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

Accounting Issues Top Other Significant Concerns Mercury Interactive Corporation (NASDAQ:MERQ)

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Mercury Interactive is a provider of integrated performance management solutions that enable businesses to test and monitor their Internet applications, helping to improve the performance, availability, reliability and scalability of Websites.

Summary of 3DAdvisors Findings for MERQ

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Discussion of 3DAdvisors Findings

Governance: An undisclosed director conflict of interest

Mercury Interactive disclosed, this past June, that it had agreed to acquire the private entity Kintana Incorporated in a cash and stock-swap deal valued at $225 million ($125 million in cash and $100 million in stock). What was not disclosed in any Company communiqué related to the deal was the fact that MERQ director Anthony Zingale (appointed in July of 2002), who is also a director of Kintana, had a vested interest in the deal. Although the MERQ Proxy reveals the fact that Zingale is also a Kintana director, there is no mention of the fact that he held a fair sum of options in Kintana shares prior to the deal.

It turns out that Kintana had filed an S-1 registration statement back in June of 2001 when it had originally intended to go public. Although this original registration statement was pulled after the ensuing stock market collapse later that year, these filings remain accessible on the Edgar system. The document reveals that Zingale had been granted options, for 50,000 Kintana shares, upon his joining the company's board back in 1997. In addition to this, under Kintana's 2001 Equity Incentive Plan, each Kintana director was granted an automatic option to purchase 35,000 shares in June of 2001. For serving on one of Kintana's board committees, Zingale was granted options for another 15,000 shares. In all, he held options for 100,000 shares, which, if he hadn't converted them prior to the Mercury Interactive acquisition, would have become 100% vested upon the change of control.

So now we have an undisclosed item where a Mercury Interactive director (Zingale) seems to have profited from an acquisition, which was being approved by the board of which he is a member. This behavior alone provided ample cause for us to dig deeper into the situation.

Accounting: Insider loans booked in a curious fashion

Mercury Interactive has, in the past, loaned a fair sum to insiders to purchase Company shares. At the end of F/Y 2002, $11.1 million in notes receivable remained outstanding from company employees who had used the proceeds to buy MERQ shares. These loans were collateralized by the stock bought by those employees and officers. We have always been wary of insider loans where stock purchased, from the proceeds, is the only collateral pledged.

These loans were booked in a fashion that seemed to indicate that payback might not have been anticipated. We say this because the loans, instead of being carried on the books as an asset, were immediately charged to shareholders' equity. Indeed, with the shares down significantly from their 2000/2001 peaks in the $100 to $160 range, it would seem that insiders are not scurrying to repay anything. Except, that is, Chairman and CEO Amnon Landan who paid $3.4 million, in Q1, 2003, to clear out his loan balances. His move, to early repayment, could have been an olive branch thrown to the Sarbanes-Oxley hawks since through Q2 of this year there have been no further payback of these loans whose balance outstanding remains at $8.6 million (of which $2.13 million are owed by COO Kenneth Klein), and continue to be represented as a charge to Shareholders' Equity.

An interesting angle to these loans is that, in Q1 2003, MERQ booked $1.2 million to other income as "interest income associated with notes receivable from issuance of stock to foreign employees under our stock options plans." It is not clear as to whether cash was actually collected and we have not been able to trace the cash receipt. It is very curious that the very loans, which seem to have been booked in a fashion that would imply that payment was not expected, would be generating interest income. The amount of interest, related to these, in Q1 of 2003 amounted to about $0.01 per share (after tax).

In addition to loans, other officer perks include "car arrangements". The amounts related to these "car arrangements" did not seem inconsequential. In 2002, the related tax reimbursements to Chairman Landon and President Klein totaled $124,408 and $118,400 respectively. The reimbursements for "car arrangements", paid in 2002, included arrangements for prior years.

Accounting: Revenue recognition long on estimates, short on facts

The risk to the quality of earnings for Mercury Interactive is primarily that earnings are subject to so many estimates and judgments that hard numbers do not make up any significant part of the reported earnings. We would contend that the quality of earnings is in direct proportion to the soundness of the estimates and judgments that go into deciding what to report. Admittedly, there are estimates and judgments that go into all financial reports, but in the case of MERQ those things are predominant in the reporting.

