MERCURY INTERACTIVE

ANNUAL REPORT 1999

RAISING THE BAR ON WEB PERFORMANCE

How critical is Web performance to business today? Ask our customers.

Mercury Interactive Corporation is the leading provider of Web performance management solutions that help e-businesses ensure a positive user experience. Mercury Interactive solutions turn Web application performance, scalability and user experience into competitive advantage. The Company's performance management products and hosted services are open and integrated to best test and monitor business-critical Web applications.

Mercury Interactive was founded in 1989 and went public in 1993. The Company is based in Sunnyvale, California, with additional offices providing sales, support, and research and development around the world. The Company's common stock trades on the NASDAQ National Market tier of The Nasdaq Stock Market under the symbol MERQ. Reach Mercury Interactive on the Web at www.mercuryinteractive.com.

Our Customers

Citibank

E*TRADE

Bitlocker

Infoseek

→ PHH Vehicle Management Services

Charles Schwab

DIGEX

eGain Communications

Gallagher Financial Services

Gap Inc.

Ford Motor Company

→ Send.com

Catholic Healthcare West

jcrew.com

Norwich Union

living.com

Merrill Lynch

J.P. Morgan

Microsoft

Neoforma.com

Prudential

→ barnesandnoble.com

OurBeginning.com

Priceline.com

Tickets.com

Sabre Group

Siemens Information & Communications Networks

Scalability

User Experience

Reliability

Total Performance

Testing

Monitoring

Hosted Services

1999 was the most significant and successful year in Mercury Interactive's history. It was marked by strong financial results, a large number of new products and hosted services, a rapidly growing base of both business-to-business and business-to-consumer e-commerce customers and an improved competitive position. In addition, 1999 was the year we successfully established Mercury Interactive as a major e-commerce infrastructure company. Revenues grew 55% to $187.7 million from $121 million in 1998, earnings per share were up 56% to $0.39 from $0.25 in 1998 and the operating margin improved to about 20%.

The year 1999 was also when the Web not only gave rise to hundreds of dot-com organizations, but it also became the single biggest initiative in the IT industry. Because a Web site that is down or even slow can mean millions of dollars in lost business, Web performance management, including both testing and monitoring of performance, has become absolutely mandatory for success. We were able to take advantage of this opportunity with new products, business models and distribution channels, and by growing our Web business more than 300% in 1999.

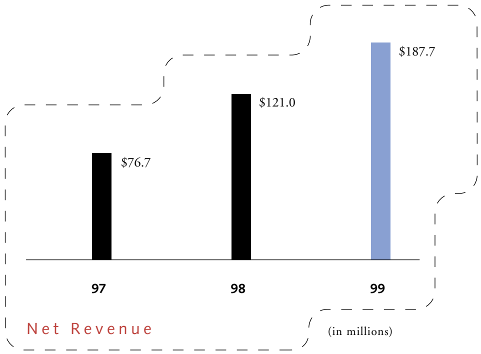
To Our Shareholders

Moving from Testing to Performance Solutions to Meet the New Challenges of the Web

In 1999 we rapidly adapted our product offerings and distribution channels to meet the imperatives of this new Web-dominated business environment. As a result, we successfully transformed Mercury Interactive from a testing product vendor into a premier Web performance solution provider. Last year we offered only testing solutions; today our offerings extend to the production environment. Last year we sold only products; today we offer hosted services for both testing and monitoring. Last year we offered only perpetual licensing; today all our new offerings are subscription based. Last year we sold primarily shrink-wrapped products; today, we have a direct distribution channel via Web download. The result is a new and fast-expanding customer base and a new business model with significant recurring revenue streams. And all our offerings share the same underlying technology, providing our customers with the ability to migrate easily from one product/service to another.

New Customers and Partnerships Drive the Business

Because scalability, availability and reliability are so critical to the success of a Web site, we were able to market our solutions to a whole new class of customers—the dot-coms. New customers in 1999 represented a wide range of industries, ranging from Internet-based companies such as living.com, Fatbrain.com, garden.com, e-STEEL.com, barnesandnoble.com, Send.com, Fairmarket, jcrew.com, Priceline.com, DIGEX and USinternetworking, to Fortune 1000 customers moving critical operations to the Internet, such as Charles Schwab, Ford Motor, Gap Inc., J.P. Morgan and Merrill Lynch.



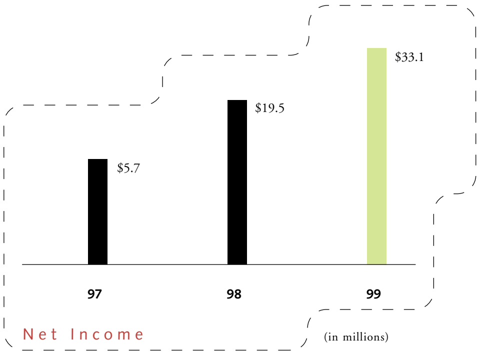
During 1999 we established alliances with a number of market-leading e-business independent software companies (ISVs), including Allaire, Ariba, BEA, Bluestone, BroadVision, Calico Commerce, CommerceQuest, DoubleClick, GemStone Systems, HAHT Software, IBM, IONA Technologies, OneSoft, Selectica, SilverStream, Sun-Netscape Alliance, Vignette, Vision Software and others. These alliances allow us to ensure that our performance management solutions complement the product offerings of these ISVs.

We also enhanced our channels with new partnerships with Web-centric systems integrators such as iXL, ZEFER, Inventa, Viant and USWeb. These partners recommend, sell and use our performance management solutions to enhance the Web sites that they build for their clients. These channel relationships substantially expanded our eco-system and enhanced our presence in the market.

New Products Enlarged Our Markets

In 1999 we launched several exciting new product initiatives, which not only expanded our technological leadership but also propelled our evolution to an e-commerce infrastructure company:

- We launched 6.0 versions of our market-leading TestSuite product family—LoadRunner, WinRunner and TestDirector—and increased the technology lead we enjoy in that market.
- We introduced the Astra family of products, which make testing fast and simple. These products are very easy to use and available for easy purchase and quick distribution via Web download. As a result, they make testing accessible to a much larger mass market. Astra became an immediate market success and also opened the door to larger transactions, as Astra customers migrated up to purchase our most powerful testing applications—WinRunner and LoadRunner.
- We leveraged our technology leadership in the Web testing market by introducing Topaz, the first application performance management solution to measure end-user experience on the Web. Topaz has gained rapid acceptance and has opened a new market for us, one that promises to be as large as the e-business testing markets we already serve.
- We delivered our most significant and exciting new offerings—Topaz ActiveWatch and LoadRunner ActiveTest—the world's first hosted application monitoring and load testing services. Topaz ActiveWatch is a hosted application performance management service, which can monitor Web sites from more than 20 points-of-presence across the world. LoadRunner ActiveTest is the first hosted load-testing service available for stress testing e-commerce applications. These hosted services allow us to serve a whole new class of customers who previously could not take advantage of our products due to lack of time, resources or hardware infrastructure.



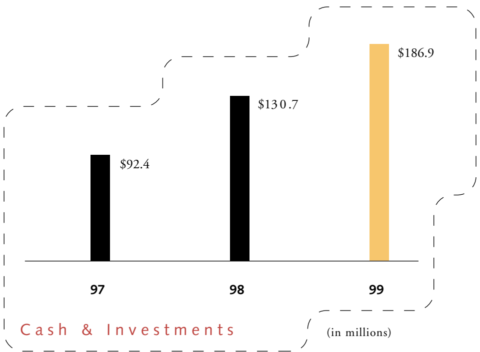
Positioning Mercury Interactive for the Future Growth of E-commerce

The urgency and importance that the Web imposed on businesses in 1999 were driving forces behind our success; in fact, the Web accounted for more than two-thirds of our revenues in the fourth quarter. Although the Web is still in its early stages, business-to-business e-commerce is expected to soon dwarf all other e-commerce activity. Business-to-business sites tend to be able to integrate with more back-end applications and are significantly more complex than business-to-consumer sites. As a leading provider of complete performance management solutions, working with our key software vendors and system integrator partners, Mercury Interactive is well-positioned to take advantage of the future growth of business-to-business e-commerce.

In 1999 we were able to re-create our company on the fly to respond to our customers' needs in an increasingly Web-centric world. Today Mercury Interactive is the only company to provide comprehensive and flexible performance management solutions, spanning testing and performance monitoring and offering both products and hosted services. However, our goal is even more ambitious: Mercury Interactive will continue to raise the bar on Web performance to provide new and innovative products and services that will help our customers become more competitive and successful. Our performance solutions enable them to deliver enhanced business value through their Web sites with the higher performance, scalability and reliability demanded by today's Web users.

Sincerely,

Amnon Landan
President and Chief Executive Officer
Mercury Interactive Corporation
March 31, 2000



Amnon Landan, President and Chief Executive Officer, Mercury Interactive Corporation, March 31, 2000


SCALA
BILITY

PHH Vehicle Management Services

Launching a Web site is always a risky business. New customers and orders can quickly expand a business—or overwhelm it. How much traffic can the servers and back-end infrastructure actually handle? Without load testing, it's impossible to know for sure. A surge in unanticipated users can swamp a site and slow responses to a crawl—or worse.

That's the dilemma every company faces when launching a new site. And that's why leading Web sites and Web-enabled businesses turn to Mercury Interactive for help. Take PHH Vehicle Management Services, a leading global vehicle management company that manages the vehicles for nearly one-third of the Fortune 500 companies. PHH chose our technology to test its cutting-edge PHH InterActive℠ site before going live. Our performance management solutions enabled PHH to mirror its expected volumes, transaction types and the overall mix of business operations. The result? PHH was able to identify and fix numerous potential site problems before deployment. Today PHH is confident that its application servers can comfortably scale to handle robust increases in its user base. And that's the kind of security PHH needs to successfully grow its business.

PHH VEHICLE MANAGEMENT SERVICES

PHH Vehicle Management Services looks to Mercury Interactive to help it master load testing and take the risk out of growth.

The benefits of Mercury Interactive products are enormous from the point of view of customer relations. We can detect a problem first, before clients spot it. For companies like ours that want to take high-risk applications to the Internet, Mercury Interactive gives us a performance management solution that substantially lowers risk and makes the whole development process faster and more effective. ⇢

Mickey Lutz

Senior Vice President, Information Technology Services

PHH Vehicle Management Services


USER
EXPER
IENCE

Send.com

Today simply having a Web site isn't good enough; it has to be highly responsive to keep users engaged and coming back for more. While functional and stress testing prior to deployment are essential to success, a site must also be continuously monitored to access the quality of the end-user experience in real time. For e-businesses the million-dollar questions are always: *How fast are pages downloading now? Are the system responses to user choices the right ones?*

To address these critical issues, Send.com—a fast-growing e-commerce company specializing in unique gifts fulfilled by local retailers—turned to Topaz, our live performance-monitoring solution. Using Topaz, Send.com's operations staff is alerted to potential performance problems before users experience them and can make adjustments to ensure the highest quality user experience. As a result, Send.com sailed through its first holiday season, chalking up unprecedented site traffic and sales volume with zero performance problems.

