3COM CORP
Form 10-Q
April 05, 2005

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended February 25, 2005**

**OR**

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from to**

**Commission File No. 0-12867**

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# 3Com Corporation

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware**<br>(State or other jurisdiction of incorporation or organization) | **94-2605794**<br>(I.R.S. Employer Identification No.) |
| **350 Campus Drive**<br>**Marlborough, Massachusetts**<br>(Address of principal executive offices) | **01752**<br>(Zip Code) |

Registrant s telephone number, including area code: **(508) 323-5000**

Former name, former address and former fiscal year, if changed since last report: **N/A**

**Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.**

**Yes ý No o**

**Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act).**

**Yes ý No o**

**As of March 25, 2005, 383,668,086 shares of the registrant s Common Stock were outstanding.**

**3Com Corporation**

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**PART I. FINANCIAL INFORMATION**

## *Item 1.* Financial Statements

**3Com Corporation**

**Condensed Consolidated Statements of Operations**

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| **(In thousands, except per share data)** | **February 25, 2005** | **February 27, 2004** | **February 25, 2005** | **February 27, 2004** |
| Sales | $ 161,185 | $ 171,769 | $ 474,602 | $ 515,539 |
| Cost of sales | 103,825 | 111,500 | 302,456 | 348,376 |
| Gross margin | 57,360 | 60,269 | 172,146 | 167,163 |
| Operating expenses: | | | | |
| Sales and marketing | 59,358 | 61,846 | 173,851 | 190,090 |
| Research and development | 24,445 | 23,776 | 67,369 | 75,124 |
| General and administrative | 13,959 | 17,599 | 44,016 | 63,522 |
| Amortization and write down of intangibles | 1,716 | 1,071 | 4,905 | 5,553 |
| In-process research and development | 5,100 | | 6,775 | |
| Restructuring charges | 9,093 | 39,534 | 16,374 | 147,050 |
| Total operating expenses | 113,671 | 143,826 | 313,290 | 481,339 |
| Operating loss | (56,311) | (83,557) | (141,144) | (314,176) |
| Gain (loss) on investments, net | 1,661 | 880 | 1,743 | (11,314) |
| Interest and other income, net | 4,853 | 3,612 | 10,667 | 11,364 |
| Loss from continuing operations before income taxes and equity interest in loss of unconsolidated joint venture | (49,797) | (79,065) | (128,734) | (314,126) |
| Income tax benefit (provision) | (959) | (1,626) | (1,502) | 2,909 |
| Equity interest in loss of unconsolidated joint venture | (2,249) | (4,196) | (7,125) | (16,789) |
| Loss from continuing operations | (53,005) | (84,887) | (137,361) | (328,006) |
| Discontinued operations, net of taxes | | (685) | | (2,541) |
| Net loss | $ (53,005) | $ (85,572) | $ (137,361) | $ (330,547) |
| Basic and diluted loss per share: | | | | |
| Continuing operations | $ (0.14) | $ (0.22) | $ (0.36) | $ (0.87) |
| Discontinued operations, net of taxes | | | | (0.01) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net loss | $ | (0.14) | $ | (0.22) | $ | (0.36) | $ | (0.88) |
| Shares used in computing per share amounts: | | | | | | | | |
| Basic and diluted | | 379,946 | | 385,019 | | 382,075 | | 376,077 |

*See notes to condensed consolidated financial statements.*

**3Com Corporation**

**Condensed Consolidated Balance Sheets**

(Unaudited)