For customer relationships containing multiple obligations, revenue is allocated to each component of the arrangement using the residual value of the fair value of undelivered elements. MERQ defers revenue from the associated fee equivalent to the fair value of the undelivered elements. Whatever judgments management makes as to the fair value of what is yet to be delivered determines how much of the fee is to be recognized currently. This is reminiscent of the EDS situation and clearly allows for much latitude in deciding how much revenue to report. Again, earnings are a series of judgments.

The judgment as to whether a fee is “fixed or determinable” plays a big role in arriving at the quarterly recognition of revenue. If it is not fixed or determinable, revenue consists of estimates in a large sense.

MERQ prepays commissions before deferred revenue is recognized. There appears to be considerable latitude in how this expense gets allocated to various periods.

Accounting: Earnings boosted by interest rate swaps and debt retirement

Interest rate swaps, related to $300 million of MERQ’s convertible notes have been contributing about 10% to the Company’s bottom line EPS recently. Through 2002, swap-related gains (related to both hedge ineffectiveness and net interest income) totaled $7 million. The $5.3 million, after tax portion of this amounted to $0.07 of the Company’s 2002 $0.78 EPS number, or 9% of EPS

In F/Y 2002, MERQ retired $77.6 million face value of its convertible notes, resulting in an $11.6 million gain. This gain, after tax, contributed $0.11 to EPS for the period. So in F/Y 2002, $0.18 of the $0.78 earned (23%) came from non-core sources.

These swap-related gains held up in Q1 as well, this time totaling $2.6 million. The after tax contribution, of $2.05 million, represented $0.021 of the quarter’s $0.21 EPS or 10%. Add that $0.01 coming from “interest income associated with notes receivable from issuance of stock to foreign employees under our stock options plans” and you have 15% of after tax EPS coming from non-core sources in Q1 of 2003.

Accounting: FIN 46 issues may be looming

Mercury provides little detail about its non-consolidated entities. Its investment in private companies totaled $15.4 million at the end of Q2, 2003. The Company has committed to additional capital contributions to an unidentified private equity fund totaling $10 million of which $7.1 million will be made through March 31, 2004.

MERQ uses the cost versus equity method for the investments in unconsolidated entities. This gives the company more flexibility in delaying the recognition of loss of value on those investments. If the equity method were used, the losses or gains of the unconsolidated entities would be recognized immediately as an increase or decrease in the carrying value of the investments and the investments would still be subject to impairment review.

It should be noted that it would not really be necessary to have significant influence over the entities in order to use the equity method. Here again the company is not necessarily using hard numbers to evaluate impairment but rather estimates and judgments come into play. And the carrying values are only as good as the judgments and estimates. In general we would expect the company to be at a fairly high risk of continuing material impairment losses on those investments. And due to the material nature of the impairment losses, we would expect that the risk of delaying recognition of the losses is also a factor in evaluating the company's financial soundness going forward.

In spite of the flexibility provided by the cost method, for the F/Y 2002, MERQ recorded a $5.3 million loss, or ($0.045) per share after tax, in other income, on three of its investments in early stage private companies. Through Q2 of 2003, the Company has recorded an additional $1.34 million loss, or ($0.011) per share after tax, related to its investments in non-consolidated companies.

It is quite apparent that the Company anticipates some effects from Fin 46 – "Consolidation of Variable Interest Entities" in the near future. Again, disclosure is not specific. The only clue that MERQ will provide at this time is that it is still evaluating the impact of the "far-reaching effects" (MERQ quote) of this adoption on its financial position and results of operations.

Accounting: Material exposure to option expensing

Mercury Interactive has one of the biggest exposures, on a relative basis, to any mandate requiring the expensing of options that we've seen. The Company's F/Y 2002 earnings of $0.78 per share would have reversed rather dramatically had expensing of options been required. The result, for the period, would have been a net loss of ($0.49) per share.

