3D ADVISORS

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

Run Up in Stock Belies Accounting and Insider Issues Symantec Corporation (NASDAQ:SYMC)

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Symantec Corporation provides content and network security software and appliance solutions to enterprises, individuals and service providers. The Company provides client, gateway and server security solutions for virus protection, firewall and virtual private network (VPN), security management, intrusion detection, Internet content and e-mail filtering, remote management technologies and security services to enterprises and service providers worldwide. Symantec has offices in 36 countries worldwide. The Company views its business in five operating segments: enterprise security, enterprise administration, consumer products, services and other activities.

Summary of 3DAdvisors Findings for SYMC

- **Insider Trading:** Insiders seem unwilling to hold much stock
- **Accounting:** Option plans produce big tax benefits and bigger dilution
- **Accounting:** Goodwill treatment carries significant impairment risks
- **Accounting:** Deferred revenue growth slows
- **Accounting:** Interesting movement in accounts receivable
- **Accounting:** Restatement in Q1 '04 benefits future earnings

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Discussion of 3DAdvisors Findings

All the right planets seem to be lining up for Symantec these days. With the seemingly ubiquitous recurrences of one virus after another, SYMC shares have enjoyed one of their best-ever runs. Even with some analysts rightly pointing out that Microsoft's acquisition of Gencad Software portends the software giant's entry into the market in a major way, the stock continues to climb to reach very lofty valuations.

However, there are times when the perception of precision tends to mask certain imperfections festering beneath the surface. With regards to Symantec, this seems to be the case as we are monitoring a number of factors that could affect that near-perfect alignment that seems to be driving the stock price at this time.

Insider Trading: Insiders seem unwilling to hold much stock

Symantec is not a company whose insiders seem to be committed to holding much of a stake. Indeed, including vested options, directors and management own just 2.3% of the outstanding shares. Take out Chairman and CEO John Thompson, who has been granted options totaling 1.6 million shares over the past three years, and that percentage comes down to just 1.2%. Although the Company mandates that each officer and director must hold at least 10,000 shares, we find that many continue to hold far less.

We found a sale by **Gail Hamilton (53)** - Executive V.P., Product Delivery and Response, to be very interesting. Hamilton joined Symantec in 2000. She leads the development of the full range of Symantec's security solutions, including gateway, server and client security products, firewall, intrusion detection, vulnerability management, filtering and antivirus applications. She is responsible for both the enterprise administration and consumer products segments of Symantec's business, or, more succinctly put, 56% of revenues.

Between July 31 and August 14, she exercised options for, and sold, 222,000 shares at prices around $48 per share. This is far more than any sale she has executed in the past (her next largest was a 100,000 share sale in January of 2002 for $38 each, after which the shares drifted lower for the next nine months). Her sales trimmed her actionable holdings (stock held plus vested options) by 76%, truly a significant reduction for such a key individual. In the past, this kind of action has been a tip-off that the individual involved may be leaving the company. We also note that she has yet to attempt to boost her stock holdings up to the minimum 10,000 shares required, by company policy, continuing instead to maintain her actual common holdings at 4,539 shares.

Another selling insider that has yet to get his holdings up to the mandated 10,000-share level is **Donald Frischmann (60)** - Senior V.P., Communications and Brand Management. Frischmann exercised options for, and sold, 16,666 shares, in early August, at about $46.50 each. He has been selling fairly regularly, on the way up, since last December, clearing out over 66,000 shares in all, exercising options and selling the underlying shares each time. In doing so, he has consistently held his actual stock holdings at just 1,714 shares.

Other sellers of Symantec shares in recent months include Chairman and CEO **John Thompson** (100,000 shares), Director **Daniel Schulman** (3,750 shares) and Director **Kris Halvorsen** (11,000 shares). Neither Schulman nor Halvorsen maintain their holdings at the required 10,000-share level. So far, there have been no insider sales since the recent run up in the shares. This could change however, when the window again opens after the release of Q2 earnings next month.

Accounting: Option plans produce big tax benefits and bigger dilution

Symantec's options programs generated tax benefits totaling $40 million in F/Y 2003, $46 million in 2002 and $8.4 million in 2001. These benefits were enhanced by cash flows from employees exercising options. In F/Y 2003 Symantec took in $138 million from Employee Stock Option Exercises, up from $134 million in 2003 and $46 million in 2001. This makes F/Y 2003 the year of highest Company benefit from its options programs. It's already looking as if F/Y 2004 will top all other years. Through just one quarter, the Company has taken in $57 million in cash from exercises and has generated a tax benefit of $15 million for the period. Of course, the high level of options exercising is a clear indicator that general employee stock selling (not just Section 16 filing insiders) is running at all time highs as well.

The options programs, however, come with big corresponding costs. Dilution is a big issue as outstanding options, plus options available for grant (but not yet issued) amounted to a potential dilution of almost 26% as of earlier this year. Symantec's shares outstanding have increased from 116 million shares in F/Y 2000, to 145 million at F/Y end, 2003, an increase of 25%. This dilution risk, spawned from Company options programs, carries an additional significant burden if (or should we say, when?) option expensing becomes mandatory. Symantec estimates that the inclusion of options expensing would have trimmed F/Y 2003's EPS by about 33% (to $1.15 per share vs. a reported $1.71).

