This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

10b5-1 and Option Plans Abused, Earnings in Question F5 Networks Inc. (NASDAQ:FFIV)

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F5 Networks, Inc. is a provider of application traffic management products. The Company develops, manufactures and sells products and services to help companies efficiently and securely manage their Internet traffic. The Company's BIG-IP application traffic management products help manage Internet protocol (IP) traffic to servers and network devices in a way that maximizes the availability, scalability and throughput of those network components and the applications that run on them. F5 Networks' complementary FirePass products provide secure user access to corporate networks and applications, enabling companies to extend secure remote access to anyone connected to the Internet by leveraging standard Web browser technology. The Company's TrafficShield application firewall product provides security for IP-based applications and data, protecting them from hackers and other malicious attacks at the application layer. On May 31, 2004, F5 Networks acquired MagniFire Websystems, Inc.

Summary of 3DAdvisors Findings for FFIV

- **Accounting:** Change in revenue recognition for clients with "extended" credit
- **Accounting:** Manipulation of allowances boosts reported earnings
- **Governance:** Loophole allows granting of options without shareholder approval
- **Insider Trading:** 10b5-1 plans camouflage accelerated holdings reductions
- **Insider Trading:** Rank and file employees follow executives, selling jumps

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Discussion of 3DAdvisors Findings

F5 Networks initially came to our attention in early March (see the *Insider Research Bulletin* of 03/09/05) as it became evident to us that persistent insider selling was starting to take its toll on the actionable holdings of many key insiders at the company. This is an example of a situation where there has been ongoing selling for an extended period of time which has a tendency to lull you to sleep and accept the behavior as "normal". The fact that this was accomplished under the camouflage of 10b5-1 trading plans that had been discreetly increasing in size only served to increase our interest. The extent to which actionable holdings (common stock plus exercisable options) have been quietly gutted has probably been overlooked by most observers.

Further inspection into executive behavior at the Company has proven fruitful as we have uncovered evidence of both governance and accounting behavior to complement our initial insider findings. Through manipulation of certain valuation allowances and revenue timing issues, it seems that the Company has seized selected opportunities for managing earnings. Also, the extensive use of options compensation has put F5 in the ranks of companies most likely to be materially affected by the coming expensing of options. In spite of this, certain gaming of the Company's option plans, utilizing a loophole that allows F5 to issue new "Outside of Plan" options that do not require shareholder approval, reveals a rare practice that seems designed to prevent incoming new executives from depleting the options pool available for incumbent members of management, while at the same time diluting shareholders.

Accounting: Change in revenue recognition for clients with "extended" credit

F5 offers extended payment terms, ranging from three to six months, to "certain customers". In these cases, the Company discloses that "revenue is recognized when payments are made". At first glance, the revenue recognition policy seemed innocuous enough, even conservative. We did, however, wonder why, if all the conditions for revenue requirements (title passing to customer, fixed and determinable price, reasonability of collection, etc.), the Company would choose to hold off recording of revenues to the extent that they could end up being out-of-period. There are provisions acceptable under GAAP that would permit or even require the delay of revenue recognition. There is no indication that any such provisions exist in this case and it is very unlikely that merely granting payment terms of three to six months would justify delaying revenue recognition.

Further checking into this revealed a subtle but important change in F5's revenue recognition related to situations where it has extended credit to "certain customers". A comparison of the Company's 2003 Form 10-K opened our eyes a bit wider when the related disclosure of revenue recognition read differently than it currently does. In 2003, the disclosure **"The Company has offered extended payment terms to certain customers, in which case, revenue is recognized when payments become due."** This is quite different from the related 2004 disclosure which states that **"revenue is recognized when payments are made"**.

It would seem that, by changing revenue recognition from a due date to an actual payment date, the opportunity for out-of-period recognition becomes even wider when, given the chance, it would be possible to ask "certain customers" to delay payment in situations which may inure to F5's benefit. While on the surface it may seem that this change represents a more conservative policy, to us it is in fact the opposite and represents a possible "Cookie Jar" opportunity to manipulate revenue.

