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

Insider Selling, Accounting and Business Model Issues Tessera Technologies Inc. (NASDAQ:TSRA)

July 11, 2005

Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Tessera Technologies, Inc., together with its subsidiaries, develops semiconductor-packaging technology for miniaturization of electronic products. The company operates through two segments, Intellectual Property, which includes license fees for patented technologies and royalties on semiconductors shipped by licensees that employ patented technologies; and Services, which include engineering services. The company's technology enables the production of smaller and faster semiconductors, which are used in various electronics products, including digital cameras, MP3 players, personal computers, personal digital assistants, video game consoles, and wireless phones. Tessera's patented technology enables its customers to assemble semiconductor chips into chip-scale packages. The technology also enables multiple chips to be stacked vertically in a single three-dimensional multichip package. Tessera also provides engineering, assembly, and infrastructure services.

Summary of 3DAdvisors Findings for TSRA

- **Accounting:** Revenue timing offers plentiful opportunities to manage earnings
- **Governance:** Related party dealings between TSRA and ISR stand out
- **Insider Trading:** Insiders sell heavily into significant price drop
- **Other:** Business model and industry questions may provide context for behavior

---

Discussion of 3DAdvisors Findings

When looking to understand management-speak concerning a June Q2 guidance increase at Tessera Technologies, one should look no further back than March 21st of this year when the Company also hiked guidance in its first quarter. At that time, citing "the impact of new licenses signed", Chairman and CEO **Bruce McWilliams** boosted the revenue outlook by 18%. TSRA shares responded quickly with a sharp 13% rally which contained enough follow through to take the shares back up to the $46 range where they flirted with the all-time highs reached earlier in the month. However, seemingly as soon as one could say "double top", the shares proceeded to lose 45% of their value upon the release of the Q1 earnings which revealed their true quality, or lack thereof.

The release disclosed that revenue was driven by license sales resulting from litigation settlements and associated make-up payments, while its core business was flat. Meanwhile, with rising litigation costs and lowered Q2 guidance, it was quite clear that the Company would have to continue to get much of its revenue growth via the courts as it defends its patents. In the midst of all this, insiders have been selling heavily while reducing their actionable holdings dramatically. Most importantly though, much of the selling has occurred ***after*** the big May drop in the share price. This gains even more significance since Tessera is a company whose insiders are not restrained from selling by company-induced trading windows, making it indisputable that the decisions made to sell shares at big discounts were not prompted by earnings release-related timing constraints.

Further inspection of Tessera reveals what appears to be a rather tenuous business model. The Company seems heavily reliant on revenues derived from successful defense of its patents to bridge the gap while awaiting the timing of acceptance of new generation DRAM technology which it has bet much of its future leverage on. Along the way, interesting revenue recognition and timing issues have come into play, which appear to raise questions about revenue visibility and/or controls. Add to this the potential for competing technologies to have a significant impact on TSRA and we need little reason to wonder why such insider selling has taken place so far this year, which has reduced holdings of key insiders by between 46% and 87%.

Accounting: Revenue timing offers plentiful opportunities to manage earnings

A number of issues make revenue reporting at Tessera appear to be a weak area. With regards to its Intellectual Property Revenues, the Company regularly discloses that it experiences a one-quarter lag in reporting revenue from licensees who "generally report shipping information 30 to 60 days after the end of the quarter". We are prone to wonder whether this lag exists more to accommodate the customers' payment terms than an actual inability to get the information more quickly. In either case, it would seem that it gives TSRA plenty of latitude in the timing of its revenue recognition. If Tessera wanted to push some revenue into the next period, it could simply advise a licensee to delay. It strains credulity to accept the fact that with sophisticated technology in use by both the Company and its customers, information processing will not allow for timelier reporting of shipments by customers and revenue recognition by the Company.

This could very well be what is behind the most recent guidance hike by TSRA, issued on June 8th, which seemed reminiscent of the guidance increase issued back in March: According to CEO McWilliams, "We are revising our second quarter and full year guidance upwards based on larger than expected payments from existing customers for past production, as well as better than expected royalty payments in the second quarter."

