channel stuffing, its distributors
26 held such huge inventories of McAfee products that they refused to buy additional product.
27 Consequently, on December 26, 2000, McAfee was forced to announce in a press release that its
28 sales for that quarter would be only \$55 million, seventy-eight percent less than the \$245 million

1 in sales that McAfee had projected publicly only two months earlier, on October 14, 2000. Also
2 on December 26, McAfee announced without explanation the resignations of its Chief Executive
3 Officer, Chief Financial Officer, and President.

4 5. This news sent McAfee's stock price down sharply, slashing more than \$1 billion
5 from the company's market capitalization. On December 26, 2000, prior to the issuance of the
6 press release, McAfee's stock price had closed at \$11.75. After the press release, in after hours
7 trading, McAfee's share price dropped sixty-six percent to open on December 27, 2000, at \$3.97.
8 That day, McAfee's share price reached a low of \$3.25 and closed at \$4.50.

9 6. On October 31, 2003, nearly three years after it had announced the sales shortfall,
10 McAfee restated its financial results to correct for the fraudulent revenue and earnings inflation
11 scheme. The October 2003 restatement was the company's third restatement in five years and it
12 affected seven years of previously reported financial results – from 1997 through the second
13 quarter of 2003. Among other things, the company acknowledged that material amounts of
14 revenue for that period had been improperly recorded in violation of Generally Accepted
15 Accounting Principles ("GAAP"). As a result, McAfee recalculated all revenue that had been
16 previously recognized at the time of sale to a distributor from 1998 through 2000, postponing the
17 recognition of revenue until the time a distributor actually sold the products.

18 7. The October 2003 restatement, and a prior partial restatement made in June 2002,
19 decreased McAfee's previously reported revenues in 1998 by approximately \$562 million, an
20 overstatement of one hundred and thirty-one percent, and cut previously reported net income
21 from approximately \$36 million to a net loss of approximately \$320 million. As result of the
22 restatements, McAfee's cumulative net revenues for the period 1998 through 2000 decreased by
23 \$622 million and cumulative net losses increased by \$353 million from what had been previously
24 publicly reported.

25 8. From 1997 through 2004, McAfee failed to maintain an adequate system of
26 internal accounting and financial reporting controls to ensure that McAfee's financial results
27 were reported accurately and fairly to investors. In part as a result, McAfee had to restate its
28 reported financial results on five occasions from 1999 through 2004. Most recently, on March

1 31, 2005, McAfee's external auditors determined that McAfee's internal control over financial
2 reporting for such critical accounting areas as the recognition of revenue for software contracts
3 was materially deficient in several areas.

4 9. By engaging in the acts alleged in this complaint, McAfee violated the antifraud,
5 issuer reporting, books and records, and internal controls provisions of the federal securities
6 laws. Unless enjoined by this Court, McAfee may violate these laws in the future. The
7 Commission requests that the Court permanently enjoin McAfee from engaging in further
8 violations and impose civil penalties.

9 **JURISDICTION, VENUE, AND INTRADISTRICT ASSIGNMENT**

10 10. This Court has jurisdiction over this action pursuant to Sections 20(b), 20(d), and
11 22(a) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77t(b), 77t(d), and 77v(a)]
12 and Sections 21(d) and (e), 21A, and 27 of the Securities Exchange Act of 1934 ("Exchange
13 Act") [15 U.S.C. §§ 78u(d) and (e), 78u-1, and 78aa].

14 11. Venue properly lies in this Court pursuant to Section 22 of the Securities Act [15
15 U.S.C. § 77v] and Section 27 of the Exchange Act [15 U.S.C. § 78aa] because McAfee transacts
16 business in this judicial district, because offers and sales of the securities at issue in this case
17 took place in this judicial district, and because certain of the acts and transactions constituting the
18 violations in this case occurred within this judicial district.

19 12. McAfee made use of the means and instrumentalities of interstate commerce in
20 connection with the acts alleged in this complaint.

21 13. A substantial part of the events that gave rise to the claims occurred in Santa
22 Clara County, California. However, related criminal and civil cases concerning the same or
23 substantially similar conduct as alleged herein have been filed in this Division. *United States of*
24 *America v. Terry W. Davis, CR-03-0172-MJJ; Securities and Exchange Commission v. Terry W.*
25 *Davis, C-03-2729-MJJ; United States of America v. Prabhat Goyal, CR-04-0201-MJJ;*
26 *Securities and Exchange Commission v. Prabhat K. Goyal, C-04-2372-MJJ; United States of*
27 *America v. Evan Collins, CR-04-0392-MJJ; and Securities and Exchange Commission v. Evan S.*
28 *Collins, C-04-5030-MJJ.*

1 of the purchase price is probable. In the financial reports filed with the Commission during the
2 relevant period, McAfee asserted that it had recognized revenue in accordance with GAAP.