Providing confirmation to this is the rise in inventories at F5 that has occurred in the past year, the year in which the revenue recognition changed from a due date to a payment date. F5 inventories, which were at $762,000 at 09/30/03, have swelled to $1.73 million by 12/31/04, an increase far larger than that of revenues for the period. This dovetails with the change in revenue recognition for extended credit customers. Since F5 delays the recordation of extended credit-related revenues, they must also delay the recognition of related costs and any related delivered product must remain in inventory until the ultimate recognition of revenue (read: payment). The fact that they have shifted recognition from a payment due date to an actual payment date could very well provide the opportunity for increased use of this ability to move revenues around among periods.

Accounting: Manipulation of allowances boosts reported earnings

Since F5's earnings have been volatile, and with significant losses for F/Y's 2001 through 2003, we were not surprised to see that, prior to Q4 2004 (F/Y ends 09/30) the Company had set up a Valuation Allowance for the entire amount of its $30.7 million of Deferred Tax Assets. What did surprise us, however, was the fact that they were able to abruptly reverse the entire allowance attributable to U.S. operations ($28.1 million) in Q4 of 2004 (09/30/04). It is certainly unusual to see such a big swing in a valuation allowance in one year. At the end of F/Y 2003, the Company's view was that it was more likely than not that the deferred tax assets would not be realized. Then, just one year later, the Company's view is that, based on current operating results and future taxable income it is more likely than not that the deferred tax assets will be realizable. This reversal accounted for a tax benefit of $7.3 million in Q4, or $0.21 per share.

It is difficult to see how the Company's income prospects have changed so much in one year so as to go from a full allowance to none. Clearly, the independent auditors went along with the reversal. The timing and extent of this, however, given the volatile earnings history of the Company, certainly has our attention.

This isn't the first time F5 has quietly manipulated an allowance. In prior reporting, the Company had been clearly demonstrating the need for recognition of inventory obsolescence and carried a reserve to provide for it. Then in '03 the reserve appears to have disappeared with no explanation from the Company. Evidence of this move exists in the elimination of the reference to the Reserve for Obsolete Inventory in F5's Critical Accounting Policies section in the 2004 Form 10-K. Oddly enough, the Company continued to reference this reserve in that same section of its 2003 Form 10-K in spite of the fact that a review Cash Flow statements clearly show the cessation of any provision for inventory write downs (in Cash from Operations) after F/Y 2002.

It is likely that the Company received some sort of earnings kick from this back in 2003 but any amount is difficult to determine. Even if minimal, any effect of that reserve disappearance had to go to income, probably washed through cost of products. To us, the most important aspect to this was that no disclosure of this apparent change was ever offered, and absent any explanation for the change, we have to regard inventory valuations with a somewhat jaundiced eye.

Governance: Loophole allows granting of options without shareholder approval

Upon researching F5's option plan history, we immediately became curious at the fact that separate plans had been set up, without shareholder approval, for certain individual insiders. When these high-level executives were hired, separate option plans were created in their name. Each plan covered a large initial option grant and nothing more. Five such plans have been created since 2000 with the most recent (created for **Karl Triebes**, the incoming Chief Technical Officer) being adopted as recently as August of 2004. In addition to the Triebes plan, similar deals have been established upon the hiring of CFO **Steve Coburn**; Sr. V.P, Worldwide Sales, **Thomas Hull**; Sr. V.P. Marketing and Business Development, **Jeff Pancottine**; and CEO **John McAdam**.

Governance and compensation experts we have consulted concerning these plans tell us that they have never seen nor heard of a company going through such efforts to create individual plans such as these. Equally interesting is the fact that F5 has been able to pull these off without shareholder approval. The Company never explains the loophole but we were able to find it on the NASDAQ website (bolding is ours for emphasis):

> **"An option grant made to a person who has not been an employee or director of the company before is considered an "inducement award" and is exempt from shareholder approval requirements. However, either the Compensation Committee (comprising a majority of independent directors) or a majority of the Board's independent directors must approve the award."**

This is just the kind of getting around the spirit of the rules that gets our attention. Even broad based plans, which had historically not required shareholder approval for adoption, now require approval by shareholders.   F5's jumping through the loophole (the most recent individual plan was adopted in August of 2004) is a direct challenge to the spirit of the new direction of corporate governance. In addition to the above plans, two separate plans have also been adopted for incoming employees from two recent acquisitions, uRoam and MagnifFire. In all, 5.79 million options have been granted under these seven plans through the loophole that allowed them to avoid shareholder approval (see Appendix A).