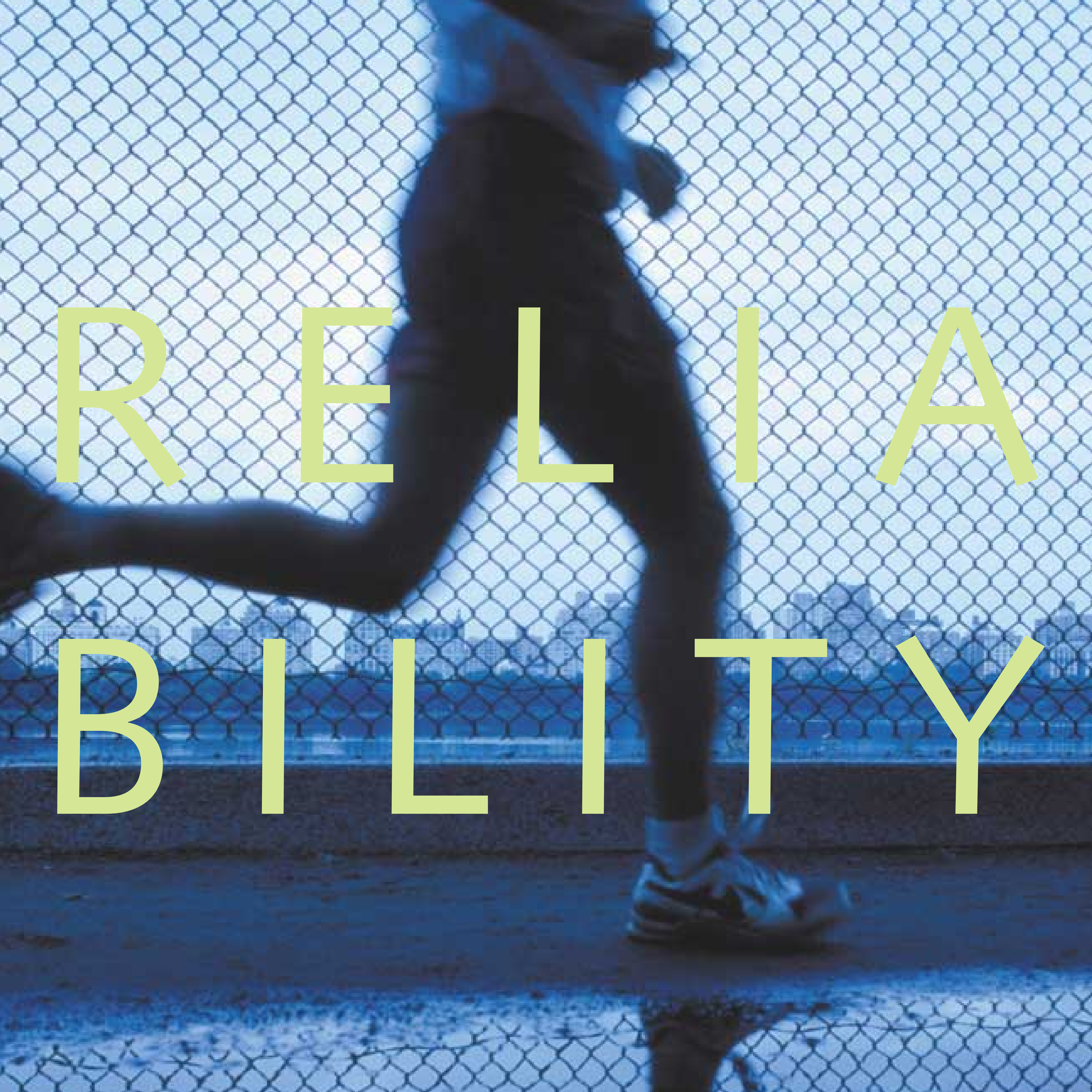
SEND.COM

Send.com counts on Mercury Interactive technology to deliver a consistent and engaging user experience.

Our use of Mercury Interactive performance solutions has had a direct impact on our business, enabling us to maintain and even increase our strategic emphasis on delivering a superior customer experience. → Thomas Harden

Executive Vice President of Worldwide Operations

Send.com


RELIA
BILITY

barnesandnoble.com

On the Web it's showtime all the time. Customers give you one chance to do it right, or else it's *click*—and they're gone. But you never know where the next performance problem may be lurking. Given the constant changes and improvements needed to keep a site current—from fresh content and graphics to software and hardware upgrades—any new element can have an unanticipated impact on performance.

That's why major e-commerce sites like barnesandnoble.com rely on Mercury Interactive's state-of-the-art performance management solutions for ongoing functional and stress testing of its site. Anticipating a big jump in shoppers and daily page hits during the 1999 holiday season, barnesandnoble.com began a comprehensive testing program several months in advance. Thanks to the insights gained through testing, the company was able to double the capacity of its site by improving Web server capacity and optimizing other key aspects of its infrastructure. In the end barnesandnoble.com cut its average homepage download time to four seconds while successfully handling a peak of 12 million daily hits, up dramatically from a previous high of 4 million hits per day.

BARNESANDNOBLE.COM

barnesandnoble.com relies on Mercury Interactive performance tools to satisfy a four-second attention span. Or else.

Mercury Interactive's automated performance management tools are vital to where we've been in the past and where we're going in the future. With the rapid pace of change on our site, there is no possible way we could keep enough people around to do the necessary functionality and load testing manually. Without Mercury Interactive we would be subject to the whims of the Internet—something no serious e-business today can afford.

Barry Weber

Vice President, Technical Infrastructure

barnesandnoble.com

TOTAL
PERFOR
MANCE

On the Web, businesses live or die based on performance. It's what drives results—be it numbers of eyes on a page, clicks on an order button or customer questions quickly answered. In such a mission-critical environment, there's little room for error. At Mercury Interactive we know from experience that without continuous testing and monitoring of site performance, every e-business—and its revenues—is extremely vulnerable. Our job is to ensure that great Web performance is something every one of our customers can count on, every day, to maximize reliability, protect revenue streams and stay competitive.

For today's most successful e-businesses, great performance on the Web comes down to two critical words: Mercury Interactive.

We're constantly raising the bar on Web performance by providing new innovative products and services that help our customers become more competitive and successful. Our solutions enable them to deliver enhanced business value through their Web sites with the higher performance, scalability and reliability demanded by today's Web users.

Amnon Landan
President & CEO
Mercury Interactive

Financial review

Selected consolidated **financial data**[1]

(in thousands, except per share amounts)	Year ended December 31, 1999	1998	1997	1996	1995
Statements of Operations Data:					
Revenue:					
License	$ 130,900	$ 84,450	$ 56,683	$ 43,270	$ 32,765
Service	56,800	36,550	20,017	11,280	6,685
Total revenue	187,700	121,000	76,700	54,550	39,450
Cost of revenue:					
License	7,736	6,291	4,351	3,419	2,626
Service	18,642	11,757	6,225	3,240	1,887
Total cost of revenue	26,378	18,048	10,576	6,659	4,513
Gross profit	161,322	102,952	66,124	47,891	34,937
Operating expenses:					
Research and development, net	23,484	16,907	11,333	9,670	6,523
Write off of in-process research and development and related expenses	—	—	5,500	—	7,700
Marketing and selling	88,609	57,243	37,073	29,426	21,361
General and administrative	11,242	8,466	6,642	4,178	3,911
Settlement of litigation	—	—	—	2,600	2,000
Merger related expenses	2,000	—	—	—	—
Total operating expenses	125,335	82,616	60,548	45,874	41,495
Income (loss) from operations	35,987	20,336	5,576	2,017	(6,558)
Other income, net	6,026	4,640	3,083	3,375	2,277
Income (loss) before provision for income taxes	42,013	24,976	8,659	5,392	(4,281)
Provision for income taxes	8,869	5,451	2,927	1,157	970
Net income (loss)	$ 33,144	$ 19,525	$ 5,732	$ 4,235	$ (5,251)
Net income (loss) per share (basic)[2]	$ 0.44	$ 0.28	$ 0.09	$ 0.07	$ (0.09)
Net income (loss) per share (diluted)[2]	$ 0.39	$ 0.25	$ 0.08	$ 0.06	$ (0.09)
Weighted average common shares (basic)[2]	76,112	70,654	65,494	63,634	55,788
Weighted average common shares and equivalents (diluted)[2]	85,208	78,818	68,458	66,254	55,788

	December 31, 1999	1998	1997	1996	1995
Balance Sheet Data:					
Working capital	$ 137,066	$ 97,288	$ 87,733	$ 78,046	$ 75,475
Total assets	$ 297,218	$ 204,686	$ 143,663	$ 117,625	$ 112,820
Stockholders' equity	$ 199,531	$ 146,408	$ 112,120	$ 99,048	$ 92,616

(1) All historical information has been restated to reflect the acquisition of Conduct Ltd. on November 30, 1999, which was accounted for as a pooling of interests.
(2) All share and per share information gives effect to our two-for-one stock split distributed to our stockholders as a stock dividend on February 11, 2000.

Management's Discussion and analysis of financial condition and results of operations

The following discussion contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. In some cases, forward-looking statements are identified by words such as "believes," "anticipates," "expects," "intends," "plans," "will," "may" and similar expressions. In addition, any statements that refer to our plans, expectations, strategies or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those discussed in, or implied by, these forward-looking statements. Factors that could cause actual results or conditions to differ from those anticipated by these and other forward-looking statements include those more fully described in "Risk Factors." Our business may have changed since the date hereof, and we undertake no obligation to update these forward-looking statements.

Overview

We were incorporated in 1989, and began shipping automated software testing products in 1991. Since 1991, we introduced a number of new products, and new versions of existing products, including products and versions designed for e-business applications. We believe that a majority of customers that licensed our products in 1999 are using these products to test and monitor their Web applications. Recently, we began offering hosted load testing and monitoring services for Web applications.

On November 30, 1999 we acquired Conduct Ltd., an Israeli-based provider of software for monitoring network performance. We issued approximately 408,000 shares of common stock in exchange for all of Conduct's outstanding capital stock (including outstanding Conduct stock options and warrants that we assumed). We accounted for the transaction as a pooling of interests, and all prior periods presented in our financial statements have been restated to reflect this transaction.

Results of Operations

The following table sets forth, as a percentage of total revenue, certain consolidated statements of operations data for the periods indicated. These operating results are not necessarily indicative of the results for any future period.

	Year ended December 31,		
	1999	1998	1997
Revenue:			
License	70%	70%	74%
Service	30	30	26
Total revenue	100	100	100
Cost of revenue:			
License	4	5	6
Service	10	10	8
Total cost of revenue	14	15	14
Gross profit	86	85	86
Operating expenses:			
Research and development, net	13	14	15
Write off of in-process research and development and related expenses	—	—	7
Marketing and selling	47	47	48
General and administrative	6	7	9
Merger related expenses	1	—	—
Total operating expenses	67	68	79
Income from operations	19	17	7
Other income, net	3	4	4
Income before provision for income taxes	22	21	11
Provision for income taxes	5	5	4
Net income	17%	16%	7%

Management's Discussion and analysis of financial condition and results of operations

Revenue

License revenue increased to $130.9 million in 1999 from $84.5 million in 1998 and $56.7 million in 1997. Our growth in license revenue is attributable primarily to growth in license fees from the LoadRunner, WinRunner and TestDirector products, particularly for use by customers to test e-business applications.

Service revenue increased to $56.8 million or 30% of total revenue in 1999 from $36.6 million or 30% of total revenue in 1998 and $20.0 million or 26% of total revenue in 1997. The absolute dollar increase in service revenue in 1999 compared to 1998 and 1997 was primarily due to the renewal of maintenance contracts. We expect that service revenue will continue to increase in absolute dollars as long as our customer base continues to grow.

Cost of revenue

License cost of revenue as a percentage of license revenue decreased to 6% in 1999 from 7% in 1998 and 8% in 1997. License cost of revenue includes cost of production personnel, product packaging and amortization of capitalized software development costs. The decrease in license cost of revenue as a percentage of license revenue in 1999 primarily reflected flat absolute dollar amortization of capitalized software development costs during each of the three years.