| **(In thousands, except par value)** | | **February 25, 2005** | | **May 28, 2004** |
|---|---|---|---|---|
| ASSETS | | | | |
| Current assets: | | | | |
| Cash and equivalents | $ | 226,979 | $ | 476,274 |
| Short-term investments | | 655,802 | | 907,082 |
| Accounts receivable, less allowance for doubtful accounts ($15,181 and $16,276, respectively) | | 74,018 | | 66,372 |
| Inventories | | 24,263 | | 27,679 |
| Other current assets | | 33,335 | | 42,270 |
| Total current assets | | 1,014,397 | | 1,519,677 |
| | | | | |
| Investment in Huawei-3Com joint venture | | 135,766 | | 142,891 |
| Property and equipment, net | | 71,346 | | 72,452 |
| Property and equipment held for sale | | | | 42,147 |
| Deposits and other assets | | 43,983 | | 34,806 |
| Deferred income taxes | | 3,053 | | 2,937 |
| Intangible assets, net | | 69,966 | | 5,009 |
| Goodwill | | 310,367 | | 899 |
| | | | | |
| Total assets | $ | 1,648,878 | $ | 1,820,818 |
| | | | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ | 77,725 | $ | 80,408 |
| Accrued liabilities and other | | 232,992 | | 226,161 |
| | | | | |
| Total current liabilities | | 310,717 | | 306,569 |
| | | | | |
| Deferred revenue and long-term obligations | | 9,149 | | 15,135 |
| | | | | |
| Stockholders equity: | | | | |
| Preferred stock, $.01 par value, 10,000 shares authorized; none outstanding | | | | |
| Common stock, $.01 par value, 990,000 shares authorized; shares issued: 383,286 and 392,738, respectively | | 2,302,372 | | 2,262,223 |
| Treasury stock, at cost, 10,127 and 0 shares, respectively | | (49,577) | | |
| Unamortized stock-based compensation | | (13,279) | | (2,577) |
| Retained deficit | | (905,702) | | (755,244) |
| Accumulated other comprehensive loss | | (4,802) | | (5,288) |
| Total stockholders equity | | 1,329,012 | | 1,499,114 |
| | | | | |
| Total liabilities and stockholders equity | $ | 1,648,878 | $ | 1,820,818 |

*See notes to condensed consolidated financial statements.*

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**3Com Corporation**

**Condensed Consolidated Statements of Cash Flows**

(Unaudited)

| (In thousands) | Nine Months Ended February 25, 2005 | Nine Months Ended February 27, 2004 |
|---|---|---|
| Cash flows from operating activities: | | |
| Loss from continuing operations | $ (137,361) | $ (328,006) |
| Adjustments to reconcile loss from continuing operations to cash (used in) operating activities: | | |
| Loss from discontinued operations | | (2,541) |
| Depreciation and amortization | 36,797 | 96,789 |
| Write down of intangibles | 1,242 | 1,905 |
| (Gain) loss on property and equipment | (5,445) | 41,111 |
| (Gain) loss on investments, net | (1,769) | 11,314 |
| Equity interest in loss of unconsolidated joint venture | 7,125 | 16,789 |
| Deferred income taxes | (118) | (207) |
| Purchased in-process research and development | 6,775 | |
| Stock-based compensation expense | 1,778 | 2,206 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (7,646) | 3,319 |
| Inventories | (4,581) | (2,090) |
| Other assets | (5,884) | (8,611) |
| Accounts payable | (2,682) | (8,746) |
| Accrued liabilities and other | 2,074 | 27,831 |
| Net cash (used in) operating activities | (109,695) | (148,937) |
| Cash flows from investing activities: | | |
| Investment in Huawei-3Com joint venture | | (160,000) |
| Purchases of investments | (466,330) | (662,734) |
| Proceeds from maturities and sales of investments | 706,071 | 782,310 |
| Purchases of property and equipment | (13,704) | (12,552) |
| Businesses acquired in purchase transactions, net of cash acquired | (355,686) | |
| Proceeds from sale of property and equipment | 50,946 | 100,240 |
| Net cash provided by (used in) investing activities | (78,703) | 47,264 |
| Cash flows from financing activities: | | |
| Issuances of common stock | 11,779 | 106,521 |
| Repurchases of common stock | (73,365) | |
| Collection of note receivable issued for warrants | | 8,421 |
| Repayments of borrowings | (1,308) | (346) |
| Net cash provided by (used in) financing activities | (62,894) | 114,596 |
| Effect of exchange rate changes on cash and equivalents | 1,997 | 1,222 |
| Increase (decrease) in cash and equivalents during period | (249,295) | 14,145 |
| Cash and equivalents, beginning of period | 476,274 | 415,798 |

| | | | | |
|---|---|---|---|---|
| Cash and equivalents, end of period | $ | 226,979 | $ | 429,943 |

*See notes to condensed consolidated financial statements.*

**3Com Corporation**

**Notes to Condensed Consolidated Financial Statements**

(Unaudited)

## Note 1. Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments necessary for a fair presentation of our financial position as of February 25, 2005 and May 28, 2004, and our results of operations and cash flows for the three and nine months ended February 25, 2005 and February 27, 2004.