What we have here is a device whereby F5 management has found a way to preserve the amount of options available to incumbent executives under existing plans (the Company's 1998 Equity Incentive Plan and the 2000 Employee Equity Incentive Plan), while issuing out-of-plan options to new hires. This means that more options are available for incumbent members of the management team at the expense (read: dilution) of the shareholders. Indeed, almost 20% of the current outstanding shares have been issued in conjunction with option plans.

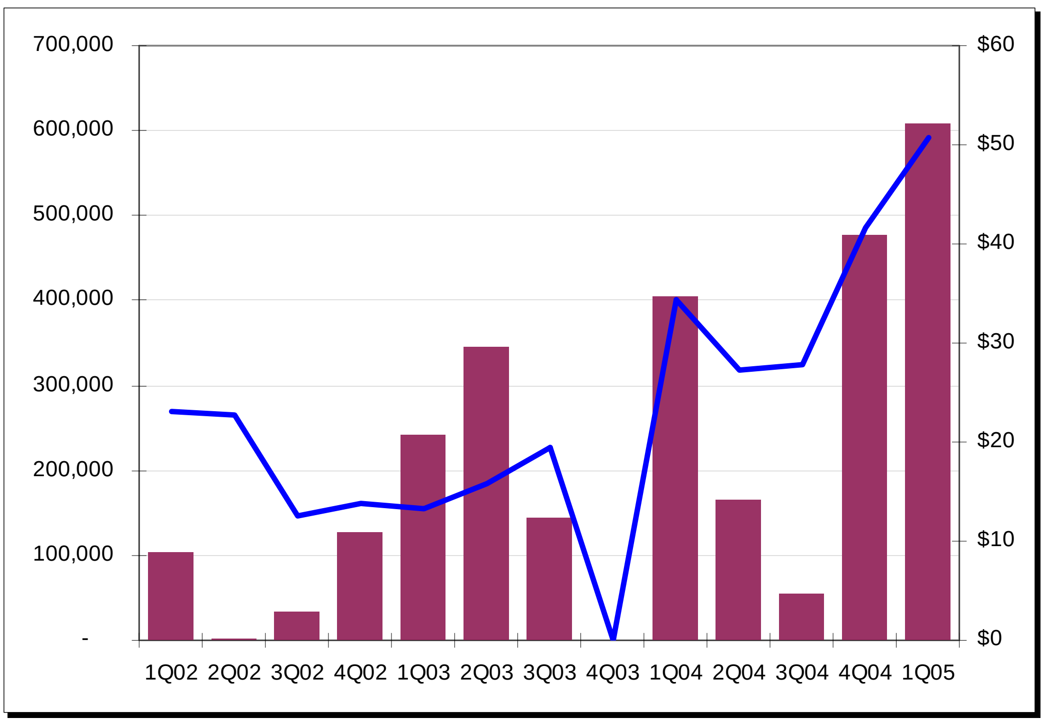
And all this at a Company that has a very significant exposure to options expensing. By the Company's estimate, 2004 diluted earnings of $0.92 per share would have been slashed to $0.39 if options expensing had been required. No wonder shareholders voted down last year's attempt to increase the amount of options available under the 1998 Plan by 2 million shares, even though two new incoming executives (Hull and Triebes) were granted 525,000 options during fiscal 2004 that weren't part of any shareholder approved plan.   No worries to management though, who managed to get 1.7 million new options available for issue under the 2005 Equity Incentive Plan, which was approved by shareholders just this past February (see Appendix A).

<u>Insider Trading: 10b5-1 plans camouflage accelerated holdings reductions</u>

The insider story about F5 is not that the selling is new, for it has been going on for some time and much of it under the cover of 10b5-1 trading plans, some of them adopted as far back as early 2003. What catches our attention here is the fact that insiders have been altering those plans to increase the number of shares they are selling. In doing so, the continued selling under these "safe harbor" plans has significantly eroded the actionable holdings of key Company insiders.