Service cost of revenue increased to $18.6 million in 1999 from $11.8 million in 1998 and $6.2 million in 1997. As a percentage of service revenue, it increased to 33% in 1999 from 32% in 1998 and 31% in 1997. Service cost of revenue consists primarily of costs of providing customer technical support, training and consulting. The increased service cost of revenue in 1999 as compared to 1998 was primarily due to an increase in personnel-related costs of $4.2 million reflecting growth in customer support headcount from 126 at December 31, 1998 to 171 at December 31, 1999 and a $2.2 million increase in training and consulting out-sourcing expense.

Research and development, net

For the year ended December 31, 1999, research and development, net was $23.5 million, or 13% of total revenue, an increase from $16.9 million, or 14% of total revenue in 1998, and $11.3 million, or 15% of total revenue in 1997. The increase in absolute dollars in 1999 as compared to 1998 reflected an increase in spending of $4.1 million due to growth in research and development headcount from 166 at December 31, 1998 to 226 at December 31, 1999, as well as $1.6 million of research grants received in 1998 from the Israeli Office of the Chief Scientist, as compared to no grants received in 1999.

In September of 1997, we acquired technologies from Dixon Software Technology that we integrated into our load testing products. As a result of this purchase, in the third quarter of 1997, we recorded a one-time charge for write off of in-process research and development and related expenses of $5.5 million.

Research and development expense is reported net of research grants received from the government of Israel, and includes royalty expense for obligations to the government of Israel for sales of products developed under government-funded research. No grants were obtained from the Office of the Chief Scientist in the Israeli Ministry of Industry and Trade during 1999. Research grants received amounted to $1.6 million in 1998 and $2.1 million in 1997. We were not obligated to repay these grants; however, we agreed to pay royalties at rates ranging from 2% to 5% of product sales resulting from the research, up to the amount of the grants obtained and for certain grants up to 150% of the grants obtained. Royalty expense under these agreements amounted to approximately $2.7 million for each of the years ended December 31, 1999 and 1998, and $1.6 million for the year ended December 31, 1997. As of December 31, 1999, we had no outstanding royalty obligations. We have not applied for, nor do we anticipate applying for, any future grants from the Office of the Chief Scientist.

During 1999 and 1998, no software development costs were capitalized because the costs incurred subsequent to achieving technological feasibility and before the general release of our products were not significant. We capitalized $500,000 of software development costs during the year ended December 31, 1997. Amortization charges included in cost of license revenues were $585,000 in 1999 and $600,000 in each of 1998 and 1997. In conjunction with the technology acquisition in 1997, we wrote off approximately $250,000 of capitalized development costs as obsolete. At December 31, 1999, we did not have any capitalized software development costs. At December 31, 1998 we had a net balance of capitalized software development costs of $585,000.

Marketing and selling

Marketing and selling expenses were $88.6 million, or 47% of total revenue, in 1999, compared to $57.2 million, or 47% of total revenue, in 1998 and $37.1 million, or 48% of total revenue, in 1997. The increase in expenses in 1999 as compared to 1998 was primarily due to an increase in personnel-related costs of $14.6 million reflecting growth in headcount from 265 at December 31, 1998 to 377 at December 31, 1999, an increase in sales commissions of $4.8 million attributable to higher revenue, an increase in facilities and related costs of $1.8 million and an increase in spending on marketing programs of $7.5 million. We expect marketing and selling expenses to increase in absolute dollars as total revenue increases, but these expenses may vary as a percentage of revenue.

General and administrative

General and administrative expense increased to $11.2 million, or 6% of total revenue in 1999, from $8.5 million, or 7% of total revenue in 1998 and $6.6 million, or 9% of total revenue in 1997. The increase in expenses in 1999 as compared to 1998 was primarily due to an increase in personnel-related costs of $1.6 million reflecting growth in headcount from 53 at December 31, 1998 to 70 at December 31, 1999.

Other income, net

Other income, net consists primarily of interest income and foreign exchange gains and losses. The increase in other income, net to $6.0 million in 1999 from $4.6 million in 1998 reflected increased interest income on higher average cash and investment balances.

Provision for income taxes

We have structured our operations in a manner designed to maximize income in Israel where tax rate incentives have been extended to encourage foreign investments. The tax holidays and rate reductions that we will be able to realize under programs currently in effect expire at various dates through 2007. Future provisions for taxes will depend upon the mix of worldwide income and the tax rates in effect for various tax jurisdictions. See Note 4 of Notes to Consolidated Financial Statements and "—Risk Factors—We are subject to the risk of increased taxes."

We calculated the 1999 tax provision without the benefit of Conduct's pre-acquisition net operating losses because we may not be able to offset these losses against our future income.

Merger related expenses

In connection with the acquisition of Conduct, we incurred merger-related expenses of approximately $2.0 million, primarily relating to legal and accounting expenses, severance and the write off of redundant facilities and equipment.

Net income

We reported net income of $33.1 million in 1999, compared to net income of $19.5 million in 1998 and $5.7 million in 1997.

Management's Discussion and analysis of financial condition and results of operations

Risk Factors

In addition to the other information included in this Annual Report on Form 10-K, the following risk factors should be considered carefully in evaluating us and our business.

Our future success depends on our ability to respond to rapid market and technological changes by introducing new products and to continually improve the performance, features and reliability of our existing products and respond to competitive offerings. Our business will suffer if we do not successfully respond to rapid technological changes. The market for our software products is characterized by:

- rapidly changing technology;
- frequent introduction of new products and enhancements to existing products by our competitors;
- increasing complexity and interdependence of Internet related applications;
- changes in industry standards and practices; and
- changes in customer requirements and demands.

To maintain our competitive position, we must continue to enhance our existing software testing and application performance management products and to develop new products and services, functionality and technology that address the increasingly sophisticated and varied needs of our prospective customers. The development of new products and services, and enhancement of existing products and services, entail significant technical and business risks and require substantial lead-time and significant investments in product development. If we fail to anticipate new technology developments, customer requirements or industry standards, or if we are unable to develop new products and services that adequately address these new developments, requirements and standards in a timely manner, our products may become obsolete, our ability to compete may be impaired and our revenues could decline.

We expect our quarterly revenues and operating results to fluctuate, which may cause the price of our stock and the notes to decline. Our revenues and operating results have varied in the past and are likely to vary significantly from quarter to quarter in the future. These fluctuations are due to a number of factors, many of which are outside of our control, including:

- fluctuations in demand for and sales of our products and services;
- our success in developing and introducing new products and the timing of new product introductions;
- our ability to introduce enhancements to our existing products in a timely manner;
- the introduction of new or enhanced products by our competitors and changes in the pricing policies of these competitors;
- the discretionary nature of our customers' purchase and budget cycles;
- the amount and timing of operating costs and capital expenditures relating to the expansion of our business;
- deferrals by our customers of orders in anticipation of new products or product enhancements; and
- the mix of our domestic and international sales, together with fluctuations in foreign currency exchange rates.

In addition, the timing of our license revenues is difficult to predict because our sales cycles are typically short and can vary substantially from product to product and customer to customer. We base our operating expenses on our expectations regarding future revenue levels. As a result, if total revenues for a particular quarter are below our expectations, we could not proportionately reduce operating expenses for that quarter.

We have experienced seasonality in our revenues and earnings, with the fourth quarter of the year typically having the highest revenue and earnings for the year and higher revenue and earnings than the first quarter of the following year. We believe that this seasonality results primarily from the budgeting cycles of our customers and from the structure of our sales commission program. We expect this seasonality to continue in the future.

Due to these and other factors, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. If our operating results are below the expectations of investors or securities analysts, the price of our common stock, and therefore the notes, could decline.

We expect to face increasing competition in the future, which could cause reduced sales levels and result in price reductions, reduced gross margins or loss of market share. The market for our testing and application performance management products and services is extremely competitive, dynamic and subject to frequent technological changes. There are few substantial barriers to entry in our market. In addition, the rapid growth and use of Internet for e-business is a recent and emerging phenomenon. The Internet lowers the barriers to entry for other companies to compete with us in the testing and application performance management markets. As a result of the increased competition, our success will depend, in large part, on our ability to identify and respond to the needs of potential customers, and to new technological and market opportunities, before our competitors identify and respond to these needs and opportunities. We may fail to respond quickly enough to these needs and opportunities.

In the testing applications market, our principal competitors include Compuware, Radview, Rational Software, RSW (a division of Teradyne) and Segue Software. In the new and rapidly changing market for application performance management solutions, our competitors include providers of hosted services such as Keynote Systems and Service Metrics (a division of Exodus Communications), and emerging application providers such as Freshwater Software. In addition, we face potential competition in this market from existing providers of testing solutions such as Segue. Finally, in both the market for testing solutions and the market for application performance management solutions, we face potential competition from established providers of systems and network management software such as BMC Software and Computer Associates.

The software industry is increasingly experiencing consolidation, and this could increase the resources available to our competitors and the scope of their product offerings. Our competitors and potential competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies or make more attractive offers to distribution partners and to employees.

If we fail to maintain our existing distribution channels and develop additional channels in the future, our revenues will decline. We derive a substantial portion of our revenues from sales of our products through distribution channels such as system integrators and value-added resellers. We expect that sales of our products through these channels will continue to account for a substantial portion of our revenues for the foreseeable future. We have also entered into private labeling arrangements with ASPs and an enterprise software company who incorporate our products and services into theirs. We may not experience increased revenues from these new channels, which could harm our business.

The loss of one or more of our system integrators, value-added resellers or ASPs, or any reduction or delay in their sales of our products and services could result in reductions in our revenue in future periods. In addition, our ability to increase our revenue in the future depends on our ability to expand our indirect distribution channels. Our dependence on indirect distribution channels presents a number of risks, including:

- each of our system integrators, value-added resellers and ASPs can cease marketing our products and services with limited or no notice and with little or no penalty;
- our existing system integrators, value-added resellers and ASPs may not be able to effectively sell any new products and services that we may introduce;
- we may not be able to replace existing or recruit additional system integrators, value-added resellers and ASPs if we lose any of our existing ones;
- our system integrators, value-added resellers and ASPs also offer competitive products and services from third parties;
- we may face conflicts between the activities of our indirect channels and our direct sales and marketing activities; and
- our system integrators, value-added resellers and ASPs may not give priority to the marketing of our products and services as compared to our competitors' products.

Management's Discussion **and analysis of financial condition and results of operations**

In March 1999, we entered into an agreement with Tivoli Systems, a subsidiary of IBM, for the joint development and marketing of a family of products for enterprise application performance management, incorporating elements of our technology, which would be marketed and sold only by Tivoli. Under this agreement, we agreed that until October 2002, we will not license this technology to any other party for purposes of developing a product similar to any developed under this agreement. In addition, we agreed that until October 2002, we will not enter into technology relationships to create similar products with specified competitors of Tivoli as long as Tivoli continues to agree to pay minimum royalties. These restrictions may limit our ability to enter into new private labeling relationships. In addition, Tivoli may not succeed in developing and selling these new products.