There is considerable latitude in recognizing revenues from Service Contracts as well. While Tessera describes using Completed-Contract accounting for short term fixed fee contracts, it also uses Percentage of Completion (PoC) accounting for cost reimbursement-type contracts. Virtually nothing is said about the amount of revenue that is attributable to PoC accounting. It's interesting to note how TSRA keeps the door open for its use of PoC accounting in its financials (bolding is ours):

> **"The Company utilizes the completed-contract and the percentage-of-completion methods of accounting for both commercial and government contracts, dependent upon the type of the contract. The completed-contract method of accounting is used for fixed-fee contracts with relatively short delivery times. Revenues from fixed-fee contracts are recognized upon acceptance by the customer or in accordance to the contract specifications, assuming: title and risk of loss has transferred to the customer; prices are fixed and determinable; no significant Company obligations remain; and collection of the related receivable is reasonably assured.**
>
> **The Company uses the percentage-of-completion method of accounting for cost reimbursement-type contracts, which generally specify the reimbursable costs and a certain billable fee amount."**

In the above disclosure, Tessera indicates that the Completed Contract method is utilized "for fixed fee contracts with relatively short delivery times". Tessera does not define "long" and "short" term and instead uses **"relatively short"** as a benchmark. Under this scenario, it would not be difficult to give the customer a choice: They could take a longer term contract of, say, 18 months which would allow for the use of PoC accounting, or they could opt to take a contract of a year or less (relatively short term) and Tessera would use Completed Contract accounting. By getting the customer to specify which they would prefer, and possibly offering incentives in doing so, TSRA could influence the kind of accounting that would be utilized for a given service contract.

To this, we should also note that, although it has the right to do so, TSRA does not audit its customers' records to verify the accuracy of the royalty reports received. Though we can understand the motives in not doing so, we also recognize that the absence of such actions could eventually cause pressure from independent auditors to develop systems to reduce the significant amounts of out of period revenues and income that seem to manifest themselves regularly at Tessera.

Governance: Related party dealings between TSRA and ISR stand out

When thinking about what companies may be willing to play ball with Tessera on service revenue contract types, one may have to look no further than the Company's relationship with Isothermal Systems Research (ISR). Tessera CEO, Bruce McWilliams sat on ISR's board until March, 2005 and in the past has performed consulting services for them. In doing so, he has received options for 100,000 ISR shares. Tessera discloses that McWilliams may continue to perform consulting services for ISR.

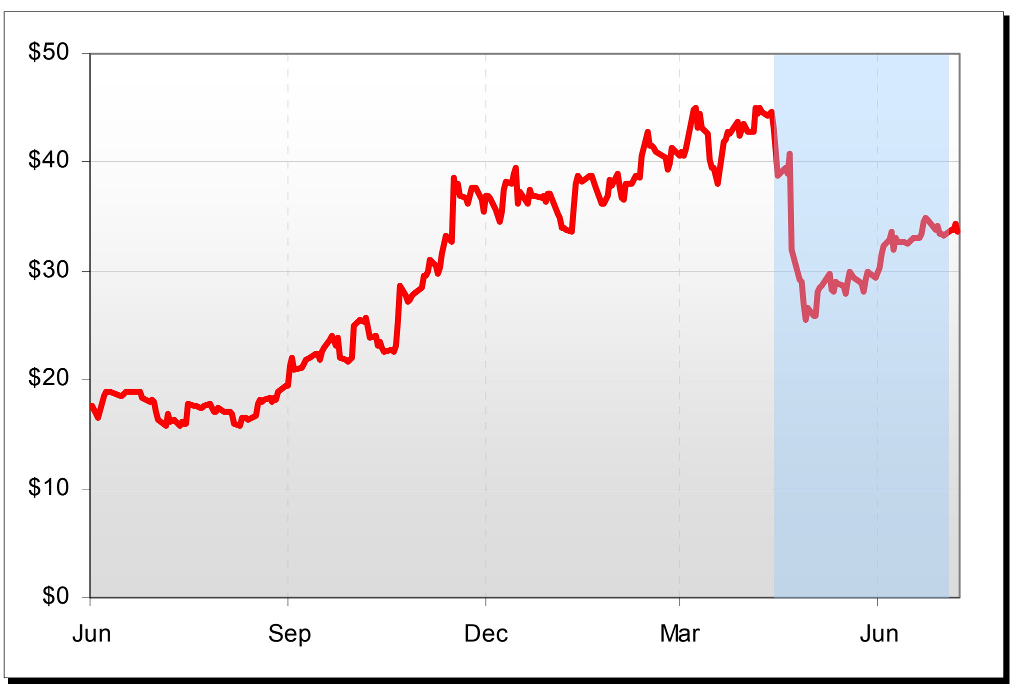
Also interlacing with ISR and Tessera is **Al Joseph** who is both ISR's Chairman and a Tessera board member. Joseph, a director at Tessera since 2001, has performed consulting services for TSRA which he received options for 324,000 shares in payment in addition to his director's compensation. This raised our eyebrows a bit because it would seem that a portion of that advice TSRA received from Joseph should have been what he had been paid for as a director. But there's more here: In December of 2004, Joseph entered into an employment agreement with Tessera to serve as a part-time Vice President, receiving an annual salary of $50,000 plus options for 100,000 TSRA shares.