The Company has never disclosed terms of the 10b5-1 plans, but the modification that has taken place is rather evident. For example, President, CEO John McAdam had been consistently selling 50,000 shares per quarter through 2003, but increased his volume to 120,000 or 150,000 shares per quarter in February 2004, while Senior V.P. **Edward Eames** was selling less than 10,000 shares per month, but then sold 140,000 shares over the past three months. We should also point out that simultaneous to the issuing of our last report, Senior V.P. **Thomas Hull** executed his first sale. It is exactly this type of change in behavior that alerts us to a management team's changing sentiment. You can see from Figure 1 below how selling volume in 2004 increased 50% over 2003, while the majority of sellers were still under pre-arranged trading plans. And with only two months on the books, the selling in 2005 is on pace to top last year's mark. We haven't seen this many shares being sold by insiders since 1999 when the issue traded between $60 and $160.

Figure 1. Shares Sold by Insiders (Red Bars and Left Scale) and Weighted Average Price of Shares Sold (Blue Line and Right Scale). Source: FFIV SEC Filings.



The additional issue here is that insiders are increasing their selling while their option grants have been on the decline year-over-year, despite the out of plan grants. And it might not be a coincidence that options granted prior to 2004 had a two-year vesting schedule, whereas those granted in 2004 vest in full one year from the grant date, allowing insiders quicker access to their shares. In effect, this ultimately inhibits management from focusing on long-term goals.

The bottom line here is that the only unvested options held by this group is an immaterial amount that will vest in full by May 2005 with nothing else vesting until at least this time in 2006 (see Appendix B). We say this because any of F5's to-be-granted options will have aggressive one-year vesting schedules and this year's grants have yet to be disclosed.

The options holdings of the five execs listed in Appendix B gains significance when one takes into account that as a group they only hold a total of 58,003 shares of common stock, 56,582 of which are in the hands of McAdam. The acceleration in selling has led to holdings reductions for the Company's most senior executives between 32% and 76% (see Table 1 below). We have adjusted these holdings reductions since our last report, as a number of options have since vested due to their monthly vesting schedule. We have also taken into account the option series granted to executives in April 2004, which as we mentioned, vest in full later this month. This type of group move to diversify away their exposure to the Company's stock shouldn't be taken lightly.

Table 1. Holdings Reduction for Named Executives. Source: FFIV SEC Filings.

Executive	12/17/01	11/15/02	02/20/04	04/30/05	Holdings Reductions Since 2004
McAdam	357,500	772,776	615,610	408,248	**33.68%**
Coburn	--	102,499	133,957	65,415	**51.17%**
Pancottine	109,377	228,349	187,787	45,983	**75.51%**
Eames	--	171,134	234,649	160,435	**31.63%**

- **John McAdam (53)** – President, CEO, Director. McAdam, who joined the Company in 2000, didn't begin selling until late 2002 when he initiated a pre-arranged trading plan. His sales had been quite predictable, which is to be expected under such plans, as he sold exactly 75,000 shares per quarter through August 2003. But it is the predictable traders who when they break pattern give us some of the best clues. In February 2004, McAdam increased his volume to 150,000 shares quarterly, which we first expected was for him to make up for not selling during the fourth quarter 2004. But when he sold another 150,000 shares in May 2004, we took notice. Including the 120,000 shares he sold on February 1st at \$47.16, McAdam has now dumped 540,000 shares over the past 53 weeks, after selling just 300,000 shares between 2000 and 2003. The selling during this period **trimmed his holdings by 34%**, and leaves his actionable shares at their lowest levels since he first joined the Company. Though he will have 126,666 new options vest by June, McAdam is not scheduled to have any options vest thereafter (see Appendix B).