We depend on strategic relationships and business alliances for continued growth of our business. Our development, marketing and distribution strategies rely increasingly on our ability to form strategic relationships with software and other technology companies. These business relationships often consist of cooperative marketing programs, joint customer seminars, lead referrals and cooperation in product development. Many of these relationships are not contractual and depend on the continued voluntary cooperation of each party with us. Divergence in strategy or change in focus by, or competitive product offerings by, any of these companies may interfere with our ability to develop, market, sell or support our products, which in turn could harm our business. Further, if these companies enter into strategic alliances with other companies or are acquired, they could reduce their support of our products. Our existing relationships may be jeopardized if we enter into alliances with competitors of our strategic partners. In addition, one or more of these companies may use the information they gain from their relationship with us to develop or market competing products.

If we are unable to manage our growth, our business may be harmed. Since 1991, we have experienced significant annual increases in revenue, employees and number of product and service offerings. This growth has placed and, if it continues, will place a significant strain on our management and our financial, operational, marketing and sales systems. If we cannot manage our growth effectively, our business, competitive position, operating results and financial condition could suffer. Although we are implementing a variety of new or expanded business and financial systems, procedures and controls, including the improvement of our sales and customer support systems, the implementation of these systems, procedures and controls may not be completed successfully, or may disrupt our operations. Any failure by us to properly manage these transitions could impair our ability to attract and service customers and could cause us to incur higher operating costs and experience delays in the execution of our business plan.

The success of our business depends on the efforts and abilities of our senior key personnel. We depend on the continued services and performance of our senior management and other key personnel. We do not have long term employment agreements with any of our key personnel. The loss of any of our executive officers or other key employees could hurt our business.

If we cannot hire qualified personnel, our ability to manage our business, develop new products and increase our revenues will suffer. We believe that our ability to attract and retain qualified personnel at all levels in our organization is essential to the successful management of our growth. In particular, our ability to achieve revenue growth in the future will depend in large part on our success in expanding our direct sales force and in maintaining a high level of technical consulting, training and customer support. There is substantial competition for experienced personnel in the software and technology industry. If we are unable to retain our existing key personnel or attract and retain additional qualified individuals, we may from time to time experience inadequate levels of staffing to perform services for our customers. As a result, our growth could be limited due to our lack of capacity to develop and market our products to our customers.

We depend on our international operations for a substantial portion of our revenues. Sales to customers located outside the United States have historically accounted for a significant percentage of our revenue and we anticipate that such sales will continue to be a significant percentage of our revenue. As a percentage of our total revenues, sales to customers outside the United States were approximately 34% in 1999, 35% in 1998 and 36% in 1997. In addition, we have substantial research and development operations in Israel. We face risks associated with our international operations, including:

- changes in taxes and regulatory requirements;
- difficulties in staffing and managing foreign operations;
- reduced protection for intellectual property rights in some countries;
- the need to localize products for sale in international markets;
- longer payment cycles to collect accounts receivable in some countries;
- seasonal reductions in business activity in other parts of the world in which we operate;
- political and economic instability; and
- economic downturns in international markets.

Any of these risks could harm our international operations and cause lower international sales. For example, some European countries already have laws and regulations related to technologies used on the Internet that are more strict than those currently in place in the United States. Any or all of these factors could cause our business to be harmed.

Because our research and development operations are primarily located in Israel, we may be affected by volatile economic, political and military conditions in that country and by restrictions imposed by that country on the transfer of technology. Our operations depend on the availability of highly-skilled and relatively low-cost scientific and technical personnel in Israel. Our business also depends on trading relationships between Israel and other countries. In addition to the risks associated with international sales and operations generally, our operations could be adversely affected if major hostilities involving Israel should occur or if trade between Israel and its current trading partners were interrupted or curtailed.

These risks are compounded due to the restrictions on our ability to manufacture or transfer outside of Israel any technology developed under research and development grants from the government of Israel, without the prior written consent of the government of Israel. If we are unable to obtain the consent of the government of Israel, we may not be able to take advantage of strategic manufacturing and other opportunities outside of Israel. We have, in the past, obtained royalty-bearing grants from various Israeli government agencies. In addition, we participate in special Israeli government programs that provide significant tax advantages. The loss of or any material decrease in these tax benefits could negatively affect our financial results.

We are subject to the risk of increased taxes. We have structured our operations in a manner designed to maximize income in Israel where tax rate incentives have been extended to encourage foreign investment. Our taxes could increase if these tax rate incentives are not renewed upon expiration or tax rates applicable to us are increased. Tax authorities could challenge the manner in which profits are allocated among us and our subsidiaries, and we may not prevail in any such challenge. If the profits recognized by our subsidiaries in jurisdictions where taxes are lower became subject to income taxes in other jurisdictions, our worldwide effective tax rate would increase.

Our financial results may be negatively impacted by foreign currency fluctuations. Our foreign operations are generally transacted through our international sales subsidiaries. As a result, these sales and related expenses are denominated in currencies other than the U.S. Dollar. Because our financial results are reported in U.S. Dollars, our results of operations may be harmed by fluctuations in the rates of exchange between the U.S. Dollar and other currencies, including:

- a decrease in the value of Pacific Rim or European currencies relative to the U.S. Dollar, which would decrease our reported U.S. Dollar revenue, as we generate revenues in these local currencies and report the related revenues in U.S. Dollars; and
- an increase in the value of Pacific Rim, European or Israeli currencies relative to the U.S. Dollar, which would increase our sales and marketing costs in these countries and would increase research and development costs in Israel.

Management's Discussion and analysis of financial condition and results of operations

We attempt to limit foreign exchange exposure through operational strategies and by using forward contracts to offset the effects of exchange rate changes on intercompany trade balances. This requires us to estimate the volume of transactions in various currencies. We may not be successful in making these estimates. If these estimates are overstated or understated during periods of currency volatility, we could experience material currency gains or losses.

Our ability to successfully implement our business strategy depends on the continued growth of the Internet. In order for our business to be successful, the Internet must continue to grow as a medium for conducting business. However, as the Internet continues to experience significant growth in the number of users and the complexity of Web-based applications, the Internet infrastructure may not be able to support the demands placed on it or the performance or reliability of the Internet might be adversely affected. Security and privacy concerns may also slow the growth of the Internet. Because our revenues ultimately depend upon the Internet generally, our business may suffer as a result of limited or reduced growth.

Our recent acquisition and any future acquisitions may be difficult to integrate, disrupt our business, dilute stockholder value or divert the attention of our management. We have acquired, and in the future we may acquire or make investments in other companies with similar products and technologies. For example, in November 1999, we completed our acquisition of Conduct Ltd. In the event of any future acquisitions or investments, we could:

- issue stock that would dilute the ownership of our then-existing stockholders;
- incur debt;
- assume liabilities;
- incur amortization expense related to goodwill and other intangible assets; or
- incur large write offs.

If we fail to achieve the financial and strategic benefits of past and future acquisitions, our operating results will suffer. Acquisitions and investments involve numerous other risks, including:

- difficulties integrating the acquired operations, technologies or products with ours;
- failure to achieve targeted synergies;
- unanticipated costs and liabilities;
- diversion of management's attention from our core business;
- adverse effects on our existing business relationships with suppliers and customers or those of the acquired organization;
- difficulties entering markets in which we have no or limited prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

The price of our common stock may fluctuate significantly, which may result in losses for investors and possible lawsuits. The market price for our common stock has been and may continue to be volatile. For example, during the 52-week period ended March 17, 2000, the closing prices of our common stock as reported on the Nasdaq National Market ranged from a high of $132.13 to a low of $10.94. We expect our stock price to be subject to fluctuations as a result of a variety of factors, including factors beyond our control. These factors include:

- actual or anticipated variations in our quarterly operating results;
- announcements of technological innovations or new products or services by us or our competitors;
- announcements relating to strategic relationships or acquisitions;
- changes in financial estimates or other statements by securities analysts;
- changes in general economic conditions;
- conditions or trends affecting the software industry and the Internet; and
- changes in the economic performance and/or market valuations of other software and high-technology companies.

Because of this volatility, we may fail to meet the expectations of our stockholders or of securities analysts at some time in the future, and our stock price could decline as a result.

In addition, the stock market has experienced significant price and volume fluctuations that have particularly affected the trading prices of equity securities of many high technology companies. These fluctuations have often been unrelated or disproportionate to the operating performance of these companies. Any negative change in the public's perception of software or Internet software companies could depress our stock price regardless of our operating results.

If we fail to adequately protect our proprietary rights and intellectual property, we may lose a valuable asset, experience reduced revenues and incur costly litigation to protect our rights. We rely on a combination of patents, copyrights, trademarks, service marks and trade secret laws and contractual restrictions to establish and protect our proprietary rights in our products and services. We will not be able to protect our intellectual property if we are unable to enforce our rights or if we do not detect unauthorized use of our intellectual property. Despite our precautions, it may be possible for unauthorized third parties to copy our products and use information that we regard as proprietary to create products that compete with ours. Some license provisions protecting against unauthorized use, copying, transfer and disclosure of our licensed programs may be unenforceable under the laws of certain jurisdictions and foreign countries. Further, the laws of some countries do not protect proprietary rights to the same extent as the laws of the United States. To the extent that we increase our international activities, our exposure to unauthorized copying and use of our products and proprietary information will increase.

In many cases, we enter into confidentiality or license agreements with our employees and consultants and with the customers and corporations with whom we have strategic relationships and business alliances. No assurance can be given that these agreements will be effective in controlling access to and distribution of our products and proprietary information. Further, these agreements do not prevent our competitors from independently developing technologies that are substantially equivalent or superior to our products.

Litigation may be necessary in the future to enforce our intellectual property rights and to protect our trade secrets. Litigation like this, whether successful or unsuccessful, could result in substantial costs and diversions of our management resources, either of which could seriously harm our business.

Third parties could assert that our products and services infringe their intellectual property rights, which could expose us to litigation that, with or without merit, could be costly to defend. We may from time to time be subject to claims of infringement of other parties' proprietary rights. We could incur substantial costs in defending ourselves and our customers against these claims. Parties making these claims may be able to obtain injunctive or other equitable relief that could effectively block our ability to sell our products in the United States and abroad and could result in an award of substantial damages against us. In the event of a claim of infringement, we may be required to obtain licenses from third parties, develop alternative technology or to alter our products or processes or cease activities that infringe the intellectual property rights of third parties. If we are required to obtain licenses, we cannot be sure that we will be able to do so at a commercially reasonable cost, or at all. Defense of any lawsuit or failure to obtain required licenses could delay shipment of our products and increase our costs. In addition, any such lawsuit could result in our incurring significant costs or the diversion of the attention of our management.

Defects in our products may subject us to product liability claims and make it more difficult for us to achieve market acceptance for these products, which could harm our operating results. Our products may contain errors or "bugs" that may be detected at any point in the life of the product. Any future product defects discovered after shipment of our products could result in loss of revenues and a delay in the market acceptance of these products that could adversely impact our future operating results.

Management's Discussion and analysis of financial condition and results of operations

In selling our products, we frequently rely on "shrink wrap" or "click wrap" licenses that are not signed by licensees. Under the laws of various jurisdictions, the provisions in these licenses limiting our exposure to potential product liability claims may be unenforceable. We currently carry errors and omissions insurance against such claims, however, we cannot assure you that this insurance will continue to be available on commercially reasonable terms, or at all, or that this insurance will provide us with adequate protection against product liability and other claims. In the event of a products liability claim, we may be found liable and required to pay damages which would seriously harm our business.

We have adopted anti-takeover defenses that could delay or prevent an acquisition of our company, including an acquisition that would be beneficial to our stockholders. Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. We have no present plans to issue shares of preferred stock. Furthermore, certain provisions of our Certificate of Incorporation and of Delaware law may have the effect of delaying or preventing changes in our control or management, which could adversely affect the market price of our common stock.