Beginning in 2002, Tessera and ISR began entering into a series of agreements to develop applications and high density chip packages under subcontracting arrangements which relate to work that ISR has contracted to perform for the Department of Defense. These contracts provided total revenues to Tessera of over $6 million in 2004. Tessera's disclosure makes it clear that "a series of agreements" have been entered into with ISR. If TSRA were looking to choose a customer whom it could persuade to sign agreements to fit its needs (read: Percentage of Completion or Completed Contract methods) it would, no doubt, find a willing candidate in ISR.

Insider Trading: Insiders sell heavily into significant price drop

Perhaps the most telling component of the recent insider selling at TSRA, outside of the large erosion of the holdings of those involved, is the fact that of the 626,857 shares sold by Tessera insiders between April 1st and July 5th (the blue shaded area of Figure 1), over 438,000 of them were let go after the post earnings plunge in the shares, and these insiders were not restricted by trading windows that permit selling only during periods immediately following the release of earnings. This type of trading behavior

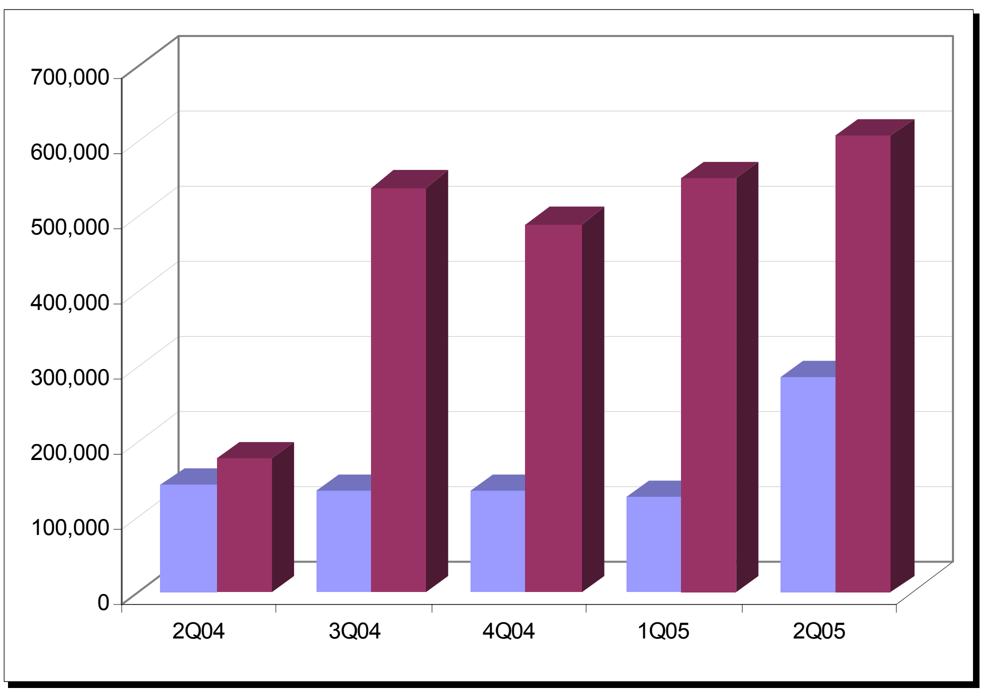
Figure 1. TSRA Daily Closing Price, June 1, 2004 through July 8, 2005. Blue shaded area is where 7 insiders sold 626,857 shares (April 1 to July 5). Source: Reuters and TSRA SEC Filings.