3 MCAFEE'S REVENUE INFLATION SCHEME

4 17. In early 1998, McAfee changed the manner in which it sold its software and
5 related products. Instead of selling directly to end-user customers through its own sales force,
6 McAfee contracted with distributors who purchased product from McAfee and then sold the
7 product to resellers, who in turn, sold the product to end-users. Contemporaneously, the
8 company adopted a new revenue recognition practice pursuant to which the company recorded
9 revenue at the time of the sale to the distributor, less a reserve for returns. This methodology is
10 commonly referred to as the "sell-in" method of accounting.

11 18. Beginning in 1998 and continuing through 2000, McAfee's senior executives
12 formulated quarterly revenue goals for the company. To meet its quarterly revenue goals,
13 McAfee's sales managers and other senior employees sold McAfee products to distributors in
14 large dollar amounts. McAfee then immediately recognized and recorded a portion of the
15 revenues from these purported sales. During the relevant period, McAfee, through the actions of
16 certain of its officers and employees, adopted a variety of undisclosed ploys to oversell its
17 products to its distributors in order to improperly record hundreds of millions of dollars of
18 revenue in violation of GAAP and artificially boost the company's earnings and publicly
19 announced financial results.

20 **A. McAfee Created Net Tools, Inc., to Repurchase Inventory from Distributors**

21 19. In the second quarter of 1998, McAfee created a wholly-owned subsidiary, Net
22 Tools, Inc., principally to repurchase inventory that McAfee had oversold to its distributors.
23 McAfee induced distributors to enter into large purchases with the understanding that the
24 distributors could sell at a profit any unsold inventory to McAfee's subsidiary, Net Tools, rather
25 than return the product directly to McAfee. Through the use of Net Tools, McAfee avoided
26 direct returns of inventory by the distributors and the consequent reduction in its own revenue
27 stream. By avoiding the returns of inventory by its distributors, McAfee was able to maintain
28

1 lower returns reserves and, thus, report higher revenues. McAfee encouraged distributors to use
2 Net Tools by allowing the distributors to sell the products to Net Tools at a profit.

3 20. With regard to products that McAfee ultimately repurchased from distributors
4 through Net Tools, McAfee's recognition of revenue upon the original sale to its distributors
5 failed to conform with GAAP. SFAS No. 48, *Revenue Recognition When Right of Return Exists*,
6 prohibits the immediate recognition of revenue if, among other things, the seller (i.e., McAfee)
7 has "significant obligations for future performance to directly bring about resale of the product"
8 for the distributor. Through Net Tools, McAfee directly assisted distributors in the resale of
9 McAfee's products. Consequently, McAfee should not have recorded revenue upon sale to the
10 distributors.

11 21. From June 1998 through 2000, McAfee used Net Tools to repurchase a total of
12 approximately \$78 million worth of McAfee's products from distributors. As a result, McAfee
13 reported revenues during the relevant period that were materially overstated. In public
14 statements and Commission filings, McAfee never disclosed that it used a subsidiary to
15 repurchase product from McAfee's distributors, nor revealed that such repurchases rendered
16 McAfee's recognition of revenue from the initial sale of the repurchased product improper.

17 **B. McAfee Disguised Payments and Discounts to Distributors**

18 22. In order to reduce distributor returns, and induce distributors to purchase greater
19 quantities of McAfee's products, McAfee senior executives authorized secret payments to
20 distributors and undisclosed deep discounts on amounts that distributors purportedly owed
21 McAfee for products purchased under prior product purchase agreements. McAfee did not
22 properly account for these undisclosed discounts, payments, and other concessions under GAAP,
23 and, as a result, McAfee materially overstated the revenues reported on its product sales to
24 distributors.

25 23. McAfee granted distributors substantial discounts in the form of "price
26 protection," pursuant to which McAfee reimbursed distributors for the discounts that the
27 distributors gave to their customers to meet or beat the prices of McAfee's competitors.
28 Consequently, the payments that distributors purportedly had agreed to make to McAfee were

1 reduced by the amounts of the price protection reimbursements. From 1998 through 2000,
2 McAfee granted its largest distributor, Ingram Micro, Inc., approximately \$209 million in price
3 protection discounts on invoices from McAfee totaling \$1.2 billion, thereby reducing Ingram
4 Micro's payment obligations to McAfee by nearly seventeen percent. McAfee failed to properly
5 account for the price protection discounts under GAAP, and, as a result, McAfee materially
6 overstated the revenues it reported during the period.

7 24. McAfee also granted distributors large discounts on amounts they owed to
8 McAfee by offering a "stock rotation" program that allowed distributors to exchange less-
9 marketable McAfee inventory for new inventory in the same dollar amount. The practical effect
10 was that distributors were allowed to discount the payment amounts that they were obligated to
11 make to McAfee by the dollar amounts of the inventory exchanged. From 1998 through 2000,
12 McAfee granted nearly \$464 million in stock rotation discounts to Ingram Micro on a total of
13 approximately \$1.2 billion invoiced by McAfee, a discount of twenty-eight percent. McAfee
14 failed to properly account for the stock rotation discounts under GAAP, and, as a result, McAfee
15 materially overstated the revenues it reported during the period.