Leverage and debt service obligations may adversely affect our cash flow. Upon completion of the currently proposed offering of up to $500,000,000 principal amount of convertible subordinated notes, we will have a substantial amount of outstanding indebtedness, primarily the notes. There is the possibility that we may be unable to generate cash sufficient to pay the principal of, interest on and other amounts due in respect of our indebtedness when due. Our leverage could have significant negative consequences, including:

- increasing our vulnerability to general adverse economic and industry conditions;
- requiring the dedication of a substantial portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of our expected cash flow available for other purposes, including capital expenditures; and
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete.

Liquidity and Capital Resources

At December 31, 1999, our principal source of liquidity consisted of $186.9 million of cash and investments compared to $130.7 million at December 31, 1998 and $92.4 million at December 31, 1997. The December 31, 1999 balance included $137.1 million of short-term and $15.6 million of long-term investments in high quality government and corporate securities.

During 1999, we generated $61.1 million cash from operating activities, compared to $39.5 million in 1998 and $17.1 million in 1997. The increase in 1999 compared to 1998 was due primarily to an increase in net income and increases in accounts payable and accrued liabilities.

Our primary investing activities were net purchases of investments in 1999 of $39.7 million compared to net proceeds from investments of $1.3 million in 1998 and $512,000 in 1997. We also purchased property and equipment, which totaled $23.9 million in 1999, $15.0 million in 1998 and $11.9 million in 1997. Of these amounts, we spent $8.2 million in 1999, and $1.5 million 1998, for purchase and renovation of our headquarters buildings in Sunnyvale, California. We expect to spend an additional $3.5 million to complete the construction in California. We spent $5.6 million in 1999, and $5.7 million in 1998, on construction of a new research and development facility in Israel. Also in 1999, we spent $2.7 million to purchase additional land in Israel for anticipated future expansion.

Our primary financing activity consisted of issuances of common stock under our stock option and stock purchase plans. Proceeds from issuance of stock under these plans, net of notes receivable issued and collected from issuance of stock, amounted to $20.4 million in 1999, $14.4 million in 1998 and $7.7 million in 1997.

Assuming there is no significant change in our business, we believe that our current cash and investment balances and cash flow from operations will be sufficient to fund our cash needs for at least the next twelve months. We also expect to satisfy our financing requirements through the incurrence of debt from time to time. As of December 31, 1999, we did not have any debt outstanding. We currently plan to issue up to $500,000,000 in principal amount of convertible subordinated notes. If we complete this transaction, our leverage will increase significantly. We may not succeed in completing this transaction.

New Accounting Pronouncements

In March 1998, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 98-1, "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use" ("SOP 98-1"). SOP 98-1 is effective for the financial statements of years beginning after December 15, 1998. SOP 98-1 provides guidance over accounting for computer software developed or obtained for internal use including the requirement to capitalize specified costs and amortization of such costs. We adopted the provisions of SOP 98-1 in our fiscal year ended December 31, 1999. Adoption did not have a material effect on our financial statements.

In March 1998, the AICPA issued Statement of Position 98-4, "Deferral of Effective Date of a Provision of SOP 97-2" ("SOP 98-4"). SOP 98-4 defers for one year the application of certain provisions of Statement of Position 97-2 "Software Revenue Recognition" ("SOP 97-2"). Different informal and non-authoritative interpretations of certain provisions of SOP 97-2 have arisen and, as a result, the AICPA issued Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions" ("SOP 98-9") in December 1998 which is effective for periods beginning after March 15, 1999. SOP 98-9 extends the effective date of SOP 98-4 and provides additional interpretive guidance. The adoption of SOP 97-2, SOP 98-4 and SOP 98-9 did not have a material effect on our results of operations, financial position or cash flows.

In June 1999, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 137, "Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133" ("SFAS 137"). SFAS 137 defers for one year the application of Statement of Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") to all fiscal quarters of fiscal years beginning after June 15, 2000. SFAS 133 establishes accounting and reporting standards for derivative instruments and hedging activities. The adoption of SFAS 133 and SFAS 137 have not had and are not expected to have a material effect on our results of operations, financial position or cash flows.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," ("SAB 101") which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosures related to revenue recognition policies. We believe that the impact of SAB 101 will not have a material effect on our results of operations, financial position or cash flows.

Consolidated **balance sheets**

(in thousands, except per share amounts)	December 31, 1999	1998
Assets		
Current assets:		
Cash and cash equivalents	$ 113,346	$ 96,836
Short-term investments	57,981	13,130
Trade accounts receivable (net of allowance for doubtful accounts and sales returns of $5,533 and $3,623)	40,399	27,903
Other receivables	6,325	6,012
Prepaid expenses and other current assets	16,702	11,685
Total current assets	234,753	155,566
Long-term investments	15,555	20,697
Property and equipment, net	46,910	28,423
	$ 297,218	$ 204,686
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,469	$ 4,422
Accrued liabilities	33,433	18,236
Income taxes payable	19,945	11,498
Deferred revenue	35,840	24,122
Total current liabilities	97,687	58,278
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Common stock, par value $.002 per share, 120,000 shares authorized; 78,090 and 73,990 shares issued and outstanding	156	148
Capital in excess of par value	148,826	128,428
Notes receivable from issuance of stock	(5,090)	(5,130)
Accumulated other comprehensive loss	(1,242)	(775)
Retained earnings	56,881	23,737
Total stockholders' equity	199,531	146,408
	$ 297,218	$ 204,686

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated **statements of operations**

	Year ended December 31,		
(in thousands, except per share amounts)	1999	1998	1997
Revenue:			
License	$ 130,900	$ 84,450	$ 56,683
Service	56,800	36,550	20,017
Total revenue	187,700	121,000	76,700
Cost of revenue:			
License	7,736	6,291	4,351
Service	18,642	11,757	6,225
Total cost of revenue	26,378	18,048	10,576
Gross profit	161,322	102,952	66,124
Operating expenses:			
Research and development, net	23,484	16,907	11,333
Write off of in-process research and development and related expenses	—	—	5,500
Marketing and selling	88,609	57,243	37,073
General and administrative	11,242	8,466	6,642
Merger related expenses	2,000	—	—
Total operating expenses	125,335	82,616	60,548
Income from operations	35,987	20,336	5,576
Other income, net	6,026	4,640	3,083
Income before provision for income taxes	42,013	24,976	8,659
Provision for income taxes	8,869	5,451	2,927
Net income	$ 33,144	$ 19,525	$ 5,732
Net income per share (basic)	$ 0.44	$ 0.28	$ 0.09
Net income per share (diluted)	$ 0.39	$ 0.25	$ 0.08
Weighted average common shares (basic)	76,112	70,654	65,494
Weighted average common shares and equivalents (diluted)	85,208	78,818	68,458

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated **statements of shareholders' equity**

(in thousands)	Common stock Shares	Common stock Amount	Capital in excess of par value	Notes receivable from issuance of stock	Retained earnings/ accumulated deficit	Accumulated other comprehensive loss	Stockholders' equity	Comprehensive income (loss)
Balance at December 31, 1996	64,226	$ 128	$ 100,539	—	$ (1,520)	$ (99)	$ 99,048	
Net income	—	—	—	—	5,732	—	5,732	$ 5,732
Currency translation adjustments	—	—	—	—	—	(325)	(325)	(325)
Comprehensive income								$ 5,407
Stock issued under stock option and employee stock purchase plans	2,728	6	7,560	—	—	—	7,566	
Pooling of interests acquisition	—	—	99	—	—	—	99	
Balance at December 31, 1997	66,954	134	108,198	—	4,212	(424)	112,120	
Net income	—	—	—	—	19,525	—	19,525	19,525
Currency translation adjustments	—	—	—	—	—	(351)	(351)	(351)
Comprehensive income								$ 19,174
Stock issued under stock option and employee stock purchase plans	6,300	12	16,266	(5,130)	—	—	11,148	
Pooling of interests acquisition	736	2	3,964	—	—	—	3,966	
Balance at December 31, 1998	73,990	148	128,428	(5,130)	23,737	(775)	146,408	
Net income	—	—	—	—	33,144	—	33,144	33,144
Currency translation adjustments	—	—	—	—	—	(467)	(467)	(467)
Comprehensive income								$ 32,677
Collection of notes receivable	—	—	—	387	—	—	387	
Stock issued under stock option and employee stock purchase plans	4,100	8	20,398	(347)	—	—	20,059	
Balance at December 31, 1999	78,090	$ 156	$ 148,826	$ (5,090)	$ 56,881	$ (1,242)	$ 199,531	

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated **statements of cash flows**

(in thousands)	Year ended December 31, 1999	1998	1997
Cash flows from operating activities:			
Net income	$ 33,144	$ 19,525	$ 5,732
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	6,063	4,223	3,775
Loss on retirement of property and equipment	121	—	—
Deferred income taxes	(2,802)	(1,840)	270
Changes in assets and liabilities:			
Trade accounts receivable	(12,349)	(4,006)	(7,240)
Other receivables	(428)	(4,034)	(730)
Prepaid expenses and other current assets	(3,277)	(1,879)	857
Accounts payable	4,076	803	1,923
Accrued liabilities	16,164	5,309	5,141
Income taxes payable	8,688	8,373	2,485
Deferred revenue	11,718	13,030	4,936
Net cash provided by operating activities	61,118	39,504	17,149
Cash flows from investing activities:			
Maturity of investments	28,616	35,128	35,640
Purchases of investments	(68,325)	(33,826)	(35,128)
Acquisition of property and equipment, net	(23,897)	(15,040)	(11,927)
Capitalization of software development costs	—	—	(500)
Net cash used in investing activities	(63,606)	(13,738)	(11,915)
Cash flows from financing activities:			
Proceeds from issuance of common stock, net	20,406	19,494	7,665
Notes receivable from issuance of stock	(347)	(5,130)	—
Notes receivable collected from issuance of stock	387	—	—
Net cash provided by financing activities	20,446	14,364	7,665
Effect of exchange rate changes on cash	(1,448)	(585)	(28)
Net increase in cash	16,510	39,545	12,871
Cash and cash equivalents at beginning of year	96,836	57,291	44,420
Cash and cash equivalents at end of year	$ 113,346	$ 96,836	$ 57,291

Supplemental Disclosure:

Cash paid during the year for income taxes	$ 1,354	$ 1,365	$ 2,083

The accompanying notes are an integral part of these consolidated financial statements.

Notes to consolidated financial statements

Note 1. The Company and its Significant Accounting Policies

Mercury Interactive Corporation (the "Company") develops, markets and supports performance management solutions that enable businesses to test and monitor their Internet and other applications. The Company operates in one industry segment. (See Note 7 for geographic reporting.) No customer accounted for more than 10% of revenue in 1999, 1998 or 1997.

The Company acquired Conduct Ltd. on November 30, 1999, which was accounted for as a pooling of interests. The consolidated financial statements for each of the three years ended December 31, 1999, 1998 and 1997 and the accompanying notes reflect the results of operations as if the acquired entity was a wholly owned subsidiary since its inception (see Note 8).

Basis of presentation

The Company has a wholly owned research and development and sales subsidiary incorporated in Israel and sales subsidiaries in Brazil, Canada, Europe, South Africa and the Pacific Rim for marketing, distribution and support of products. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

In January 2000, the Company's Board of Directors approved a two-for-one split of the Company's common stock, which was distributed as a stock dividend to the Company's stockholders, on February 11, 2000. All share and per share amounts reflect the effect of the split.