ranks high among the most significant of all insider actions. The reactions of Tessera insiders strongly imply that there is much more risk lurking in the Company's business model than even may have been discounted for by the recent stock plunge.

Even prior to this period, Tessera Tech executives have displayed a proclivity towards monetizing their options, which vest monthly, nearly as soon as they can get their hands on them. We can't remember another company where this type of behavior has persisted for this long a period. Since early 2004, a majority of the current sellers have executed monthly distributions, in many cases increasing their pace, despite a steadiness in the number of new options that vest. The options burn rate has decimated their holdings since early last year and have left them at such low levels that with the exception of Chairman, President, CEO Bruce McWilliams, not one of the senior execs possesses enough shares to sell at the same pace as they had just months earlier, even after options vest over the next few quarters. Figure 2 below shows the new options that have become exercisable each quarter for the seven named executives compared to their total distributions.

Figure 2. Options That Have Become Exercisable (Blue Bars) and Shares Sold (Red Bars) by TSRA Named Executives. Source: TSRA SEC Filings.



The effects of this "burn rate" are most evident in their holdings, which are down dramatically since early last year as shown in Table 1. The named executives' holdings were diminished even more starting in the second quarter, when all seven of them sold 626,857 shares from April 1st to July 5th, as the stock fell from $44.50 to lows of $24.95 (see Figure 1 above). As mentioned earlier, a few of the sellers were not shy about selling into the issue's weakness. Senior V.P., CFO **R. Douglas Norby** sold a total of 80,000 shares in the first quarter at an average price of $41 but then dropped 120,000 shares in the fourth quarter, 80,000 of which were sold in the $30 to $33 range at 26% lower prices, while McWilliams sold considerably more shares in the second quarter at prices as low as 38% below where he sold a quarter earlier. This type of action is rare as their willingness to shed substantial portions of their holdings at depressed prices compels us to look for other indicative behavior and ulterior motives.

In addition, not lost on us is the fact that two of the three new divisional heads named in the recent restructuring, **Kirk Flatow**, head of Tessera's Advanced Semiconductor Packaging Group and **Nick Colella**, head of the Company's Product Miniaturization Division, are among those with the most dramatic holdings reduction in the entire group. Not much of a vote of confidence from newly promoted lieutenants.

Another important point about option burn rate should be noted here. Tessera attempted to expand its current option plan by 1.2 million shares in the most recent proxy vote. The move was turned down by shareholders.

Table 1. Holdings and Percentage Reductions for TSRA Named Executives. Source: TRSA SEC Filings.

Named Executive	Position	04/01//2004	07/08/2005	Reduction since 2004
B. McWilliams	CB, P, CEO	1,794,968	967,561	**46%**
R. Norby *	SVP, CFO	36,666	113,370	**N/A**
M. Forman	VP-Finance	223,302	69,338	**69%**
N. Colella	Director	220,000	38,135	**83%**
K. Flatow	SVP	220,651	14,246	**94%**
C. Pickett	General Counsel	478,979	38,472	**92%**
D. Tuckerman	SVP, CTO	129,131	155,265	**N/A**

* R. Norby had 275,000 options vest by September 2004.