16 25. Throughout 1999 and 2000, McAfee also paid in cash the deep discounts and
17 concessions that it granted the distributors, rather than allowing distributors to deduct the
18 discounts from the amounts they owed. One purpose of these undisclosed cash payments was to
19 disguise McAfee's improper accounting for the discounts and concessions. These payments
20 ensured that the distributors would not deduct from payments to McAfee the amounts that they
21 were owed, and, as a result, created the false appearance that McAfee was being paid in full by
22 distributors on its invoices. From 1999 through 2000, McAfee made undisclosed payments to
23 Ingram Micro totaling approximately \$132 million. In one instance, in November 1999, senior
24 McAfee officials directed payments totaling over \$21 million to Ingram Micro in eight separate
25 wire transfers on a single day. The purpose of the payments was to compensate Ingram Micro
26 for the discounts, fees, and other concessions that Ingram Micro had claimed from McAfee and
27 to keep Ingram Micro from reducing its accounts payable to McAfee by the amounts of the
28 discounts. To disguise the purpose of the payments, eight letters that falsely characterized the

1 payments as reimbursement for expenses such as “marketing fund rebates and other promotional
2 programs” were sent to Ingram Micro. Letters containing similar mischaracterizations
3 accompanied nearly \$12 million in payments that McAfee made on June 12, 2000 also to Ingram
4 Micro. From August through October 2000 alone, McAfee made additional undisclosed
5 payments to Ingram Micro totaling approximately \$27 million.

6 26. Another purpose of the disguised payments was to induce the distributors not to
7 return unsold inventory to McAfee. If such returns had been made and properly accounted for
8 on McAfee’s financial statements, McAfee’s revenues would have been reduced by
9 corresponding amounts, making it difficult or impossible for McAfee to meet its quarterly
10 revenue targets. In one instance, near the end of the first quarter of 2000, Ingram Micro
11 demanded a fee from McAfee for holding “excess inventory” because Ingram Micro held well
12 over \$54 million in excess, unsold McAfee inventory. Rather than accept a return and properly
13 reduce recorded revenue, senior McAfee officials instead agreed to discount the amount that
14 Ingram Micro owed McAfee by two percent of the value of the excess inventory – or
15 approximately \$1.1 million. This discount was memorialized in a side letter dated March 8,
16 2000. Subsequently, Ingram Micro did not return the excess McAfee inventory, and on March
17 24, 2000, entered into a new agreement to purportedly purchase approximately \$31.4 million in
18 additional McAfee products.

19 27. The discounts, payments, and inventory returns had a significant effect on
20 McAfee’s actual cash collections from distributors. For example, Ingram Micro paid McAfee
21 only fifteen cents for every dollar invoiced in 2000. On average, from 1998 through 2000,
22 Ingram Micro paid only 32 cents for every dollar it was invoiced by McAfee.

23 28. GAAP provides that in order for a vendor to recognize revenue upon sale to a
24 distributor, the fees – or product purchase price – that a vendor expects to collect must be “fixed
25 or determinable at the date of sale.” GAAP further provides that a “fixed fee” is a “fee required
26 to be paid at a set amount that is not subject to refund or adjustment.” If fees are not “fixed or
27 determinable,” then GAAP requires, among other things, that the vendor defer recognizing
28 revenue on those fees until such time as the distributor actually sells the product to an end-user

1 or customer. McAfee admitted in its October 2003 restatement that its “accounting for sales to
2 distribution partners in 1998, 1999 and 2000” violated GAAP due to the “concessions, including
3 return rights and stock rotation rights, that were being offered to distributors outside the
4 contractual terms.”

5 29. As a result of the undisclosed payments, discounts, rebates, and other concessions
6 granted to distributors, the fees that McAfee expected to collect from its distributors during the
7 relevant period were not “fixed or determinable” at the time it sold its products to distributors.
8 Accordingly, McAfee’s accounting for the revenue from those fees was improper under GAAP,
9 and caused the financial statements that McAfee included in its periodic reports filed with the
10 Commission from 1998 through 2002 to be false and materially misleading. McAfee similarly
11 failed to disclose in those annual and periodic filings with the Commission the material
12 information about the payments, discounts, rebates, and other concessions granted to distributors
13 that would have revealed the true state of McAfee’s earnings and revenues.

14 **C. McAfee Fraudulently Manipulated Tax Reserve Accounts and**
15 **Other Reserve Accounts in Order to Increase Inadequate Sales**
16 **Reserves and Disguise Payments to Distributors**

17 30. McAfee’s practice of improperly accounting for the discounts, payments, and
18 rebates that it granted to its distributors rendered its immediate recognition of revenue from sales
19 to distributors improper under GAAP. Accounting for these distributor concessions in
20 accordance with GAAP would have required McAfee to increase its reserves for returns and,
21 correspondingly, reduce revenues. In order to avoid reducing revenues, and possibly missing
22 quarterly revenue and earnings targets that were watched closely by analysts and investors,
23 McAfee improperly increased its sale returns reserves by transferring amounts from unrelated
24 income tax and other reserve accounts.