Certain amounts from prior periods have been reclassified to conform to the current period presentation. In connection with the preparation of this report, we concluded that it was appropriate to classify auction rate securities, which are securities with longer stated maturities, but have interest rates that reset similar to short-term securities, as short-term investments. Previously, such investments had been classified as cash and equivalents. We made corresponding adjustments to our Condensed Consolidated Statement of Cash Flows and to our Condensed Consolidated Balance Sheet. These reclassifications had no impact on working capital, our results of operations or our cash flows from operating activities.

We use a 52 or 53-week fiscal year ending on the Friday nearest to May 31. The results of operations for the three and nine months ended February 25, 2005 may not be indicative of the results to be expected for the fiscal year ending June 3, 2005. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K for the fiscal year ended May 28, 2004.

*Recent Accounting Pronouncements*

In March 2004, the Emerging Issues Task Force (EITF) of the FASB issued EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. We do not believe that adoption of EITF 03-1 will have a material impact on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123R, Share-Based Payment (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123R is effective for all interim periods beginning after June 15, 2005 and, thus, will be effective for us beginning with the second quarter of fiscal 2006. Retroactive application of the provisions of SFAS 123R to the beginning of the fiscal year that includes the effective date is permitted, but not required. We are currently evaluating the impact of SFAS 123R on our financial position and results of operations. See Note 3 for information related to the pro forma effects on our reported net loss and net loss per share of applying the fair value recognition provisions of the previous Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

## Note 2. Discontinued Operations

On March 4, 2003, we entered into an agreement (Asset Purchase Agreement) to sell selected assets and liabilities of our CommWorks division to UTStarcom, Inc. in exchange for $100 million in cash, subject to certain closing adjustments. On May 23, 2003, we completed the sale pursuant to the terms of the Asset Purchase Agreement. As a result, we reported the CommWorks division as a discontinued operation beginning in the fourth quarter of fiscal 2003 and restated all prior periods presented on a comparative basis. The loss from discontinued operations for the three months and nine months ended February 27, 2004 resulted from adjustments to previous estimates of liabilities related to the sale of the CommWorks division.

## Note 3. Stock-Based Compensation

We have stock option plans under which employees and directors may be granted options to purchase common stock. Options generally are granted with exercise prices at not less than the fair market value at the date of the grant, vest annually over two to four years, and expire seven to ten years after the grant date.

Restricted stock represents shares of common stock that are issued at no cost to key employees and that generally vest over a one to four-year period. Such shares are subject to our right to reacquire those shares upon such person s termination of employment to the extent that such right has not lapsed. We also grant time accelerated restricted stock awards whereby shares with a specified time-based vesting period may be accelerated if specific performance milestones are achieved.

Additionally, we have an employee stock purchase plan (ESPP) under which eligible employees may authorize payroll deductions of up to ten percent of their compensation, as defined, to purchase common stock at a price of 85 percent of the lower of the fair market value as of the beginning or end of the six-month offering period.

As permitted under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, we follow Accounting Principles Board (APB) Opinion 25 and related Interpretations in accounting for stock-based awards to employees. Under APB Opinion 25, compensation expense associated with employee stock awards is measured as the difference, if any, between the price to be paid by an employee and the fair value of the underlying common stock on the grant date, which usually is the measurement date for accounting purposes. Generally, we recognize no compensation expense with respect to stock-based option awards and stock issued under the ESPP. However, to the extent that we modify an employee s stock options subsequent to the grant date (for example, by extending the period of time permitted for exercising a stock option following an employee s involuntary termination), we record compensation expense attributable to the modifications. Also, we record compensation expense related to restricted stock over the applicable vesting period; such compensation expense is measured as the fair market value of the restricted stock at the date of the grant.

SFAS 123 requires disclosure of the pro forma effects on our reported net loss and net loss per share of applying the fair value recognition provisions of SFAS 123 to stock-based employee compensation. The following table illustrates such pro forma effects:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| **(in thousands, except per share amounts)** | **February 25, 2005** | **February 27, 2004** | **February 25, 2005** | **February 27, 2004** |
| Net loss as reported | $ (53,005) | $ (85,572) | $ (137,361) | $ (330,547) |
| Add: Stock-based compensation included in reported net loss | 913 | 955 | 1,778 | 2,206 |
| Deduct: Total stock-based compensation determined under the fair value-based | (5,163) | (4,229) | (12,898) | (14,918) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| method, net of related tax effects | | | | | | | | |
| Pro forma net loss | $ | (57,255) | $ | (88,846) | $ | (148,481) | $ | (343,259) |
| | | | | | | | | |
| Net loss per share-basic and diluted: | | | | | | | | |
| As reported | $ | (0.14) | $ | (0.22) | $ | (0.36) | $ | (0.88) |
| Pro forma | | (0.15) | | (0.23) | | (0.39) | | (0.91) |

For purposes of this pro forma disclosure, the estimated fair values of employee stock options (ESOs) are assumed to be amortized over the applicable vesting periods, and the estimated fair values of ESPP shares are assumed to be amortized over the applicable subscription periods.