- **Kirk Flatow (46)** – Senior V.P., Product Miniaturization Division. On April 4th, Flatow exercised one option series set to expire in February 2012 and then monetized the 12,500 shares at $41.45. Just one month later on May 4th he tapped into the same option series for another 12,500 shares, only this time he sold into the issue's weakness, accepting 37% less for his shares (sale price: $26.22). Then, on June 6th and July 5th he again exercised his February 2012s and sold another 25,000 shares at roughly $33. In all, Flatow has sold 98,319 shares on the year, **equal to 87% of his actionable holdings** (exercisable options plus common stock). Even though he liquidated a large percentage of his holdings in the second half of 2004, that hasn't stopped him from immediately monetizing his options upon their monthly vesting. After holding 220,000 shares just one year earlier, he now has holdings totaling 14,246 shares, only 78 of which are in actual common stock. Although he will have 42,500 options vest in both the third and fourth quarters (see Appendix A), his average quarterly selling over the past year has been 86,000 shares.

- **R. Douglas Norby (69)** – Senior V.P., CFO. Norby joined the Company in July 2003 and was immediately provided two grants covering a total of 440,000 options. The disclosure on his Form 4s of these series' vesting schedules is very misleading, as he claims that one of the series vests 25% on the first anniversary (July 2004) and 1/36th each month thereafter. However, the Form 4 (along with our data records) shows that Norby has already monetized 92% of one series, including the 120,000 shares he sold between April 11th and June 10th. But what stands out most about his activity is that he has been selling, and at larger increments, into the shares' weakness. Norby's first sales occurred in the first quarter when he sold 80,000 shares at an average price of $39. Since then, he sold 40,000 shares on April 11th at $44.20, and then sold an additional 40,000 shares at 32% lower prices on May 19th. He didn't wait for the stock to pick up much of its losses before selling again, as he unloaded an additional 40,000 shares on June 10th at marginally higher prices ($32). On the year, **Norby has now cashed out 71% of his position**, a majority of which were distributed well off the highs. Should he continue at the current pace, he will liquidate his entire holdings in a few months since he only has 4,583 options vesting each month down the road (see Appendix A).

- **Christopher Pickett (38)** – Senior V.P., Licensing, General Counsel. Pickett has been selling above his means since 2Q04, as he has routinely sold considerably more shares than he's had new options vest. With the exception of the current quarter, he has only had 12,500 new options vest each quarter, while over that same period, his quarterly selling has averaged 104,644 shares. The activity has dropped his actionable holdings from just under 500,000 in early 2004 to its current level of 35,347 vested options (Pickett doesn't own any common stock). Although his selling volume is down this quarter, it is only because he no longer has enough shares to sell at his accustomed rate. This quarter, Pickett first exercised three series (expiration dates 6/08, 2/09, 7/11) and sold the underlying 50,000 shares on April 1st at $42.50. Shortly after the first quarter earnings release, he sold another 25,000 shares at 40% lower prices on May 2nd. Then, on June 20th he exercised two newly-vested series (expiration dates: 4/05/14, 4/15/14) to sell an additional 9,191 shares at $32. **This year alone Pickett has liquidated 87% of his holdings**, and with only 63,542 new options vesting by year end (see Appendix A), it is impossible for him to maintain his current distribution pace.

- **Bruce McWilliams (48)** – Chairman, President, CEO. If you want to find the conductor of the insider activity, look no further than the Company's chief executive. McWilliams had been selling roughly 110,000 shares per quarter, well in excess of his monthly vesting, but since the issue's weakness unloaded 304,001 shares. In fact, after selling 42,001 shares on April 1st at $42, he later sold the other 262,000 shares at an average price of $28, the lowest prices he accepted for his shares since last October. All of the recently sold shares were acquired from the exercise of one long-held option series which isn't set to expire until October 2009. **McWilliams' 1.79 million share ownership position in March 2004 is now 46% lighter** at just below

1 million shares and vested options. Should he cease all selling, that number will increase 13% from the vesting of options by year end (see Appendix A). Considering he has sold each month dating back to last June, we don't think he's likely to stop selling anytime soon.