- **Steve Coburn (51)** – Senior V.P., Finance, CFO. Like McAdam, Coburn has picked up his volume in the past few months. Coburn joined the Company in 2001 and didn't execute his first sale until February 2004, when he distributed 100,000 shares at $33 and $35 under a 10b5-1 trading plan. He didn't resurface until November 2004, when he dumped another 100,000 shares at slightly higher prices ($38). But on February 1st, Coburn exercised two options with plenty of time remaining before expiration (expiration dates: May 2011 and May 2013) and sold the 95,000 shares at $47. We can't fault Coburn for locking in gains after the stock's appreciation, but it is the degree to which he has done so, and an apparent abuse of his trading plan (he appears to be selling only into momentum) that caught our attention. Not only have his three sales over the past year **shed 51% from his holdings**, but they also leave him with no common stock and just over 20,000 vested options (see Appendix B).

- **Jeff Pancottine (44)** - Senior V.P., General Manager, Security Business Unit. Pancottine's activity is by far the most aggressive of the bunch and originally even led us to believe that he was leaving F5 Networks, but that theory was rejected after speaking to the Company. Pancottine has been a Section 16 insider since 2000, but didn't surface with any activity until March 2003. Two months later he adopted a trading plan of his own and sold a total of 181,232 shares between March 2003 and February 2004, and then didn't resurface until December. From December 1st to February 14th Pancottine exercised every last vested option he held, including three series set to expire between October 2010 and May 2013, to acquire 239,833 shares. He monetized all the shares, **equal to 76% of his ownership position**, and now just holds 1,401 shares of common stock (see Appendix B).

- **Edward Eames (46)** - Senior V.P., Business Operations and Global Services. Eames began selling under a 10b5-1 trading plan back in May 2003, but has noticeably increased his selling as of late under the plan. After routinely selling less than 10,000 shares per month, he picked up his volume as the issue gained momentum in late 2004. From December 1st through March 1st he dumped 140,666 shares at an average price of $48, and has now **trimmed his holdings by 32%** since February 2004.

- **Thomas Hull (45)** – Senior V.P., Worldwide Sales. Hull, a Section 16 filer for only six months (October 2004), has already cashed in a substantial amount of his actionable position (common stock plus exercisable options). Hull has received two options since joining the Company, one of which vested in part, the other, which vests in full on April 30th. On March 4th he exercised a majority of his vested options and sold the underlying 55,000 shares at $56 under a newly-adopted 10b5-1 trading plan. Taking into account the options that are scheduled to vest in late April, the sale **shed 45% from his position**, which is significant this early in the game. After his April options vest, he will have 4,687 new options vest monthly for the next two-and-a-half years (see Appendix B).

Members of F5 Networks' executive ranks weren't the only ones to take advantage of the stock's gains. Directors Gary Ames (60) and Karl Guelich (62) sold 65% and 37% of their holdings, respectively, in 2005. Ames has been a director for less than a year, so we were a little surprised to see him monetize such a large percentage of his position so early in his tenure. The sale becomes even more notable when you take into account that he is also a board member at Tektronix (NYSE: TEK) and iPass

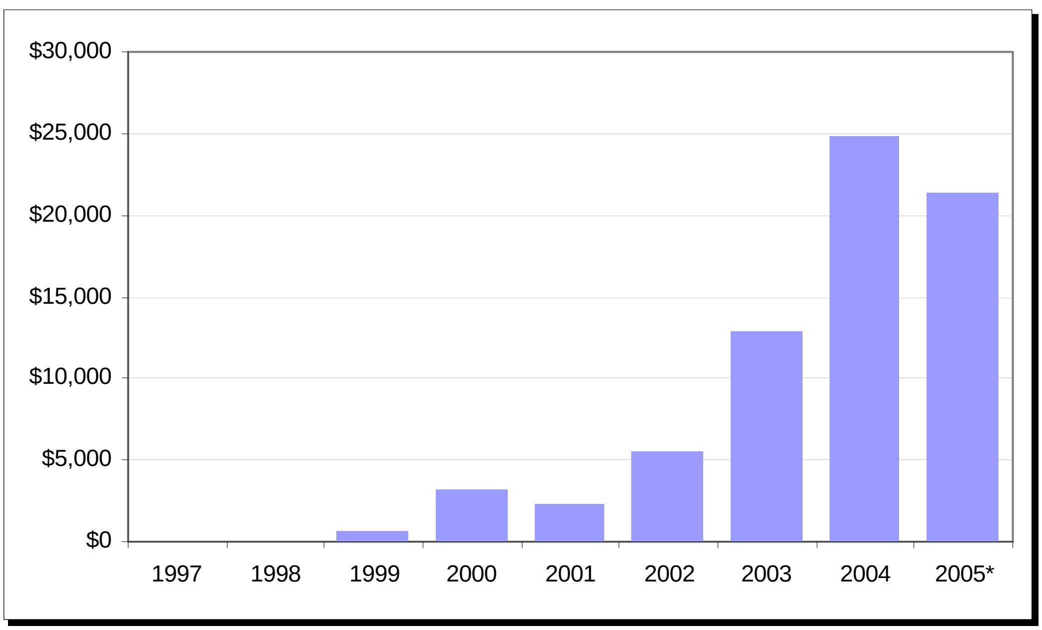
(NASDAQ: IPAS) and not only has been buying up IPAS, but sold only 14% of his stake in TEK back in March 2004; far less than what he sold of his F5 Networks holdings.