Management estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Foreign currency translation

The functional currency of the Company's subsidiary in Israel is the U.S. dollar. Assets and liabilities in Israel are translated at year-end exchange rates, except for property and equipment, which is translated at historical rates. Revenues and expenses are translated at average exchange rates in effect during the year, except for costs related to those balance sheet items, which are translated at historical rates. Foreign currency translation gains and losses, which have not been material to date for this subsidiary, are included in the consolidated statement of operations.

The functional currencies of all other subsidiaries are the local currencies. Accordingly, all assets and liabilities of these subsidiaries are translated at the current exchange rate at the end of the period and revenues and costs at average exchange rates in effect during the period. The gains and losses from translation of these subsidiaries' financial statements are recorded directly into a separate component of stockholders' equity. Net gains and losses resulting from foreign exchange transactions were not significant during any of the periods presented.

The Company enters into forward foreign exchange contracts to hedge foreign currency denominated intercompany payables against fluctuations in exchange rates. The Company does not enter into forward foreign exchange contracts for speculative or trading purposes. The criteria used for designating a contract as a hedge considers the contract's effectiveness in reducing risk by matching hedging instruments to underlying transactions. Gains and losses on forward foreign exchange contracts are recognized in income in the same period as gains and losses on the underlying transactions. At December 31, 1999, the Company had outstanding forward foreign exchange contracts to sell $10.7 million in currencies with a fair value of $10.6 million.

Cash and cash equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents.

Short-term and long-term investments

The Company considers all investments with remaining maturities of less than one year to be short-term investments and all investments with remaining maturities greater than one year to be long-term investments. In accordance with Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the Company has categorized its marketable securities as "held to maturity" securities.

The investments, which all have contractual maturities of less than two years, are carried at cost plus accrued interest. Realized gains or losses are determined based on the specific identification method and are reflected in other income.

The portfolio of short-term and long-term investments (including cash and cash equivalents) consisted of the following (in thousands):

	December 31,	
Investment Type	1999	1998
Cash and interest bearing demand deposits	$ 34,275	$ 21,655
Corporate debt securities	86,593	56,472
Municipal securities	52,670	50,936
U.S. treasury and agency securities	13,344	1,600
Total	$186,882	$130,663

Revenue recognition

Revenues are derived from product licensing fees, and from maintenance support services, training and consulting. Revenue from product licensing fees is recognized upon shipment and resolution of any material vendor obligations. Products shipped, for which material vendor obligations exist, are recorded as deferred revenue. Service revenue from customer maintenance fees for ongoing customer support and product updates is recognized ratably over the period of the contract. Payments for maintenance fees are generally made in advance, are nonrefundable and are classified as deferred revenue. Revenues for training and consulting services are recognized as the services are provided.

Property and equipment

Property and equipment are stated at cost. Depreciation and amortization are provided using the straight-line method over the estimated economic lives of assets, which are five to seven years for office furniture and equipment, three to five years for computers and related equipment, four to ten years for leasehold improvements, or the term of the lease, whichever is shorter, and thirty years for buildings.

Long-lived assets

The Company evaluates the recoverability of its long-lived assets in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" ("SFAS 121"). SFAS 121 requires recognition of impairment of long-lived assets in the event the net book value of such assets exceeds the future undiscounted cash flows attributable to such assets. No such impairments have been identified to date. The Company assesses the impairment of long-lived assets when events or changes in circumstances indicate that the carrying value of an asset may not be recoverable.

Research and development

In accordance with Statement of Financial Accounting Standards No. 86, "Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed," all costs incurred to establish the technological feasibility of a computer product to be sold, leased or otherwise marketed are expensed as research and development costs. Costs incurred subsequent to the establishment of technological feasibility, and prior to the general release of the product to the public are capitalized. Amortization of capitalized software development costs is provided on a product-by-product basis using the straight-line method over the estimated economic life of the products of two years.

Notes to consolidated financial statements

In 1999 and 1998, no software development costs were capitalized because the costs incurred subsequent to achieving technological feasibility and prior to the general release of the products were not significant. The Company capitalized $500,000 of software development costs during the year ended December 31, 1997. Amortization charges included in cost of license revenues were $585,000 in 1999 and $600,000 in each of 1998 and 1997. In conjunction with the technology acquisition in 1997 approximately $250,000 of capitalized development costs were written off as obsolete in the year ended December 31, 1997. At December 31, 1999, the Company did not have any capitalized software development costs. At December 31, 1998, the net balance of capitalized software development costs was $585,000.

Research and development expense is reported net of research grants received from the government of Israel, and includes royalty expense for obligations to the government of Israel for sales of products developed under government-funded research. No grants were obtained from the Office of the Chief Scientist in the Israeli Ministry of Industry and Trade ("the Chief Scientist") during 1999. Research grants received amounted to $1.6 million in 1998 and $2.1 million in 1997. The Company was not obligated to repay these grants; however, the Company agreed to pay royalties at rates ranging from 2% to 5% of product sales resulting from the research, up to the amount of the grants obtained and for certain grants up to 150% of the grants obtained. Royalty expense under these agreements amounted to approximately $2.7 million for each of the years ended December 31, 1999 and 1998, and $1.6 million for the year ended December 31, 1997. As of December 31, 1999, the Company had no outstanding royalty obligations. The Company has not applied for, nor does it anticipate applying for, any future Chief Scientist grants.

Stock-based compensation

The Company accounts for stock-based compensation using the intrinsic value method presented in Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The Company's policy is to grant options with an exercise price equal to the quoted market price of its stock on the grant date. Accordingly, no compensation cost has been recognized in the statements of operations. Additional pro forma disclosure is provided as required under Statement of Financial Accounting Standard No. 123 ("SFAS 123"), "Accounting for Stock-based Compensation" (see Note 3).

Concentration of risks

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash equivalents, investments and accounts receivable. The Company invests primarily in money market accounts and marketable securities and places its investments with high quality financial, government or corporate institutions. Accounts receivables are derived from sales to customers located primarily in the U.S., Canada, Europe, Pacific Rim and Israel. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses.

Net income per share

Earnings per share are calculated in accordance with the provisions of Statement of Accounting Standards No. 128, "Earnings per Share," ("SFAS 128"). SFAS 128 requires the reporting of both basic earnings per share, which is the weighted-average number of common shares outstanding, and diluted earnings per share, which includes the weighted-average common shares outstanding and all dilutive potential common shares outstanding. For the years ended December 31, 1999, 1998 and 1997, dilutive potential common shares outstanding reflects shares issuable under our stock option plans. Share and per share amounts reflect the effect of the two-for-one stock split distributed to stockholders on February 11, 2000. The following table summarizes the Company's earnings per share computations for the years ended December 31, 1997, 1998 and 1999 (in thousands, except per share amounts):

	Net income	Average shares	Earnings per share
December 31, 1997:			
Basic earnings per share	$ 5,732	65,494	$ 0.09
Dilutive adjustments	—	2,964	
Diluted earnings per share	$ 5,732	68,458	$ 0.08
December 31, 1998:			
Basic earnings per share	$ 19,525	70,654	$ 0.28
Dilutive adjustments	—	8,164	
Diluted earnings per share	$ 19,525	78,818	$ 0.25
December 31, 1999:			
Basic earnings per share	$ 33,144	76,112	$ 0.44
Dilutive adjustments	—	9,096	
Diluted earnings per share	$ 33,144	85,208	$ 0.39

At December 31, 1999, 1998 and 1997, options to purchase a total of 504,000 shares of common stock with an average exercise price of $38.50, 280,000 shares of common stock with an average exercise price of $9.62, and 941,092 shares of common stock with an average exercise price of $4.83, respectively, are considered anti-dilutive because the options' exercise price was greater than the average fair market value of our common stock for the years then ended.

Reclassifications

Certain previously reported amounts have been reclassified to conform to the 1999 consolidated financial statement presentation.

Notes **to consolidated financial statements**

Comprehensive income

Effective January 1, 1998, the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income." This statement requires that all items recognized under accounting standards as components of comprehensive earnings be reported in an annual financial statement that is displayed with the same prominence as other annual financial statements. Comprehensive income has been included in the Consolidated Statement of Stockholders' Equity for all periods.

Segment reporting

Effective January 1998, the Company adopted Statement of Financial Accounting Standard No. 131, "Disclosures about Segments of an Enterprise and Related Information." This statement establishes standards for the manner in which public companies report information about operating segments in annual and interim financial statements. Information related to geographic segments is included in Note 7.

New accounting pronouncements

In March 1998, the American Institute of Certified Public Accountants ("AICPA") issued Statement of Position 98-1, "Accounting for the Cost of Computer Software Developed or Obtained for Internal Use"("SOP 98-1"). SOP 98-1 is effective for the financial statements for years beginning after December 15, 1998. SOP 98-1 provides guidance over accounting for computer software developed or obtained for internal use including the requirement to capitalize specified costs and amortization of such costs. The Company adopted the provisions of SOP 98-1 in its fiscal year ending December 31, 1999. Adoption did not have a material effect on the financial statements.

In March 1998, the AICPA issued Statement of Position 98-4, "Deferral of Effective Date of a Provision of SOP 97-2 ("SOP 98-4"). SOP 98-4 defers for one year the application of certain provisions of Statement of Position 97-2 "Software Revenue Recognition ("SOP 97-2"). Different informal and non-authoritative interpretations of certain provisions of SOP 97-2 have arisen and, as a result, the AICPA issued Statement of Position 98-9, "Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions" ("SOP 98-9") in December 1998 which is effective for periods beginning after March 15, 1999. SOP 98-9 extends the effective date of SOP 98-4 and provides additional interpretive guidance. The adoption of SOP 97-2, SOP 98-4 and SOP 98-9 have not had a material effect on the results of operations, financial position or cash flows.

In June 1999, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 137, "Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133—an amendment of FASB Statement No. 133" ("SFAS 137"). SFAS 137 defers for one year the application of Statement of Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") to all fiscal quarters of fiscal years beginning after June 15, 2000. SFAS 133 establishes accounting and reporting standards for derivative instruments and hedging activities. The adoption of SFAS 133 and SFAS 137 have not had and are not expected to have a material effect on the results of operations, financial position or cash flows.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," ("SAB 101") which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosures related to revenue recognition policies. Management believes the impact of SAB 101 will not have a material effect on the results of operations, financial position or cash flows.

Note 2. Financial Statement Components

(in thousands)	December 31, 1999	1998
Other receivables:		
Government grants receivables	$ —	$ 400
Employee receivables	2,625	1,014
Income taxes receivable	2,178	2,618
Other receivables	1,522	1,980
	$ 6,325	$ 6,012
Prepaid expenses and other current assets:		
Prepaid compensation	$ 6,579	$ 5,717
Deferred income taxes, net	4,642	1,840
Other	5,481	4,128
	$ 16,702	$ 11,685
Property and equipment, net:		
Land and buildings	$ 35,245	$ 18,311
Computers and equipment	23,558	18,039
Office furniture and equipment	5,829	4,481
Leasehold improvements	2,888	2,934
	67,520	43,765
Less: Accumulated depreciation and amortization	(20,610)	(15,342)
	$ 46,910	$ 28,423
Accrued liabilities:		
Payroll and accrued commissions (including payroll taxes)	$ 16,751	$ 5,939
Vacation and severance	4,299	3,457
Sales tax	3,270	2,820
Royalties	1,596	2,177
Merger related expenses	937	—
Other	6,580	3,843
	$ 33,433	$ 18,236

(in thousands)	Year ended December 31, 1999	1998	1997
Other income, net:			
Interest income	$ 6,480	$ 4,741	$ 3,521
Foreign exchange losses and other	(454)	(101)	(438)
	$ 6,026	$ 4,640	$ 3,083

Notes to consolidated financial statements

Note 3. Common Stock

In August 1989, the Company adopted a stock option plan (the "1989 Plan"). Options granted under the 1989 Plan are for periods not to exceed ten years. For holders of 10% or more of the total combined voting power of all classes of the Company's stock, options may not be granted at less than 110% of the fair value of the common stock at the date of grant and the option term may not exceed 5 years. Incentive stock option grants under the 1989 Plan must be at exercise prices no less than 100% of the fair market value and non-statutory stock option grants under the 1989 Plan must be at exercise prices no less than 85% of the fair market value of the stock on the date of grant. Options are immediately exercisable but all shares purchased upon exercise of options are subject to repurchase by the Company until vested. Options generally vest over a period of four years. In August 1998, the stockholders reserved an additional 1,200,000 shares of common stock for issuance upon exercise of stock options to be granted under this plan.