25 31. During the period, a series of entries was made in McAfee’s accounting system
26 improperly decreasing the company’s income tax accounts and increasing unrelated returns
27 reserve accounts in violation of, among other GAAP provisions, Accounting Principles Board
28 Opinion No. 20, *Accounting Changes*, and Financial Accounting Standards Board Statement No.

1 5, *Accounting for Contingencies*. In one example in the fourth quarter of 1999, \$15 million was
2 transferred from a tax-related reserve account to a returns reserve account. If the \$15 million had
3 been accounted for properly in accordance with GAAP as a reduction to McAfee's revenues,
4 McAfee would have missed its revenue target for the fourth quarter of 1999.

5 32. Most of the improper tax reserve account transfers were made to offset cash
6 payments made to Ingram Micro. Specifically, over fifty percent of the approximately \$132
7 million paid to Ingram Micro for discounts, rebates, and other concessions was accomplished
8 through the improper transfers out of the McAfee tax reserve accounts. Neither the transfers
9 from the tax accounts, nor the payments to Ingram Micro, were disclosed by McAfee in the
10 company's annual or periodic filings with the Commission in the relevant periods.

11 33. On June 28, 2002, McAfee restated its financial statements for the period 1998
12 through 2000 to correct the improper tax reserve account transfers. The restatement resulted in
13 an elimination of approximately \$44 million in revenue in 1999 and 2000.

14 34. In addition to the improper tax reserve account transfers, from 1998 through 2000,
15 McAfee also improperly released amounts from the company's reserves for acquisition expenses,
16 general and administrative expenses, and bad debt expenses, and other liabilities in order to
17 bolster the deficient sales returns reserves and inflate the related revenues. The corrected
18 accounting for these additional items in McAfee's October 2003 restatement resulted in a
19 decrease in reported revenues for the period 1999 through 2000 of approximately \$58 million.

20 **D. McAfee Used Sham "Round-trip" Transactions**
21 **to Improperly Bolster Revenue**

22 **1. Round-trips with other Companies**

23 35. During the relevant period, senior McAfee officials arranged sham transactions
24 with third parties solely to create the false impression of business activity and revenues. In these
25 transactions, McAfee made cash investments in entities that, simultaneously, purportedly
26 purchased McAfee products. These transactions essentially resulted in a circular flow of money
27 from and back to McAfee, a portion of which McAfee then improperly recognized as revenue.

28

1 36. On or about December 31, 1998, McAfee entered into an agreement to invest \$8
2 million in NeoPlanet, Inc., a company offering a free web browser. The stock purchase
3 agreement incorporated a separate contract in which NeoPlanet paid McAfee \$4 million, also on
4 December 31, 1998, for non-refundable software licenses and support. However, prior to
5 receiving the cash from McAfee, NeoPlanet had a zero cash balance as of December 31, 1998,
6 and could not have paid the \$4 million back to McAfee without first receiving the \$8 million
7 investment from McAfee.

8 37. Similarly, on March 10, 1999, McAfee entered into a \$10 million investment in
9 Tesserae Information Systems, Inc., a manufacturer of technology used in Internet search
10 engines. On the same day, Tesserae paid McAfee \$5 million to license McAfee's software.
11 Ultimately, Tesserae never licensed any McAfee's software and, in any event, could not have
12 paid \$5 million to McAfee's for the licenses without first receiving funds from McAfee.

13 38. In its October 31, 2003 restatement, McAfee eliminated the reported revenue
14 related to the NeoPlanet and Tesserae deals based upon a determination that the revenue from
15 these transactions failed to conform with GAAP because, among other problems, the transactions
16 "lacked economic substance."

17 2. Round-trips with Distributors

18 39. McAfee executed round-trip transactions with Ingram Micro that were designed
19 to increase improperly McAfee's revenue. During the relevant period, Ingram Micro and
20 McAfee followed different fiscal calendars. McAfee was on a three-month reporting cycle, such
21 that its fiscal quarters ended on March 31, June 30, September 30, and December 31. Ingram
22 Micro used a thirteen-week reporting cycle, such that its quarter often ended a few days before or
23 after McAfee's quarter. Whenever McAfee's quarter ended before Ingram Micro's quarter did,
24 the discrepancy created an opportunity for revenue manipulation.