Dilution is a big issue here. With aggressive options programs that cannot be matched by share repurchases, MERQ has no option but to dilute when options are exercised. From 66.3 million shares outstanding in F/Y 1996, the total has grown to 85.33 million by Q2 of 2003, which is a 29% dilution in just seven years. This already-material effect will become exacerbated in the quarters to come as the dramatic pickup in insider options exercising, and subsequent selling (which started in Q3, 2003), takes its toll.

Accounting: Disclosure of valuation allowance is foggy

Mercury Interactive is a company that gives the appearance of full disclosure in its financials. Many items are explained thoroughly while others fall far short of any adequate explanation. For one, MERQ is one of the few companies that we have seen that doesn't include, in its 10K, a schedule for Valuation and Qualifying Accounts. The Company had provided this schedule for years up to 1999. Beginning in F/Y 2000, however, the schedule simply disappeared.

In doing so, the Company obfuscates detail on bad debt charge-offs and sales returns that it had been including prior to F/Y 2000. Instead, it leaves the related items summed to together as Sales Reserves, which are deducted from overall A/R's on the Balance Sheet.

This elimination of detail, relating to provisioning, again manifested itself in the area of Tax Benefits related to Employee Stock Option Exercises. Each year, the Company has recorded benefits to this effect. Each year, the Company has indicated that it intended to utilize those benefits. Things changed in F/Y 2003 as MERQ now indicates that it is not likely that tax benefits associated with stock option exercises will be utilized. Because of this, the Company has **"recorded a valuation allowance for the entire portion of the net operating losses related to the income tax benefits arising from the exercise of employees' stock options that will be credited directly to stockholders' equity in the future."** [The bolding is ours for emphasis.]

Though the Company discloses that it has set up this allowance, it falls short of telling us how much it is. This could get interesting as MERQ has a very large set of options programs with about 23 million options outstanding (representing an additional 27% to the outstanding share number) as of Y/E 2002. Although the Company does not reveal the amount of the allowance, it does indicate that the exercise may not be complete. **"In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could materially impact our financial position and results of operations."**

Insider Trading: A surge of insider selling

An anomalous July surge in insider selling is what originally caught our eye. Eight insiders surfaced to drop just under 500,000 shares during the month and in the days after the Q2 earnings release and conference call. All of the sales were at prices between $40 and $42. It's interesting to note that most of the sellers are operational executives who are not even close to retirement age. Yet they are converging, at the same time, to sell larger amounts of shares than we have seen them sell in the past. Also, in the group we noted selling by a newly appointed director (a rarity) and the first sales by the Chairman and CEO since 2000:

Susan Skaer (39) – V.P. and General Counsel. Skaer exercised options totaling 15,728 shares, which she sold on July 18. These are the first sales for her on record.

Larry Wear (37) – V.P. and General Manager of APM. Prior to July, we have no record of Wear having sold shares in the past five years. This changed however, when he exercised options for 64,583 shares, which he sold on July 18.

Yuval Scarlat (39) – V.P. and General Manager of Testing and Deployment. Scarlat exercised options totaling 34,500 shares, which he then sold on July 22. These are the first sales we have on record for him. He continues to hold a fairly large position as this sale trimmed his holdings by 7%.

Amnon Landan (44) – Chairman and CEO. Landan had not sold a share since back in November of 2000 when the shares were going for $125 apiece. He surfaced on July 22, dropping 250,000 in the $41 range.

Zohar Gilad (40) – V.P. of Products. Gilad, like the others, does not show having sold shares for the last five years. He surfaced on July 18th, exercising options for 20,000 shares, selling them plus an additional 30,000.

Giora Yaron (54) – Director. Yaron exercised options for, and sold, 53,000 shares on July 18th. Though he's one of the few sellers who sold in 2002 (7,000 shares), he hadn't sold this kind of volume since May of 2001.

Anthony Zingale (47) – Director. It's rare to see a new director, such as Zingale (who was just appointed in July of 2002), selling shares. He did indeed however, selling 10,000 shares on July 18th.

Though many of these sellers continue to hold significant stakes, we consider their convergence, during the same time window, to be a noteworthy event.