<u>Other: Business model and industry questions may provide some context for behavior</u>

As we cited earlier, after TSRA's Q1 release, it became evident that litigation wins, which wrestled two large customers into signing licenses, were the only real growth in the period. Tessera's guidance for legal expenses for 2005 was raised from $4.5 million to $9.5 million. The revelation prompted an analyst, on the conference call, to remark, "When I look at your year end revenue guidance from three months ago compared to what you provided today and take out the onetime adjustment that you provided two weeks ago as an upside, the only thing that is changing is just increased litigation expenses."

Tessera's long term future is leveraged heavily toward the timing of the ramp up of the latest generation DRAM chip platform called DDR2. The Company estimates that it has 50% of the total DRAM market licensed. Recent comments from Samsung and others, that they were lowering their projections for their DDR2 ramp up, weigh heavily on TSRA. This precipitated plenty of questions in the Q1 conference call. If implementation of DDR2 by TSRA's customers slows, it seems that Tessera is reliant upon litigation wins or "found revenues" to bridge the gap.

Additional big litigation wins do not seem to be in the cards near term, as CEO McWilliams disclosed in the Q1 conference call that "we've captured the bulk of the majority of the other IP (read: settlement wins) in the three agreements that we signed in the first four months of the year." The only new major litigation entered into was initiated in March (2005) against both Micron Technologies and Infineon Technologies and, according to a known expert witness in the field (not associated with the case) that we've consulted Tessera is looking at at least two years before any settlement, and certainly with no guarantees of an outcome inuring to TSRA's benefit. Indeed, in a filing with the SEC just last week, Micron said it countersued the Company, claiming that TSRA infringed on eight of its patents, suggesting that disputes between the two companies over intellectual property may not be resolved any time soon.

So, in the absence of settlement wins, it seems that the only rabbit left to pull out of the hat was named "found revenues", and they did find some, in the nick of time, enough to enable them to raise guidance in early June as they did in March. This time, however, The Street didn't bite as the shares barely rallied on the news.

At the same time, Tessera's R&D expenditures have been trailing down, catching our attention and prompting related questions from analysts recently. One of the explanations offered by the Company is that they have dropped due to "the reassignment of more personnel resources to service revenue projects", an explanation that has been offered for the past two quarters. Given this explanation, we found it interesting that in the recent Q2 guidance update, in which revenue estimates for the quarter were increased by about $5 million due to those "found revenues", there was also the additional fact that they expect "lower Product Development Services Revenue, which we expect to be down slightly sequentially from the first quarter, as it is taking us longer than expected to complete some customer funded technical development programs, but long term we see this business continuing to grow."

Given weaker revenue and increased expenses, margins in the service area have been on the decline as well, prompting an interesting exchange during the Q1 conference call:

Analyst:

> "…if I look at COGS over service revenue, we've fallen to a gross margin now of about 21%. It was 23% the quarter before that, 33% the quarter before that. How should we think about the normalized model, the amount of COGS as a percentage of service revenue…?

Bruce McWilliams:

> A good place holder is for that margin to be somewhere around 20%...."

It would seem that the timing for industry-wide acceptance of DDR2 has gotten a bit stretched out and TSRA is finding itself searching through its available cookie jars in order to extend its staying power. Going into Q4 of 2004, Tessera had deferred tax assets on the books that had been fully reserved for. In Q4, they reduced that valuation allowance by $24.7 million "to reflect the anticipated utilization of those deferred tax assets". With only 43.5 million shares outstanding, the effect was far from immaterial.

One potential worry is that TSRA's customers could become competitors. But as a niche player, that seems unlikely at this point because the revenue at stake, on a relative basis, is modest, and few analysts see this as a possible negative catalyst in the near term. Should DDR2 finally begin to ramp in a meaningful way, however, to the point that widespread industry acceptance is more or less assured, the specter of significant competitive pressures will most likely enter the picture.