25 40. To take advantage of these anomalies, in seven consecutive quarters between
26 1998 and 1999, McAfee made sales of product to Ingram Micro before the end of its quarter, but
27 permitted Ingram Micro to return the same product after McAfee's quarter had closed, but before
28 the end of Ingram Micro's quarter. The net effect of this manipulation was that McAfee could

1 record large amounts of revenue, but Ingram Micro did not have to include the purchased
 2 product as inventory in its quarterly financial statements. The following chart demonstrates that,
 3 in most quarters when this scheme was in place, a disproportionate amount of product returns
 4 took place on such “gap days”:

Quarter	Total Returns to McAfee	Returns to McAfee Occurring on Gap Days	Percentage of Total Returns Occurring on Gap Days
Q1-98	\$13.0 million	\$9.9 million	76%
Q2-98	\$4.0 million	\$2.2 million	56%
Q3-98	\$12.7 million	\$11.0 million	86%
Q4-98	\$22.1 million	\$2.3 million	10%
Q1-99	\$30.7 million	\$0.5 million	2%
Q2-99	\$87.7 million	\$72.8 million	83%
Q3-99	\$21.9 million	\$17.2 million	79%

16 41. Many of the returns that took place on gap days were returns of products that had
 17 been purchased earlier in the same quarter. On July 1, 1999 – a gap day in Ingram Micro’s
 18 second quarter – Ingram Micro returned approximately \$58.8 million of McAfee products
 19 bearing stock-keeping unit numbers (“SKUs”) identical to an equivalent amount of McAfee
 20 products purchased earlier that quarter. These purchases and subsequent returns of the same
 21 product amounted to round-trip transactions that inflated McAfee’s revenues but lacked
 22 economic substance. Because the products were not returned until McAfee’s third quarter,
 23 McAfee recorded the underlying sales as revenue in its second quarter.

24 42. During the relevant period, McAfee also sold product to Ingram Micro on terms
 25 that enabled McAfee to record revenue from the sales during McAfee’s quarter, but the
 26 purchased product would not be “delivered” into Ingram Micro’s inventory until after Ingram
 27 Micro’s quarter had ended. Such “slow-boating” arrangements were a condition of Ingram
 28 Micro’s agreement to purchase the product in question. However, the delayed delivery

1 agreements were shams because the products at issue were software licenses and not physical
2 inventory that had to be shipped or otherwise delivered.

3 43. In the second quarter of 1998, Ingram Micro and McAfee agreed on a \$60 million
4 net order of product licenses. They further agreed that the products purchased by Ingram Micro
5 would not be "received" by Ingram Micro until July 6, 1998, after Ingram Micro's quarter had
6 ended on July 4, 1998. Ingram Micro and McAfee agreed not to document this aspect of the
7 transaction. The arrangement was not disclosed in the "deal letter" between the two companies
8 for the second quarter of 1998, concealing a key element of the transaction relating to McAfee's
9 ability to recognize revenue from the sale.

10 44. Similarly, the September 1998 letter memorializing the agreement between
11 Ingram Micro and McAfee to purchase license products for the third quarter of 1998 stated that
12 the licenses were "not to arrive at Ingram Micro before 10/5/98," after the start of Ingram
13 Micro's quarter, which began on October 3, 1998.

14 45. Ingram Micro and McAfee executed many of these transactions through the use of
15 purchase orders designated "Bill Only; Do Not Ship," to ensure that McAfee could recognize
16 revenue from a sale in a particular quarter, while Ingram Micro would not have to take
17 "delivery" of the product until the following quarter. Between the first quarter of 1999 and the
18 fourth quarter of 2000, Ingram Micro ordered at least \$188.5 million in products using purchase
19 orders that were designated "Bill Only; Do Not Ship." Of this amount, Ingram Micro received
20 about \$172 million in products in the quarter after the purchase order was placed. McAfee
21 recognized all of these purchases as revenue in the quarter in which the purchase order was
22 placed, but Ingram Micro did not receive the product into its inventory until the next quarter.

23 46. Ingram Micro, in fact, returned most of the products it purchased under "Bill
24 Only; Do Not Ship" purchase orders. Of the \$172 million in products that were received after
25 the quarter in which the purchase order was placed, Ingram Micro returned approximately \$145
26 million worth of those products to McAfee. These returns completed what were round-trip
27 transactions that enabled McAfee to inflate its reported financial results. For its part, Ingram
28 Micro was compensated by McAfee with payments and other concessions associated with the

1 volume of the purported purchases. In its periodic filings with the Commission, and in its annual
2 reports, McAfee failed to disclose the material information regarding its round-trip transactions
3 with Ingram Micro that the company used to overstate its reported sales revenues.

4 **E. McAfee Entered Into Consignment Sales Agreements**
5 **with Distributors that Conflicted with the Terms of Written**
6 **Contracts and Rendered Revenue Recognition Improper Under**
7 **GAAP and McAfee's Revenue Recognition Policies**

8 47. Between 1998 and 2000, McAfee allowed distributors to ignore the payment
9 obligations in written distribution contracts, and, instead, defer payments to McAfee until after
10 the distributors had resold McAfee's products to their customers. Certain McAfee customers,
11 including McAfee's second and third largest U.S. distributors, understood that they were not
12 obligated to pay for McAfee's products until after they had sold the products to customers.

13 48. The practice of allowing distributors to sell on consignment violated McAfee's
14 stated revenue recognition policy. It also rendered McAfee's immediate recognition of revenue
15 from sales to the affected distributors improper under GAAP. SOP 97-2 dictates that
16 arrangements in which a distributor is obligated to pay only as, and if, sales are made, should be
17 accounted for as consignments, whereby the vendor can only recognize revenue after the
18 distributor has sold the product.