Perhaps this is why the September 2002 establishment of the 2002 Executive Officers Stock Purchase Plan seems to have been met with collective yawns from insiders. Under the plan, 250,000 shares were set aside for officers who wished to apply a portion, or all, of their respective bonus payments towards the purchase of up to 10,000 shares of Company stock. As of March 31, 2003, there had been no takers.

<u>Accounting: Goodwill treatment carries significant impairment risks</u>

Symantec dismissed auditors Ernst & Young on September 18, 2002. Perhaps it is coincidental, but during the same quarter of the dismissal, SYMC closed four acquisitions, of companies in similar businesses, for a total of $375.2 million in cash. The amount allocated to Goodwill, from these acquisitions, totaled $308 million, or about 82% of the purchase prices (on average). Loading the acquisitions' Goodwill allocations like this could easily avoid, as you know, certain amortization of intangibles that would have been required had the deals been allocated otherwise.

To us, it seems that paying cash for the recent acquisitions, with most of the purchase price going into Goodwill, is worthy of note. It is hard to imagine that every one of those acquisitions is going to work out, justifying such cash outlays for little more than goodwill in return. Surely, should SYMC have to absorb large impairment losses they will point out that the charges are non-cash, and from an accounting standpoint that will be true. But are they really non-cash losses? If a company lays out significant cash and puts it on the books as goodwill and within a year or two goodwill write-offs occur, isn't it a cash loss just recognized belatedly?

As a result of these deals, Symantec's Goodwill total swelled 57% to $833 million (26% of assets). So what, you say? Many companies show big Goodwill numbers and they don't seem to have big impairment issues, so what makes Symantec's situation different? We think that Symantec's Goodwill is hardly the "household name" variety such as a Proctor & Gamble's, which would, prior to SFAS 142, have been written off over a forty-year period. Indeed, prior to its SFAS 142 adoption, Symantec was amortizing its Goodwill over just a 4 to 5 year period. Yet, with two impairment tests completed, in its post-142 era, Symantec has yet to write off *any* of its Goodwill to impairment. And while most companies test for Goodwill impairment semi-annually (and some even quarterly), Symantec only tests for it annually, in its fourth quarter.

So, at the time of its next impairment test (March quarter of 2004) it will have been two years since Symantec's SFAS 142 adoption, which is quite a hiatus from any mounting Goodwill impairment pressures. Given the fact that, prior to 142, SYMC had been amortizing its Goodwill over that 4 to 5 year period, it would stand to reason that, after two years, a strong probability will exist that some significant Goodwill impairment is likely to be recorded, unless, that is, its independent auditors force the issue earlier.

<u>Accounting: Deferred revenue growth slows</u>

Symantec builds its Deferred Revenue Balance (as listed in Current Liabilities) in primarily two areas:

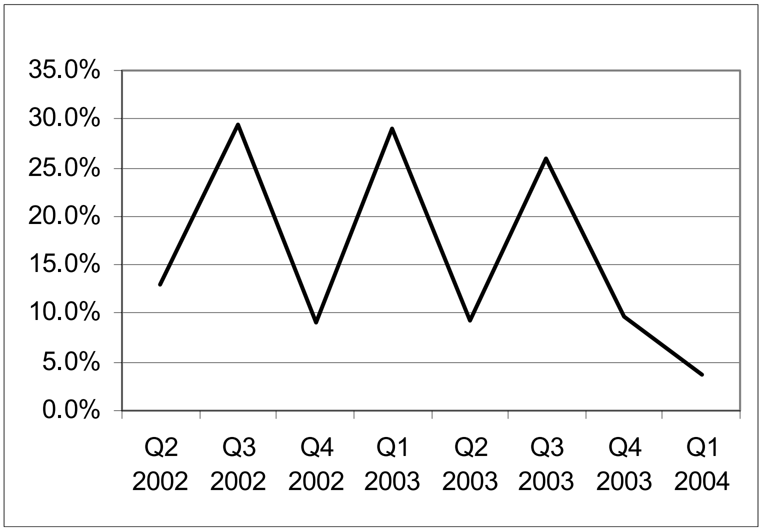
- **Perpetual License Agreements**: It's no secret that the growth of Symantec's Enterprise business is a key driver for the Company's results. Symantec's Enterprise Security and Enterprise Administration segments account for 57% of the Company's total revenues. These segments typically enter into perpetual license agreements for their products. These agreements include product maintenance agreements, for which the related revenue is deferred over the period of the agreements. Though Symantec does not come out and say it, these arrangements imply that a version of percentage of completion accounting is used in revenue recognition, giving the Company much latitude with regards to the timing of revenues.

- **Product Updates**: Symantec defers a portion of revenue from products bundled with content updates. This deferred revenue is recognized ratably over the initial year that such updates are provided.