Finally, further making TSRA investors nervous is the fact that the bulk (71%) of revenue is concentrated in just a few clients, and the mix between them has sifted significantly in recent quarters. TI is coming down, from 28% in Q1 of '04 to 15% in Q1 of '05. Intel dropped from 18% at Y/E '04 to 6% as of Q1 '05. Now Samsung and Jujitsu have come up with Samsung at 36% and Fujitsu at 14%. So in the three months since Samsung and Fujitsu have come on board, they suddenly make up 50% of the Company's revenues. One wonders if the relationships with TI and Intel may have soured. Also, the Samsung revenues are a result of the settlement of a dispute, which makes us wonder how the relationship will fare, long term.

Appendix A

Option and Restricted Stock Vesting Schedules for Selected Tessera Technologies Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
Nicholas Colella, Senior V.P.-Product Miniaturization Division. Common stock holdings: 14,086 shares								
07/16/01	Option	300,000	$2.10	07/17/01	07/16/01	24,482	6,250	Vests in full on 07/17/05
02/10/03	Option	100,000	$3.25	02/10/04	02/10/13	41,666	39,583	2,083 options vest each month through 02/07
04/05/04	Option	45,000	$18.66	04/05/05	04/05/14	34,688	30,954	938 options vest each month through 04/08
Kirk Flatow, Senior V.P.-Advanced Semiconductor Packaging. Common stock holdings: 78 shares								
03/04/02	Option	600,000	$3.25	03/04/03	02/11/02	100,001	87,500	12,500 options vest each month through 03/06
04/05/04	Option	80,000	$18.66	04/05/05	04/05/14	53,433	51,766	1,667 options vest each month through 04/08
Michael Forman, V.P.-Finance and Administration, Corporate Secretary. Common stock holdings: 0 shares								
03/19/01	Option	70,000	$2.15	03/19/02	03/19/11	56,838	0	Fully Vested
04/05/04	Option	40,000	$18.66	04/05/05	04/05/14	40,000	27,500	833 options vest each month through 04/08
Bruce McWilliams, Chairman, President, CEO. Common stock holdings: 60,445 shares								
10/07/99	Option	N/A*	$1.50	10/07/00	10/07/09	438,364	0	Fully Vested
07/16/01	Option	400,000	$2.10	07/17/01	07/16/01	400,000	8,333	Vests in full on 07/17/05
04/05/04	Option	200,000	$18.66	04/05/05	04/05/14	200,000	137,499	4,167 options vest each month through 04/08
04/15/04	Option	50,000	$17.30	04/15/05	04/15/14	50,000	35,416	1,042 options vest each month through 04/08
08/17/04	Option	230,000	$17.75	08/17/05	08/17/14	230,000	230,000	25% vest on 8/17/05, remainder vest 1/36 each month
Douglas Norby, Senior V.P., CFO. Common stock holdings: 19,703 shares								
07/16/03	Option	220,000	$5.50	07/16/04	07/16/13	18,334	0	Fully Vested
09/28/03	Option	220,000	$7.00	09/28/04	09/28/13	203,666	128,333	4,583 options vest each month through 09/07
Christopher Pickett, Senior V.P.-Licensing, General Counsel. Common stock holdings: 0 shares								
06/01/98	Option	N/A*	$4.50	06/01/99	06/01/08	1,433	0	Fully Vested
08/28/00	Option	N/A*	$6.12	08/28/01	08/28/10	24,804	0	Fully Vested
04/05/04	Option	150,000	$18.66	04/05/05	04/05/14	115,360	103,125	3,125 options vest each month through 04/08

Appendix A

Option and Restricted Stock Vesting Schedules for Selected Tessera Technologies Inc. Insiders

Grant Date	Equity Type	Options/ Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
04/15/04	Option	25,000	$17.30	04/15/05	04/15/14	17,709	17,709	521 options vest each month through 04/08
08/17/04	Option	125,000	$17.75	08/17/05	08/17/14	125,000	125,000	25% vest on 8/17/05, remainder vest 1/36 each month
David Tuckerman, Senior V.P., Chief Technical Officer. Common stock holdings: 30,863 shares								
02/10/03	Option	500,000	$3.25	02/10/04	02/10/13	322,318	197,916	10,417 options vest each month through 02/07

* The Company has never disclosed the number of options awarded in the original grant