19 49. In its October 31, 2003 restatement, McAfee acknowledged that its "accounting
20 for sales to distribution partners in 1998, 1999 and 2000" violated GAAP due to various
21 "concessions, including...the company...not obligating distributors to pay for delivered
22 inventory until they had sold the inventory."

23 **F. McAfee Improperly Sold its Accounts Receivable to**
24 **Disguise the Consignment Sales and Manipulate DSO**

25 50. By allowing distributors to delay payment or not pay their invoices in full,
26 McAfee accumulated on its balance sheet millions of dollars of aging receivables.
27 Consequently, "days sales outstanding" ("DSO") – the average number of days that it takes a
28 company to collect its accounts receivable – was directly affected. Wall Street analysts and

1 McAfee's Board of Directors regarded DSO as an important indicator of McAfee's financial
2 health; the larger the number, the more likely analysts would call into question the quality of the
3 receivables and the related revenue. To reduce DSO and get cash "in the door," McAfee sold
4 approximately \$261 million worth of its receivables from 1998 through 2000 to banks for cash
5 and immediately removed the receivables from the balance sheet.

6 51. In practice, however, the sales of receivables operated as bank loans to McAfee.
7 McAfee knew at the time that it sold the receivables that the receivables would not be collectible
8 on the terms represented to the banks, given McAfee's practice of allowing distributors to ignore
9 written contract terms and delay payment to McAfee, or remit payments at a deep discount.
10 Consequently, McAfee arranged to serve as the banks' "collection agent" for the receivables, and
11 also guaranteed the receivables, leaving McAfee with the risk of loss in these sales. Thus, even
12 when McAfee's distributors delayed payments or did not pay invoices in full, McAfee, as
13 collector and guarantor, paid the banks in full. For example, on December 31, 1998, McAfee
14 sold to a bank approximately \$16.7 million in Ingram Micro invoices, but only received payment
15 from Ingram Micro of approximately \$156,000 relating to the same invoices. McAfee then used
16 its own cash to pay the balance of \$16.5 million that was owed to the bank.

17 52. In its October 2003 restatement, McAfee admitted that its accounting for the sales
18 of its receivables during 1998 through 2000 did not conform with GAAP. Financial Accounting
19 Standard No. 125, *Accounting for Transfers and Servicing of Financial Assets and*
20 *Extinguishments of Liabilities* ("SFAS No. 125") provides that a company's receivables must
21 represent a contractual right to receive a fixed amount of cash in order to be properly removed
22 from the balance sheet. However, because McAfee's customers were not obligated to pay until
23 they had resold the product, the invoices, which required payment within a certain number days
24 from the date of receipt, did not constitute a right to receive cash from distributors to whom the
25 invoices were issued, and, therefore, no receivables existed to be transferred.

26 53. McAfee also failed to adequately disclose the financing arrangements in
27 company's annual and quarterly financial statements filed with the Commission. Item 303 of
28 Regulation S-K requires disclosure of off-balance sheet financing in the Management's

1 Discussion and Analysis of Financial Condition and Results of Operations (MD&A) portion of
2 its periodic Commission filings. Regulation S-K § 229.303 [17 CFR § 229.303]. In its 1998
3 through 2000 filings, McAfee failed to disclose that its accounts receivables often were
4 uncollectible because McAfee's customers were not obligated to pay for products until they had
5 sold them, and that, as a result, the accounts receivables could not be sold and removed from the
6 balance sheet. Rather, in its filings, McAfee merely stated: "To address [an] increase in
7 accounts receivable and to improve cash flows, we may from time to time take actions to
8 encourage earlier payment of receivables and sell receivables." In fact, McAfee sold receivables
9 in every quarter in 1998, the first quarter 1999, and the second quarter 2000, each time
10 improperly reducing the company's accounts receivable balances.

11 **MCAFEE MADE MATERIAL MISREPRESENTATIONS AND**
12 **OMITTED MATERIAL INFORMATION IN ITS COMMISSION FILINGS**

13 54. During the relevant period, McAfee filed annual and periodic reports with the
14 Commission that not only contained materially false financial statements, but they also failed to
15 include accurate disclosures concerning McAfee's business practices and results of operations in
16 sections for Management's Discussion and Analysis of Financial Condition and Results of
17 Operations (MD&A), and elsewhere. For example, in its annual report for the year ended
18 December 31, 1998, McAfee stated in the MD&A section that growth in net revenue was due to
19 increases in the licensing of its anti-virus products for both new and existing customers,
20 continuing customer acceptance of its computer network support services, and an "increase in
21 services and support revenues result[ing] from growth in all categories of service revenues,
22 principally due to the growth of our installed customer base and the resulting renewal of
23 maintenance contracts." Notably, McAfee omitted any mention of its aggressive channel
24 stuffing, which improperly allowed it to increase the revenues that it reported to investors.
25 McAfee explained in that filing that it recognized revenue "when a customer purchase order has
26 been received, a license agreement has been delivered, the software or system has been shipped
27 (or software has been electronically delivered), remaining obligations are insignificant, and
28 collection of the resulting account receivable is probable." However, as discussed above,

1 McAfee failed to disclose its actual business practices, which did not conform to its stated
2 revenue recognition policies. McAfee did not disclose that, when it recognized revenue on sales
3 to distributors, it had significant obligations to assist distributors in the resale of its products, nor
4 that collection of the resulting account receivable was, in most cases, improbable due to the
5 concessions, discounts, and payments McAfee provided to its distributors. McAfee deceived
6 investors when it omitted this information, which would have alerted investors to the true state of
7 the company's earnings and revenues.