Although the Company does not reveal the breakdown of its Deferred Revenues (between segments), a recent conference call revealed that 60% of the balance is associated with Enterprise sectors, where the most latitude exists with regards revenue recognition. The remaining 40% is attributable to the Consumer Products Segment.

With Deferred Revenue at $612 million as of Q1, 2004 (June quarter), the Company, and analysts, are quick to point out that this portends stable downstream revenues for the near term. What they are not talking about however is the fact that Deferred Revenue growth appears to be slowing. This is not evident from management discussions, which uses same-period comparisons (read: Q1 of 2002 vs. Q1 of 2002). A look at the sequential growth however, reveals much more:

Figure 1. Sequential Percentage Change in Deferred Revenue
Source: Symantec Corporation SEC Filings



Deferred Revenue growth slowed to just 3.7% in the June Quarter (Q1 ‘04). Clearly, it is too early to draw significant conclusions from this at this time. The fact stands however, that in the most recent conference call, management focused on 56% growth in year over year June quarter growth and not the fact that the rate has slowed.

Whether this recent growth abatement is a result of any slowdown in the Enterprise Segment (an important question!) will possibly be masked by the recent August 29th increase in the consumer subscription, on-line price hike of $5 per sale. The increase has a surgical tone to it. Symantec did not increase the product price, just the subscription price. By leaving the up-front price (license price) unchanged and raising the subscription price (which is recognized ratably over a year), Symantec will be able to boost that slowing growth in Deferred Revenues since a greater portion of each consumer sale will be booked as Deferred Revenues. Thus, the Company will boost Deferred Revenues with the aid of the Consumer Segment, a move that will tend to obfuscate whether the Company is experiencing less growth contribution from its critical Enterprise Segment than it had in earlier periods.

<u>Accounting: Interesting movement in accounts receivable</u>

It seems that Symantec maintains two separate deferred revenue accounts. In addition to Deferred Revenues that appear in Current Liabilities, we have “Channel Revenue Deferrals”. In both the Consumer and Enterprise Administration segments, Symantec ships product, to certain channels, in excess of “certain specified inventory levels for these channels”. When this is done, the Company defers related revenue. The obfuscation here is that the amount of this particular deferred revenue is undisclosed and excluded from “Deferred Revenues” as listed as liabilities on the

Balance Sheet. Instead, these deferred revenues are offset against accounts receivable.

With these Channel Revenue Deferrals being an offset to A/R's, their fluctuations could affect A/R levels. In periods where Channel Revenue Deferrals run high, their offsetting against receivables would tend to cause the A/R number to be understated. In other words, without actually "stuffing the channel" (by booking revenues), Symantec's policy of stuffing the inventory channels may help mask bulges in receivables, and associated DSO calculations.

In addition, the growth of the Enterprise business enhances the opportunity for revenue recognition policies that utilize versions of percentage of completion accounting. With this in mind, getting a handle on Symantec's A/R growth becomes an interesting exercise. Indeed, Symantec's A/R's have shown some real gyrations. From $47 million in F/Y 2000 (6.3% of sales), they jumped to $116.7 million in 2001 (13.6% of sales). In F/Y 2002 A/R's backed off to $89 million (6.5% of sales) only to jump again, in 2003 to $150 million (10.6% of sales). By Q1 of F/Y 2004 A/R's dropped to $129 million, and back to 6.5% of sales. Through the same periods, Days Sales Outstanding (DSO's) have fluctuated between a manageable 23 and 49 days.

It seems that there is a possibility, unconfirmed by the Company, that unbilled receivables contribute to the movements of A/R's. Now, Symantec makes no specific reference to unbilled receivables in its financials (10k's or 10Q's). We have, however, uncovered a one-time reference to them, which confirms their existence. Back in early 2000, Symantec released an 8K document describing the sale of an exclusive license of Symantec product (ACT!) and the transfer of certain assets to a third party (SalesLogix). Certain assets that were to be retained by Symantec were itemized in that 8K. These included the usual cash, bank accounts and accounts receivable, etc. Also included, however, in the itemization of "Retained Assets" to be kept by Symantec, **"Unbilled Receivables"**. This remains the only reference to unbilled receivables in any of Symantec's public disclosures. So now we know that Symantec has booked unbilled receivables in the past and very well may be doing so now. What we don't know is "how much?"

Accounting: Restatement in Q1 '04 benefits future earnings

In August of 2003, Symantec, as part of a settlement agreement, purchased a patent, from Hilgraeve Inc., for $62.5 million in cash. Originally, the Q1, 2004 10Q had disclosed that $13.9 million of the August settlement cost had been recorded in the June quarter and that the remaining $48.6 million, for acquired product rights, would be amortized over the life of the patent, which was set to expire in June 2011.

On August 18th, however, Symantec added another $9.5 million to that one-time first quarter charge in a restatement resulting in a reduction of 5 cents/share to the already-closed Q1. Now, thanks to the restatement, the remaining amount to be amortized, over the life of the patent, has been reduced to $39.1 million, as opposed to the $48.6 million originally disclosed. Though not large, the restatement allows for Symantec to reduce its annual amortization expense by $1.2 million from what it would have been, over the life of the patent, if the restatement had not occurred.