Insider Trading: Rank and file employees follow executives, selling jumps

Not only do we see aggressive selling by Section 16 filing insiders but also indications of broad-based selling by regular employees of F5 who have received options under various Option Plans. Evidence of this can be found in the proceeds received by F5 from employee stock option exercises. Prior to 2002, the Company had never received more than $5 million in any fiscal year from these. In F/Y 2004 however, F5 took in just shy of $25 million from exercises. This figure is a cinch to be dwarfed by the exercises occurring in 2005 as through Q1 alone, $21.3 million has come in over the transom from employee stock option exercises.

It has been our observation over the 24 years that we have been analyzing insider behavior that the vast majority of the time, when employees exercise options (especially rank-and-file ones) they sell the underlying shares. Having said this it is a fair assumption on our part that F5 employees (both Section 16 filers and regular employees) are selling stock at record levels, and much more aggressively than they did back in the heyday when the shares traded at prices between $60 and $160.

Figure 2. Cash Received From the Exercise of Employee Stock Options ($000). Source: FFIV SEC Filings.



* Cash received for the fiscal first quarter of 2005 (ended 12/31/04).

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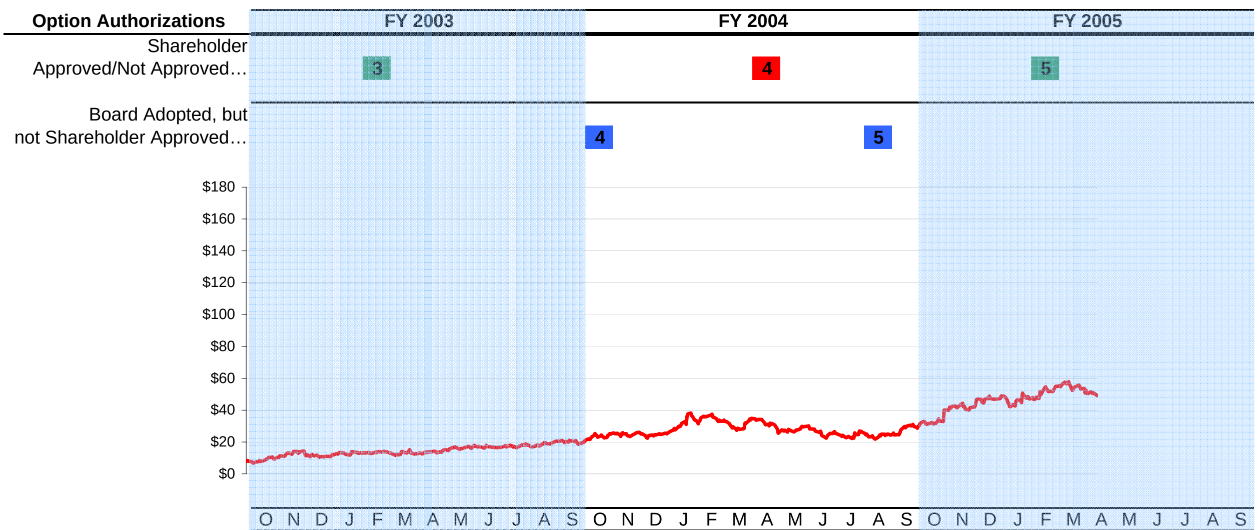
Appendix A