8 **MCAFEE FAILED TO MAINTAIN AN ADEQUATE**
9 **SYSTEM OF INTERNAL ACCOUNTING CONTROLS**

10 54. McAfee failed to maintain accounting controls sufficient to ensure that accurate
11 information concerning its financial health was reported timely to the Commission and the
12 investing public. Specifically, as a company with stock registered with the Commission,
13 McAfee is required to make and keep books, records, and accounts, which, in reasonable detail,
14 accurately and fairly reflect its transactions and disposition of assets. McAfee is further required
15 to devise and maintain a system of internal accounting controls sufficient to provide reasonable
16 assurances that transactions are recorded as necessary to permit preparation of financial
17 statements in conformity with GAAP. McAfee's failure to implement and maintain an adequate
18 system of internal accounting controls contributed, in large measure, to five restatements of its
19 financial results in a five year period.

20 55. In April 1999, McAfee restated its previously reported financial results for 1997
21 and 1998 due to its improper accounting for numerous acquisitions of other companies during
22 the same period.

23 56. In June 2002, as discussed above, McAfee restated its previously reported 1999
24 and 2000 earnings because of fraudulent entries that had been made in its tax reserve accounts.
25 Specifically, throughout 1999 and 2000, amounts were transferred from tax reserve accounts in
26 order to improperly inflate under-funded sales return reserve accounts.

27 57. In October 2003, also as discussed above, McAfee announced an extensive
28 restatement that corrected seven years of reported financial results – 1997 through the second

1 quarter of 2003. Throughout 1998, 1999, and 2000, the company had, among other things,
2 fraudulently recognized revenue on its product sales to distributors.

3 58. On March 9, 2004, McAfee disclosed in its Annual Report for 2003 that it would
4 restate its first, second, and third quarter 2003 quarterly financial statements, as well as its fourth
5 quarter 2003 and full year 2003 financial results. This restatement focused on McAfee's
6 improper recognition of deferred revenue for certain products sold internationally and its practice
7 of making manual journal entries. At the time, McAfee's outside auditors reported that the
8 underlying issues giving rise to the restatement constituted a "material weakness" in McAfee's
9 system of internal controls.

10 59. At the time of the March 9, 2004 restatement announcement, McAfee reported to
11 investors that it had "bolstered internal controls around the recognition of international revenues"
12 and was "in the process of initiating additional internal control procedures" to address the
13 material weakness identified by its auditors, "including the hiring of additional personnel,
14 determining how to automate revenue recognition calculations so as to limit the number of
15 manual adjustments, and engaging in additional testing of [its] control processes and
16 procedures."

17 60. Six months later, on August 9, 2004, McAfee restated again to correct errors in its
18 operating results for the quarter ended March 31, 2004 because the company had once more
19 improperly recognized revenue on certain product sales. McAfee's newly-hired outside auditing
20 firm found, as had McAfee's previous auditors, that the issues underlying the August 9, 2004
21 restatement constituted a material weakness in McAfee's system of internal accounting controls.
22 At the time, McAfee assured investors in its public filings that the actions it had implemented or
23 was in the process of implementing to strengthen its internal accounting controls "will correct the
24 underlying circumstances giving rise to the restatement."

25 61. On February 24, 2005, McAfee reported to investors that it had "one or more"
26 deficiencies in its financial accounting processes. McAfee stated that it would delay the filing of
27 its 2004 annual report while it took more time to evaluate and test its internal financial controls.
28 Moreover, McAfee also reported that it could only report "pre-tax operating results" for the year-

1 ended 2004 because it was “continuing to evaluate the adequacy of its income tax payable,
2 deferred taxes, and tax expense balance.” These are the same accounts presumably reviewed
3 during the company’s June 2002 restatement for fraudulent tax reserve account entries, discussed
4 above.

5 62. When McAfee filed its 2004 annual report on March 31, 2005, McAfee’s external
6 auditors cautioned investors that McAfee’s system of internal financial controls over such critical
7 accounting areas as the recognition of revenue for software contracts was materially deficient in
8 several areas. These deficiencies, or “material weaknesses,” in McAfee’s accounting controls
9 over financial reporting posed “a more than remote likelihood that material misstatement of the
10 interim and annual financial statements would not have been prevented or detected,” according
11 to the company’s auditors.