As of February 25, 2005, and February 27, 2004, the expected average life of ESOs was estimated at approximately one and a half years after the vesting date. Although there were no purchase rights granted under the ESPP for the three months ended February 25, 2005 and February 27, 2004, the expected average life of purchase rights granted under the ESPP in prior periods was estimated at six months from the subscription date. The fair values of ESOs and ESPP shares granted during the third quarter of fiscal 2005 and fiscal 2004 and the first nine months of fiscal 2005 and 2004 have been estimated as of the date of grant using the Black-Scholes option pricing model. The assumptions used in preparing the estimates and the resulting fair values are shown below:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | **February 25, 2005** | **February 27, 2004** | **February 25, 2005** | **February 27, 2004** |
| Volatility-ESO | 51.0% | 64.0% | 55.2% | 67.0% |
| Volatility-ESPP | | | 40.0% | 45.0% |
| Risk-free interest rate-ESO | 3.6% | 2.7% | 3.4% | 2.6% |
| Risk-free interest rate-ESPP | | | 2.2% | 1.0% |
| Dividend yield-ESO and ESPP | 0.0% | 0.0% | 0.0% | 0.0% |
| Per-share fair value of options granted under ESO | $ 1.59 | $ 4.08 | $ 2.06 | $ 2.86 |
| Per-share fair value of purchase rights granted under ESPP | | | $ 1.13 | $ 1.79 |

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility.

On January 31, 2005, we completed our acquisition of TippingPoint Technologies, Inc. (TippingPoint). Pursuant to the merger agreement, at the effective time of the merger, outstanding options to purchase shares of TippingPoint common stock were converted into options to purchase approximately 13.9 million shares of our common stock. The fair value of each option grant was estimated on the date of acquisition using the Black-Scholes option pricing model with input assumptions similar to those used for our stock options granted during the three months ended February 25, 2005. Deferred compensation of $9.4 million related to the intrinsic value of unvested stock options was recorded as part of the acquisition and will be amortized to expense over the remaining service period.

## Note 4. Acquisition

On January 31, 2005, we completed our acquisition of TippingPoint for consideration of $430.0 million, subject to adjustment. This amount excludes the cost of integration, as well as other costs related to the transaction. TippingPoint is a provider of networked-based intrusion prevention systems (IPS). The acquisition enabled us to expand our portfolio of secure, converged voice and data networking solutions.

The TippingPoint acquisition was accounted for as a purchase, and accordingly, the assets purchased and liabilities assumed are included in the consolidated balance sheet as of February 25, 2005. The operating results of TippingPoint are included in the consolidated financial statements since the date of acquisition.

The preliminary purchase price is shown below (in millions):

| | | |
|---|---|---|
| Cash paid for common stock | $ | 389.5 |
| Fair value of outstanding stock options assumed | | 36.1 |
| Acquisition direct costs | | 4.4 |
| Total purchase price | $ | 430.0 |

In accordance with SFAS No. 141, *Business Combinations*, we allocated the purchase price to the tangible and intangible assets acquired and liabilities assumed, including in-process research and development, based on their estimated fair values, and deferred stock compensation. The excess purchase price over those fair values is recorded as goodwill. The fair values assigned to tangible and intangible assets acquired and liabilities assumed are based on estimates and assumptions provided by management, and other information compiled by management, including valuations that utilize established valuation techniques appropriate for the high technology industry. Goodwill recorded as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized but will be reviewed at least annually for impairment. Purchased intangibles with finite lives will be amortized on a straight-line basis over their respective estimated useful lives. The total preliminary purchase price has been allocated as follows (in millions):

| | | |
|---|---|---|
| Net tangible assets (liabilities) assumed | $ | 36.1 |
| Amortizable intangible assets: | | |
| Existing technology | | 39.1 |
| Maintenance agreements | | 19.0 |
| Other | | 11.8 |
| Total amortizable intangible assets | | 69.9 |
| | | |
| In-process research and development | | 5.1 |
| Deferred compensation on unvested stock options | | 9.4 |
| Goodwill | | 309.5 |
| Total purchase price allocation | $ | 430.0 |

The purchase price and related allocation are preliminary and may be revised as a result of adjustments made to the purchase price, additional information regarding liabilities assumed, including contingent liabilities, and revisions of preliminary estimates of fair values made at the date of purchase.