In August 1998, the stockholders adopted the 1999 Stock Option Plan (the "1999 Plan") to replace the 1989 Plan, effective on the expiration of the term of such plan in August 1999. The Company reserved 900,000 shares of common stock for issuance upon exercise of stock options to be granted under this plan. The provisions of the 1999 Plan regarding option term, grant price, exercise price and vesting period are identical to those of the 1989 Plan except that all options granted under the 1999 Plan must be at exercise prices no less than 100% of the fair market value. In December 1999, the stockholders approved an automatic increase in the aggregate number of shares reserved for issuance under the 1999 Plan by 4% of the common stock and equivalents outstanding as of January 1 of each year starting in 2000 and ending in 2003.

In May 1996, the Company adopted a stock option plan solely for grants to employees of its subsidiaries located outside the United States (the "Supplemental Plan"). The Company reserved 2,000,000 shares of common stock for issuance upon exercise of stock options to be granted under this plan. The provisions of the Supplemental Plan regarding option term, grant price, exercise price and vesting period are identical to those of the Plan.

The following table presents the combined activity of the 1989 Plan, the 1999 Plan and the Supplemental Plan for the years ended December 31, 1997, 1998 and 1999 (shares in thousands):

		Options outstanding	
	Options available for grant	Number of shares	Weighted average exercise price
Balance outstanding at December 31, 1996	56	12,500	$ 2.82
Additional shares authorized	2,992	—	—
Options granted	(4,268)	4,268	2.97
Options canceled	1,252	(1,252)	3.00
Options exercised	—	(2,124)	2.41
Balance outstanding at December 31, 1997	32	13,392	2.92
Additional shares authorized	4,466	—	—
Options granted	(5,320)	5,320	6.49
Options canceled	930	(930)	4.41
Options exercised	—	(6,080)	2.72
Balance outstanding at December 31, 1998	108	11,702	4.49
Additional shares authorized	7,857	—	—
Options granted	(4,871)	4,871	16.02
Options canceled	945	(945)	6.38
Options exercised	—	(3,612)	4.42
Balance outstanding at December 31, 1999	4,039	12,016	$ 9.07

The following table presents weighted average price and remaining contractual life information about significant option groups outstanding under the above plans at December 31, 1999 (shares in thousands):

	Options outstanding			Options exercisable	
Range of Exercise Prices	Number outstanding	Weighted average remaining contractual life (yr.)	Weighted average exercise price	Number exercisable at 12/31/99	Weighted average exercise price
$ 0.08 - 3.19	3,061	5.46	$ 2.78	2,044	$ 2.85
$ 3.38 - 6.32	4,015	8.07	5.73	1,359	5.65
$ 8.10 - 12.03	3,691	9.01	11.55	192	8.89
$15.50 - 45.47	1,249	9.81	28.09	4	19.57
	12,016	7.87	$ 9.07	3,599	$ 4.24

Notes to consolidated financial statements

In October 1998, the Company issued notes receivable of $5.1 million to its officers and key employees in connection with the purchase of common stock. The notes bear interest at 5%, are secured by the shares purchased, and require quarterly interest payments. The full amount of the notes and the final interest payment are due no later than December 31, 2000.

Directors' stock option plan

On August 3, 1994, the Board of Directors adopted the 1994 Directors' Stock Option Plan (the "Directors' Plan"). The Company reserved 2,000,000 shares of Common Stock for issuance upon exercise of stock options to be granted during the ten year term of the Directors' Plan. Only outside directors may be granted options under the Directors' Plan. The Plan provided for an initial option grant of 25,000 shares to the Company's outside directors as of August 3, 1994 or upon initial election to the Board of Directors after August 3, 1994. In addition, the plan provided for automatic annual grants of 5,000 shares upon re-election of the individual to the Board of Directors. In August 1998, the stockholders agreed to amend the Directors' plan to increase the number of shares granted to 50,000 shares as an initial grant to new non-employee directors, 10,000 shares as the annual grant to continuing non-employee directors of the Company, and to provide for a one-time grant of 25,000 shares to the non-employee directors of the Company who were serving as directors of the Company as of August 14, 1998. The option term shall be ten years, and options shall be exercisable while such person remains a director. The exercise price shall be 100% of fair market value on the date of grant. The initial option grants vest 20% annually for each director on the date of each Annual Meeting of Stockholders of the Company after the date of grant of such option. The annual option grants shall vest in full on the fifth anniversary following each individual's re-election to the Board of Directors.

The following table presents the activity for the Directors' Plan for the years ended December 31, 1997, 1998 and 1999 (shares in thousands):

		Options outstanding	
	Options available for grant	Number of shares	Weighted average exercise price
Balance outstanding at December 31, 1996	1,520	360	$ 3.26
Options granted	(60)	60	3.07
Options canceled	—	—	—
Options exercised	—	(40)	2.29
Balance outstanding at December 31, 1997	1,460	380	3.33
Options granted	(360)	360	9.70
Options canceled	—	—	—
Options exercised	—	(160)	3.81
Balance outstanding at December 31, 1998	1,100	580	7.14
Options granted	(60)	60	15.50
Options canceled	—	—	—
Options exercised	—	(140)	7.96
Balance outstanding at December 31, 1999	1,040	500	$ 7.91

The following table presents weighted average price and remaining contractual life information about significant option groups outstanding under the Directors' Plan at December 31, 1999 (shares in thousands):

	Options outstanding			Options exercisable	
Range of Exercise Prices	Number outstanding	Weighted average remaining contractual life (yr.)	Weighted average exercise price	Number exercisable at 12/31/99	Weighted average exercise price
$ 2.28 - $ 3.38	140	6.47	$ 3.06	20	$ 2.28
$ 5.28 - $ 8.66	120	6.99	6.75	—	—
$ 9.91 - $ 9.91	180	8.62	9.91	—	—
$15.50 - $15.50	60	9.40	15.50	—	—
	500	7.72	$ 7.91	20	$ 2.28

Employee stock purchase plans

In October 1993, the Board of Directors and stockholders adopted the Employee Stock Purchase Plan (the "1993 ESPP") and reserved 2,000,000 shares for issuance. Under the plan, employees were granted the right to purchase shares of common stock at a price per share that was the lesser of: (i) 85% of the fair market value of the shares at the participant's entry date into the two-year offering period, or (ii) the fair market value at the end of each six-month segment within such offering period. The 1993 ESPP was terminated in February 1998. In August 1998, the stockholders adopted the 1998 Employee Stock Purchase Plan (the "1998 ESPP") to replace the 1993 ESPP and the reservation of 1,300,000 shares for issuance thereunder. Under the 1998 ESPP, employees are granted the right to purchase shares of common stock at a price per share that is the lesser of (i) 85% of the fair market value of the shares at the participant's entry date into the six month offering period, or (ii) 85% of the fair market value of the shares at the end of the six month offering period. During 1999, 1998 and 1997, approximately 345,000, 84,000 and 560,000 shares, respectively, were purchased under our Employee Stock Purchase Plans.

Pro forma disclosure

The Company has adopted the disclosure provisions only of SFAS 123 and will continue to account for its stock option plans in accordance with the provisions of APB 25. Accordingly, no compensation cost has been recognized for the option plans or the ESPP.

Pursuant to the requirements of SFAS 123, the following are pro forma net income (loss) and net income (loss) per share for 1999, 1998 and 1997, as if the compensation costs for the option plans and the ESPP had been determined based on the fair value at the grant date for grants in 1999, 1998 and 1997, consistent with the provisions of SFAS 123:

	1999	1998	1997
Pro forma net income (loss) (in thousands)	$ 13,895	$ 7,882	$ (379)
Pro forma net income (loss) per share (basic)	0.18	0.11	(0.01)
Pro forma net income (loss) per share (diluted)	0.16	0.10	(0.01)

Notes to consolidated financial statements

The fair value of options and shares issued pursuant to the option plans and the ESPP at the grant date were estimated using the Black-Scholes model with the following weighted average assumptions:

	Option plans			ESPP		
	1999	1998	1997	1999	1998	1997
Expected life (years)	4.00	4.00	5.00	0.50	0.50	0.50
Risk-free interest rate	5.01%	5.22%	6.10%	5.06%	4.90%	5.36%
Volatility	83%	83%	86%	83%	83%	86%
Dividend yield	None	None	None	None	None	None

The weighted fair value per share of options granted under the 1989 Plan, the 1999 Plan and Supplemental Plan during the years ended December 31, 1999, 1998 and 1997 were $10.12, $4.13 and $2.12, respectively. The weighted fair value per share of options granted under the Directors' Plan during the years ended December 31, 1999, 1998 and 1997 were $9.84, $6.13 and $2.18, respectively.

Note 4. Income Taxes

Income (loss) before income taxes consists of the following (in thousands):

	Year ended December 31,		
(in thousands)	1999	1998	1997
Domestic	$ 9,357	$ 6,239	$ (284)
Foreign	32,656	18,737	8,943
	$42,013	$24,976	$ 8,659

The provision for income taxes comprises the following (in thousands):

	Year ended December 31,		
(in thousands)	1999	1998	1997
Current:			
Federal	$ 5,375	$ 5,322	$ 1,222
State	931	350	355
Foreign	5,365	1,619	1,080
Total Current	11,671	7,291	2,657
Deferred:			
Federal	(2,681)	(1,756)	193
State	(121)	(84)	77
Foreign	—	—	—
Total Deferred	(2,802)	(1,840)	270
Total tax expense	$ 8,869	$ 5,451	$ 2,927

Deferred tax assets consist of the following (in thousands):

	December 31, 1999	December 31, 1998
Accruals and reserves	$ 3,644	$ 1,821
Net operating loss carryforwards	1,856	1,336
Other	998	19
	6,498	3,176
Valuation allowance	(1,856)	(1,336)
Deferred tax assets, net	$ 4,642	$ 1,840

The Company has provided a valuation allowance for the years ended December 31, 1999 and 1998 for net operating loss carryforwards in foreign jurisdictions, for which realization of future benefit is uncertain.

Management believes it is more likely than not that future operations will generate sufficient taxable income to realize the December 31, 1999 deferred tax assets, net.

The provision for income taxes differs from the amount obtained by applying the statutory federal income tax rate to income before taxes as follows (in thousands):

	Year ended December 31, 1999	1998	1997
Provision at federal statutory rate	$14,705	$ 8,492	$ 2,944
State tax, net of federal tax benefit	527	350	549
Foreign rate differentials from U.S. statutory rate	(8,234)	(5,288)	(2,739)
Non-utilized net operating losses and credits	3,625	2,826	2,722
Tax-exempt interest	(640)	(409)	(756)
Other	(1,114)	(520)	207
	$ 8,869	$ 5,451	$ 2,927

Income taxes are not provided for the undistributed earnings of the Company's foreign subsidiaries because it is management's intention to reinvest such earnings in its foreign operations.