12 **MCAFEE OFFERED AND SOLD SECURITIES**

13 **DURING THE PERIOD OF THE FRAUD**

14 63. From 1998 through 2003, McAfee filed approximately twenty registration
15 statements for its common stock, including registration statements for the sale of 5.04 million
16 shares and 19.09 million shares in 1998 and 2002, respectively, relating to convertible note
17 offerings to investors. The 2002 registration statement for 19.09 million shares related to notes
18 sold by McAfee to institutional investors in 2001 for approximately \$345 million. McAfee’s
19 registration statements and offering prospectuses for these transactions included McAfee’s
20 materially false and misleading financial statements.

21 **FIRST CLAIM**

22 **McAfee Violated Securities Act Section 17(a), Exchange Act Section 10(b),
23 and Exchange Act Rule 10b-5
[Financial Fraud]**

24 64. Paragraphs 1 through 64 are realleged and incorporated herein by reference.

25 65. McAfee, in connection with the offer, purchase, or sale of securities, knowingly
26 or recklessly made material misrepresentations and omissions of fact concerning McAfee’s
27 financial condition and operating results for the period from 1997 through 2003 in financial
28

1 statements, periodic reports, management's discussion and analysis of the company's results,
2 securities registrations filed with the Commission, and press releases.

3 66. By reason of the foregoing, McAfee violated Securities Act Section 17(a) [15
4 U.S.C. § 77q(a)] and Exchange Act Section 10(b) [15 U.S.C. § 78j(b)] and Exchange Act Rule
5 10b-5 [17 C.F.R. § 240.10b-5].

6 **SECOND CLAIM**

7 **McAfee Violated Exchange Act Section 13(a)**
8 **and Exchange Rules 12b-20, 13a-1, and 13a-13**
9 **[Reporting Violations]**

10 67. Paragraphs 1 through 67 are realleged and incorporated herein by reference.

11 68. McAfee's financial statements, which were not presented in conformity with
12 GAAP, were included in its annual, quarterly, and other reports filed with the Securities and
13 Exchange Commission from the fourth quarter of fiscal year 1997 (the period ended December
14 31, 1997) through the second quarter of fiscal year 2003 (the period ended June 30, 2003).
15 Additionally, in its Commission filings during this time, McAfee failed to disclose in
16 management's discussion and analysis of the company's results, material information needed to
17 make its required statements not misleading.

18 69. By reason of the foregoing, McAfee violated Exchange Act Sections 13(a) [15
19 U.S.C. § 78j(b), 15 U.S.C. § 78(a), 15 U.S.C. § 78m(a)] and Exchange Act Rules 12b-20, 13a-
20 1, and 13a-13 [C.F.R. § 240.10b-5, 17 C.F.R. §§ 240.12b-20, 240.13a-1, and 240.13a-13].

21 **THIRD CLAIM**

22 **McAfee Violated Exchange Act Sections 13(b)(2)(A) and 13(b)(2)(B)**
23 **[Books and Records and Internal Controls Violations]**

24 70. Paragraphs 1 through 70 are realleged and incorporated herein by reference.

25 71. McAfee failed to make and keep books, records, and accounts, which, in
26 reasonable detail, accurately and fairly reflected its transactions and disposition of assets.

27 72. McAfee failed to devise and maintain a system of internal accounting controls
28 sufficient to provide reasonable assurances that transactions were recorded as necessary to permit
preparation of financial statements in conformity with GAAP.

1 73. By reason of the foregoing, McAfee violated Exchange Act Sections 13(b)(2)(A)
2 and 13(b)(2)(B) [15 U.S.C. §§ 78m(b)(2)(A) and 78m(b)(2)(B)].

3 **RELIEF REQUESTED**

4 WHEREFORE, Plaintiff Securities and Exchange Commission respectfully
5 requests that this Court:

6 **I.**

7 Issue an order of permanent injunction restraining and enjoining McAfee, and its
8 agents, servants, employees, attorneys, and assigns, and those persons in active concert or
9 participation with McAfee, and each of them, from violating Securities Act Section 17(a) [15
10 U.S.C. § 77q(a)], Exchange Act Sections 10(b), 13(a), and 13(b) [15 U.S.C. §§ 78j(b), 78m(a),
11 and 78m(b)], and Exchange Act Rules 10b-5, 12b-20, 13a-1, and 13a-13 [17 C.F.R. §§ 240.10b-
12 5, 240.12b-20, 240.13a-1, and 240.13a-13].

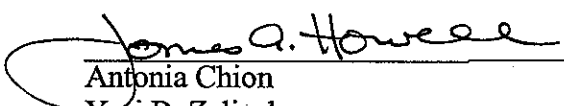
13 **II.**

14 Issue an order directing McAfee to pay civil monetary penalties under Securities
15 Act Section 20(d) [15 U.S.C. § 77t(d)] and Exchange Act Sections 21(d)(3) and 21A of the
16 Exchange Act [15 U.S.C. §§ 78u(d)(3) and 78u-1].

17 **III.**

18 Grant such other and further relief as this Court may deem just and proper.

19
20 Dated: Jan. 4, 2006

21 
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