Intangible assets include amounts recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, and non-competition agreements. These intangible assets have a weighted average useful life of approximately five years.

The following pro forma financial information presents the combined results of operations of 3Com Corporation and TippingPoint as if the acquisition had occurred as of the beginning of the periods presented. Adjustments, which reflect the amortization of purchased intangible assets and deferred stock compensation, charges to cost of sales for inventory write-ups, and in-process research and development, have been made to the combined results of operations for the three and nine months ended February 25, 2005 and February 27, 2004, respectively. The unaudited pro forma financial information is not intended to represent or be indicative of our consolidated results of operations or financial condition that would have been reported had the acquisition been completed as of the dates presented, and should not be taken as representative of our future consolidated results of operations or financial condition.

| | Three Months Ended | Nine Months Ended |
|---|---|---|

| (in millions, except per share amounts) | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
|---|---|---|---|---|
| Net sales | $ 171.6 | $ 173.7 | $ 499.1 | $ 518.3 |
| Net loss | (67.8) | (104.5) | (169.9) | (369.5) |
| Basic and diluted loss per share | (0.18) | (0.27) | (0.44) | (0.98) |

## Note 5. Restructuring Charges

In recent fiscal years, we have undertaken several initiatives involving significant changes in our business strategy and cost structure. In fiscal 2001, we began a broad restructuring of our business to enhance the focus and cost effectiveness of our business units in serving their respective markets. These efforts continued through fiscal 2002. We took the following specific actions in fiscal 2001 and 2002 (the Fiscal 2001 and 2002 Actions ): we organized around independent businesses that utilized shared central services; we exited product lines; we outsourced the manufacturing of certain high volume server, desktop and mobile connectivity products in a contract manufacturing arrangement; we implemented a reduction in workforce; and we consolidated our real estate facilities and made plans to sell excess facilities.

As a result of further sales declines and net losses, we took additional restructuring actions in fiscal 2003 (the Fiscal 2003 Actions ). We announced the integration of the support infrastructure of two of our business units to leverage a common infrastructure in order to reduce costs. Additionally, we entered into agreements to outsource certain information technology (IT) functions, reduced our workforce, and continued to consolidate and dispose of excess facilities.

In response to continuing sales declines and net losses, we took additional measures to reduce costs during fiscal 2004 (the Fiscal 2004 Actions ) and fiscal 2005 (the Fiscal 2005 Actions ). These actions included reductions of our workforce, outsourcing of our remaining manufacturing operations, and continuing efforts to consolidate and dispose of excess facilities.

Restructuring charges related to these various initiatives in the third quarters of fiscal 2005 and fiscal 2004 were $9.1 million and $39.5 million, respectively. Such charges were net of reversals of prior charges of $0.2 million and $5.8 million, respectively, related primarily to revisions of previous estimates of employee separation expenses, lease obligation costs, and values of held for sale properties. Restructuring charges related to these various initiatives in the first three quarters of fiscal 2005 and fiscal 2004 were $16.4 million and $147.1 million, respectively. Such charges were net of reversals of prior charges of $6.1 million and $7.3 million, respectively, related primarily to revisions of previous estimates of employee separation expenses, lease obligation costs, and values of held for sale properties.

Accrued liabilities associated with restructuring charges are classified as current, since we intend to satisfy such liabilities in cash within the next twelve months, and are included in the caption Accrued liabilities and other in the accompanying condensed consolidated balance sheets.