The Company's Israeli facilities have been granted the status of an "Approved Enterprise" under the Israeli law for the Encouragement of Capital Investments, 1959, as amended. An Approved Enterprise is eligible for significant tax rate reductions for several years following the first year in which there is Israeli taxable income (after consideration of tax losses carried forward). The Company realized tax savings of approximately $6.3 million, $5.2 million, and $4.2 million in 1999, 1998 and 1997, respectively, as a result of this tax holiday. Because the Israeli subsidiary currently has five overlapping Approved Enterprise plans, the tax holidays and rate reductions which the Company will be able to realize in future years are expected to extend until 2007.

The Company had U.S. federal net operating loss carryforwards of approximately $23.1 million as of December 31, 1999, expiring through the year 2019. The net operating losses are attributable to stock option compensation deductions. Accordingly, any tax benefit realized upon utilization of these net operating loss carryforwards will be accounted for as additions to Capital in Excess of Par Value. For the year ended December 31, 1999 the Company had California net operating loss carryforwards of approximately $4.4 million available to reduce future income subject to income taxes. If not utilized, the California net operating losses will expire through the year 2004.

The 1999 tax provision was calculated without the benefit of Conduct's pre-acquisition losses because the realization of any future tax benefit is uncertain.

Notes to consolidated financial statements

Note 5. Commitments and Contingencies

Royalty commitments

Research and development expense is reported net of research grants received from the government of Israel, and includes royalty expense for obligations to the government of Israel for sales of products developed under government-funded research. No grants were obtained from the Office of the Chief Scientist in the Israeli Ministry of Industry and Trade ("the Chief Scientist") during 1999. Research grants received amounted to $1.6 million in 1998 and $2.1 million in 1997. The Company was not obligated to repay these grants; however, the Company agreed to pay royalties at rates ranging from 2% to 5% of product sales resulting from the research, up to the amount of the grants obtained and for certain grants up to 150% of the grants obtained. Royalty expense under these agreements amounted to approximately $2.7 million for each of the years ended December 31, 1999 and 1998, and $1.6 million for the year ended December 31, 1997. As of December 31, 1999, the Company had no outstanding royalty obligations. The Company has not applied for, nor does it anticipate applying for, any future Chief Scientist grants.

Lease commitments

The Company leases facilities for sales offices in the U.S. and foreign locations under non-cancelable operating leases that expire from 2000 through 2004. Certain of these leases contain renewal options. The Company leases certain equipment and vehicles under various leases with lease terms ranging from month-to-month up to one year. Future minimum payments under the facilities and equipment leases with non-cancelable terms in excess of one year are as follows as of December 31, 1999 (in thousands):

2000	$ 3,101
2001	2,397
2002	1,555
2003	569
2004	229
Total	$ 7,851

Total rent expense under operating leases amounted to $2.8 million $2.0 million and $1.6 million for the years ended December 31, 1999, 1998 and 1997, respectively.

Note 6. Related Parties

At December 31, 1999, the Company held seven notes receivable with balances totaling $5.1 million from its officers and key employees. These notes arose from transactions occurring on October 5, 1998 whereby the Company loaned its key employees money to purchase an aggregate of 886,428 shares of our common stock at the then fair market value. These notes, which bear interest at the rate of 5% per annum, mature on December 31, 2000. Interest on the notes is due quarterly, with the principal amount and final interest payment being payable in full no later than the maturity date. If the officer or key employee's employment is terminated prior to January 1, 2001, the unpaid portion of the note would become payable in full. These notes are collateralized by the shares purchased. The receivable is shown on the balance sheets as a reduction in equity.

Note 7. Geographic Reporting

(in thousands)	Year ended December 31, 1999	1998	1997
Net revenue to third parties:			
North America	$ 123,900	$ 78,797	$ 49,354
Europe	49,700	33,140	21,223
Rest of the World	14,100	9,063	6,123
Consolidated	$ 187,700	$ 121,000	$ 76,700
Identifiable assets:			
North America	$ 200,854	$ 161,751	$ 111,561
Europe	25,389	14,388	11,656
Rest of the World	70,975	28,547	20,446
Consolidated	$ 297,218	$ 204,686	$ 143,663

The subsidiary located in the United Kingdom accounted for 12% and 11% of the consolidated net revenue to unaffiliated customers for the years ended December 31, 1999 and 1998, respectively. Operations located in Israel accounted 23% and 19% of the consolidated identifiable assets at December 31, 1999 and 1998, respectively. In 1997, no subsidiary represented 10 percent or more of the related consolidated amounts.

Note 8. Acquisitions

On September 30, 1997, the Company acquired technologies from Dixon Software Technology, an unrelated company, for $4.5 million and related acquisition costs of $1.0 million. As a result of this purchase, in the third quarter of 1997, the Company recorded a one-time charge for write off of in-process research and development and related expenses of $5.5 million.

On November 30, 1999, the Company acquired Conduct Ltd. Under terms of the agreement, approximately 408,000 shares of the Company's common stock were issued in exchange for all issued and outstanding convertible preferred and common shares of Conduct, and assumption of all outstanding Conduct stock options, warrants and other securities. The transaction was accounted for as a pooling of interests in the year ended December 31, 1999; therefore, all prior periods presented have been restated to include Conduct in operations since its inception.

Since its inception, Conduct Ltd. has not recorded any revenues. The net income for the separate companies and the combined amounts presented in the consolidated financial statements follow (in thousands).

(in thousands)	Year ended December 31, 1999	1998	1997
Net Income (loss):			
Mercury Interactive Corporation	$ 33,144	$ 21,805	$ 6,707
Conduct Ltd.	—	(2,280)	(975)
	$ 33,144	$ 19,525	$ 5,732

Notes to consolidated financial statements

Note 9. Subsequent Events

In January 2000, the Company declared a two-for-one stock split in the form of a stock dividend. One additional share of common stock has been issued for each share of common stock held by shareholders of record as of January 28, 2000. New shares were distributed on February 11, 2000. All per share data contained herein have been restated to reflect the increased number of shares outstanding.

Market Information Common Stock

Mercury Interactive Corporation common stock is traded publicly on the Nasdaq National Market under the trading symbol "MERQ." The following table presents, for the periods indicated, the high and low sales prices of our common stock as reported on the Nasdaq National Market.

	High	Low
Year Ended December 31, 1998		
First Quarter	$ 9.57	$ 6.10
Second Quarter	11.16	7.82
Third Quarter	11.44	7.88
Fourth Quarter	15.82	5.29
Year Ended December 31, 1999		
First Quarter	$ 19.97	$ 10.75
Second Quarter	19.94	10.50
Third Quarter	34.41	17.31
Fourth Quarter	55.13	30.94

The prices shown in the table above reflect the two-for-one splits of our common stock, each of which were distributed as stock dividends to our stockholders, on February 26, 1999 and February 11, 2000.

Unaudited **quarterly financial data**

	Quarter ended							
(in thousands, except per share amounts)	Dec. 31, 1999	Sept. 30, 1999	June 30, 1999	March 31, 1999	Dec. 31, 1998	Sept. 30, 1998	June 30, 1998	March 31, 1998
Revenue:								
License	$ 43,500	$ 33,500	$ 29,300	$ 24,600	$ 28,200	$ 21,550	$ 19,100	$ 15,600
Service	16,600	14,000	13,200	13,000	12,800	9,050	8,100	6,600
Total revenue	60,100	47,500	42,500	37,600	41,000	30,600	27,200	22,200
Cost of revenue:								
License	2,190	2,040	1,870	1,636	1,867	1,545	1,550	1,329
Service	5,181	4,948	4,441	4,072	3,864	2,959	2,600	2,334
Total cost of revenue	7,371	6,988	6,311	5,708	5,731	4,504	4,150	3,663
Gross profit	52,729	40,512	36,189	31,892	35,269	26,096	23,050	18,537
Operating expenses:								
Research and development, net	5,828	6,554	5,866	5,236	5,274	4,463	3,907	3,263
Marketing and selling	27,123	21,975	20,380	19,131	18,085	14,338	13,753	11,067
General and administrative	3,033	3,082	2,797	2,330	2,440	2,116	1,963	1,947
Merger related expenses	2,000	—	—	—	—	—	—	—
Total operating expenses	37,984	31,611	29,043	26,697	25,799	20,917	19,623	16,277
Income from operations	14,745	8,901	7,146	5,195	9,470	5,179	3,427	2,260
Other income, net	1,925	1,542	1,406	1,153	1,610	1,227	947	856
Income before provision for income taxes	16,670	10,443	8,552	6,348	11,080	6,406	4,374	3,116
Provision for income taxes	3,334	2,297	1,840	1,398	2,332	1,405	1,008	706
Net income	$ 13,336	$ 8,146	$ 6,712	$ 4,950	$ 8,748	$ 5,001	$ 3,366	$ 2,410
Net income per share (basic)	$ 0.17	$ 0.11	$ 0.09	$ 0.07	$ 0.12	$ 0.07	$ 0.05	$ 0.04
Net income per share (diluted)	$ 0.15	$ 0.09	$ 0.08	$ 0.06	$ 0.11	$ 0.06	$ 0.04	$ 0.03
Weighted average common shares (basic)	77,824	76,796	75,394	74,434	73,352	70,692	69,880	68,708
Weighted average common shares (diluted)	87,794	85,920	83,804	83,310	80,584	79,008	78,380	77,304

Report of independent accountants

To the Board of Directors and Stockholders of Mercury Interactive Corporation

In our opinion, the consolidated financial statements listed in the index appearing under Item 14(a)(1) present fairly, in all material respects, the financial position of Mercury Interactive Corporation and its subsidiaries (the "Company") at December 31, 1999 and 1998, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 14(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

San Jose, California
January 20, 2000, except as to Note 9, which is as of February 11, 2000.

Corporate **directory**

Directors

Amnon Landan
President, Chief Executive Officer and
Chairman of the Board of Directors
Mercury Interactive Corporation

Igal Kohavi
Chairman of the Board of Directors
DSP Group, Inc. and Polaris

Yair Shamir
President and Chief Executive Officer
VCON Telecommunications, Ltd.

Giora Yaron
Chairman and Chief Executive Officer
Itamar Medical
Chairman of the Board of Directors
COMSYS Communications and Signal Processing, Ltd.

Corporate Headquarters

Mercury Interactive Corporation
1325 Borregas Avenue
Sunnyvale, CA 94089
408-822-5200

Annual Meeting

The annual meeting of the stockholders of Mercury Interactive Corporation will be held at 10:00 A.M. on May 24, 2000, at the corporate headquarters in Sunnyvale, California.

Form 10-k

The Company files an annual report with the Securities and Exchange Commission on Form 10-k, pursuant to the Securities and Exchange Act of 1934. Stockholders may obtain a copy of this report without cost by writing to Investor Relations, 1325 Borregas Avenue, Sunnyvale, California 94089.

Executive Officers

Amnon Landan
President, Chief Executive Officer and
Chairman of the Board of Directors

Kenneth R. Klein
Chief Operating Officer

Sharlene Abrams
Chief Financial Officer and
Vice President of Finance and Administration

Moshe Egert
President of European Operations

Legal Counsel

General Counsel Associates LLP
Mountain View, California

Independent Accountants

PricewaterhouseCoopers LLP
San Jose, California

Registrar and transfer agent

ChaseMellon Shareholder Services
San Francisco, California

MERCURY INTERACTIVE

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