Shareholder Approved vs. Board Adopted (Not Shareholder Approved) Option Authorizations

FY 2000	FY 2001	FY 2002
	Options Granted = 4,662,574	Options Granted = 2,233,850
Options Avail. @ FYE = 5,303,271	Options Avail. @ FYE = 308,733	Options Avail. @ FYE = 1,714,262



FY 2003	FY 2004	FY 2005
Options Granted = 2,195,300	Options Granted = 2,230,515	
Options Avail. @ FYE = 1,178,737	Options Avail. @ FYE = 121,250	

1 Shareholders voted for amending the 1998 Equity Incentive Plan to increase shares from 2.3M to 3.3M

2 Shareholders voted for amending the 1998 Equity Incentive Plan to increase shares from 3.3M to 5.3M

3 Shareholders voted for amending the 1998 Equity Incentive Plan to increase shares from 5.3M to 6.3M

4 Shareholders voted **against** amending the 1998 Equity Incentive Plan to increase shares from 6.3M to 8.3M

5 Shareholders voted for the 2005 Equity Incentive Plan, which increased the shares issuable for grant by an additional 1.7M shares

1 Board adopted the 2000 Equity Incentive Plan which increased shares issuable for grant by 3.5M shares

2 Board adopted the "Pancottine Plan", which authorized the grant of 200,000 options to SVP Jeff Pancottine at the time of his hire

3 Board adopted the "Coburn Plan", which authorized the grant of 200,000 options to CFO Steve Coburn at the time of his hire

4 Board adopted the "Hull Plan", which authorized the grant of 225,000 options to SVP Thomas Hull at the time of his hire

5 Board adopted the "Triebes Plan", which authorized the grant of 300,000 options to CTO Karl Triebes at the time of his hire

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Appendix B

Option Vesting Schedules for Selected F5 Networks Inc. Insiders

Grant Date	Options	Price	Date Exercisable	Expiration Date	Remaining Options in Series	Unvested Options in Series	Vesting Dates of Remaining Options
John McAdam, President, CEO, Director. Common stock holdings: 56,582 shares							
05/06/02	200,000	$11.12	06/06/02	05/06/12	105,000	0	Fully vested
05/08/03	160,000	$14.64	06/08/03	05/08/13	160,000	6,666	6,666 vest on 5/08/05
04/30/04	100,000	$25.49	04/30/05	04/30/14	100,000	100,000	Vests in full on 4/30/05
Steve Coburn, Senior VP, Finance, CFO. Common stock holdings: 0 shares							
05/29/01	200,000	$12.72	05/29/02	05/29/11	20,000	0	Fully vested
05/08/03	55,000	$14.64	06/08/03	05/08/13	10,000	2,291	2,291 vest on 5/08/05
04/30/04	40,000	$25.49	04/30/05	04/30/14	40,000	40,000	Vests in full on 4/30/05
Jeff Pancottine, Senior VP, General Manager, Security Businss Unit. Common stock holdings: 1, 401 shares							
05/08/03	55,000	$14.64	06/08/03	05/08/13	9,167	2,291	2,291 vest on 5/08/05
04/30/04	40,000	$25.49	04/30/05	04/30/14	40,000	40,000	Vests in full on 4/30/05
Edward Eames, Senior VP, Business Operations and Global Services. Common stock holdings: 20 shares							
05/06/02	70,000	$11.12	06/06/02	05/06/12	70,000	0	Fully vested
05/08/03	55,000	$14.64	06/08/03	05/08/13	55,000	2,291	2,291 vest on 5/08/05
04/30/04	40,000	$25.49	04/30/05	04/30/14	40,000	40,000	Vests in full on 4/30/05
Thomas Hull, Senior VP, Worldwide Sales. Common stock holdings: 0 shares							
10/10/03	225,000	$23.69	10/20/05	10/20/13	170,000	140,625	4,678 vest per month
04/30/04	40,000	$25.49	04/30/05	04/30/14	40,000	40,000	Vests in full on 4/30/05

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