*Fiscal 2005 Actions*

The following table provides a summary of the components of restructuring charges recorded in the first three quarters of fiscal 2005 with respect to the Fiscal 2005 Actions, together with changes in the accrued amounts and the ending balances as of February 25, 2005 (in thousands):

| | Employee Separation Expenses | Facilities-related Charges | Other Restructuring Costs | Total |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Balance at May 28, 2004 | $ | $ | $ | $ |
| Provision | 5,439 | 59 | 333 | 5,831 |
| Payments and non-cash charges | (2,192) | (59) | (333) | (2,584) |
| Balance at August 27, 2004 | 3,247 | | | 3,247 |
| Provision | 1,788 | 5 | 87 | 1,880 |
| Payments and non-cash charges | (3,188) | (5) | (87) | (3,280) |
| Balance at November 26, 2004 | 1,847 | | | 1,847 |
| Provision | 8,572 | 4 | 438 | 9,014 |
| Payments and non-cash charges | (4,727) | (4) | (438) | (5,169) |
| Balance at February 25, 2005 | $ 5,692 | $ | $ | $ 5,692 |

Employee separation expenses include severance pay, outplacement services, and medical and other related benefits. The reduction in workforce affected employees in the research and development, product management, customer service, supply chain, sales and marketing, and general and administrative functions. The total reduction in workforce associated with actions initiated during the first three quarters of fiscal 2005 includes approximately 350 employees. Separation payments associated with actions initiated during the first three quarters of fiscal 2005 totaled $9.7 million through February 25, 2005.

Facilities-related charges include costs associated with vacating leased offices in fiscal 2005. Other restructuring costs relate mainly to payments to suppliers for restructuring-related services.

*Fiscal 2004 Actions*

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2004 Actions, together with changes in the accrued amounts during the first three quarters of fiscal 2005 and the ending balances of the associated accrued liabilities as of February 25, 2005 (in thousands):

| | Employee Separation Expenses | Facilities-related Charges | Other Restructuring Costs | Total |
|---|---|---|---|---|
| Balance at May 28, 2004 | $ 5,529 | $ 530 | $ | $ 6,059 |
| Provision (benefit) | (2,208) | (2,455) | 192 | (4,471) |
| Payments and non-cash changes | (2,596) | 2,600 | (192) | (188) |
| Balance at August 27, 2004 | 725 | 675 | | 1,400 |
| Provision | | 389 | 98 | 487 |
| Payments and non-cash changes | (91) | 78 | (98) | (111) |
| Balance at November 26, 2004 | 634 | $ 1,142 | | 1,776 |
| Provision | | 30 | | 30 |
| Payments and non-cash charges | (14) | (150) | | (164) |
| Balance at February 25, 2005 | $ 620 | $ 1,022 | $ | $ 1,642 |

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce mainly affected employees involved with the Dublin, Ireland manufacturing operations, and also affected employees in sales and marketing, research and development, and general and administrative functions.

Facilities-related charges in the first three quarters of fiscal 2005 relating to restructuring actions initiated in fiscal 2004 were the result of revisions in estimates of lease obligation costs.

Other restructuring costs primarily reflected payments to suppliers for restructuring-related services.

*Fiscal 2003 Actions*

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2003 Actions, together with changes in the accrued amounts during the first three quarters of fiscal 2005 and the ending balances as of February 25, 2005 (in thousands):

| | Facilities-related Charges |
|---|---|
| Balance at May 28, 2004 | $ 2,566 |
| Provision | 221 |
| Payments and non-cash charges | (360) |
| Balance at August 27, 2004 | 2,427 |
| Provision | 1,442 |
| Payments and non-cash charges | (360) |
| Balance at November 26, 2004 | 3,509 |
| Provision | 6 |
| Payments and non-cash charges | (447) |
| Balance at February 25, 2005 | $ 3,068 |

Additional facilities-related charges were the result of revisions in estimates of lease obligation costs.

*Fiscal 2001 and Fiscal 2002 Actions*

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2001 and Fiscal 2002 Actions, together with changes in the accrued amounts during the first three quarters of fiscal 2005 and the ending balances as of February 25, 2005 (in thousands):

| | Facilities-related Charges | Other Restructuring Costs | Total |
|---|---|---|---|
| Balance at May 28, 2004 | $ 6,723 | $ 82 | $ 6,805 |
| Provision | 1,203 | | 1,203 |
| Payments and non-cash charges | (1,320) | (31) | (1,351) |
| Balance at August 27, 2004 | 6,606 | 51 | 6,657 |
| Provision | 688 | | 688 |
| Payments and non-cash charges | (461) | (17) | (478) |
| Balance at November 26, 2004 | 6,833 | 34 | 6,867 |
| Provision | 43 | | 43 |
| Payments and non-cash charges | (518) | (15) | (533) |
| Balance at February 25, 2005 | $ 6,358 | $ 19 | $ 6,377 |

Additional facilities-related charges were the result of changes in estimates associated with various lease obligations. Activity related to other restructuring costs primarily reflected payments to suppliers for restructuring-related services.

## Note 6. Investment in Unconsolidated Joint Venture

On November 17, 2003, we formed the Huawei-3Com Joint Venture (H-3C) with a subsidiary of Huawei Technologies, Ltd. (Huawei). H-3C is domiciled in Hong Kong, and has its principal operating centers in Hangzhou and Beijing, China.

At the time of formation, we contributed cash, assets related to our operations in China and Japan, and licenses related to certain intellectual property in exchange for a 49 percent ownership interest. We recorded our initial investment in H-3C at $160.1 million, reflecting the carrying value of the assets contributed. Huawei contributed its enterprise networking business assets including Local Area Network (LAN) switches and routers; engineering, sales, and marketing resources and personnel; and licenses to its related intellectual property in exchange for a 51 percent ownership interest. Two years after formation of H-3C, we have the one-time option to purchase an additional two percent ownership interest from Huawei for an amount not to exceed $28 million. Three years after formation of H-3C, we and Huawei each have the right to purchase all of the other partner s ownership interest through a bid process.

We account for our investment in H-3C by the equity method. Under this method, we record our proportionate share of H-3C s net income or loss based on the most recently available financial statements. Since H-3C follows a calendar year basis of reporting, we report our equity in

H-3C s net income or loss based on H-3C s financial statements for the most recent calendar quarter, two months in arrears. In determining our share of H-3C s net income or loss, we make certain adjustments to H-3C s reported results. Such adjustments are made primarily to recognize the value and related amortization expense associated with Huawei s contributed assets, as well as to defer H-3C s sales and gross profit on sales of products sold to us that remained in our inventory at the end of the accounting period.

Summarized condensed unaudited financial information for H-3C, adjusted as described above, is as follows (in thousands):

Balance Sheet:

| | December 31, 2004 | March 31, 2004 |
|---|---|---|
| Current assets | $ 264,489 | $ 242,904 |
| Non-current assets | 147,906 | 208,471 |
| Current liabilities | 117,062 | 86,825 |
| Non-current liabilities | 8,866 | 8,866 |

Statements of Operations:

| | Three Months-Ended December 31, 2004 | Nine Months-Ended December 31, 2004 |
|---|---|---|
| Sales | $ 87,116 | $ 215,696 |
| Gross margin | 33,717 | 84,485 |
| Loss from operations | 5,536 | 16,663 |
| Net loss | 4,589 | 14,540 |

We and H-3C are parties to agreements providing for the sale of certain products between the two companies. During the third quarter of fiscal 2005, we made sales of products to H-3C of $3.2 million and made purchases of products from H-3C of $6.0 million. During the first nine months of fiscal 2005, we made sales of products to H-3C of $10.3 million and made purchases of products from H-3C of $12.9 million. As of February 25, 2005, our accounts receivable and accounts payable included $1.3 million and $2.8 million, respectively, related to transactions with H-3C. Also, as of February 25, 2005, we had deferred approximately $0.1 million related to sales of products to H-3C that had not yet been shipped to H-3C s end customers.

## Note 7. Comprehensive Loss

The components of comprehensive loss, net of tax, are as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
| Net loss | $ (53,005) | $ (85,572) | $ (137,361) | $ (330,547) |
| Other comprehensive income (loss): | | | | |
| Net unrealized gain (loss) on investments | (196) | 1,075 | (1,583) | (258) |
| Net unrealized gain (loss) on cash flow hedges | 817 | (713) | (81) | (713) |
| Change in accumulated translation adjustments | (208) | 556 | 2,150 | 1,214 |
| Total comprehensive loss | $ (52,592) | $ (84,654) | $ (136,875) | $ (330,304) |

**Note 8.** **Net Loss per Share**

The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share data):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
| Loss from continuing operations | $ (53,005) | $ (84,887) | $ (137,361) | $ (328,006) |
| Loss from discontinued operations | | (685) | | (2,541) |
| Net loss | $ (53,005) | $ (85,572) | $ (137,361) | $ (330,547) |
| | | | | |
| Weighted average shares-basic | 379,946 | 385,019 | 382,075 | 376,077 |
| Effect of dilutive securities: | | | | |
| Employee stock options | | | | |
| Restricted stock | | | | |
| Weighted average shares-diluted | 379,946 | 385,019 | 382,075 | 376,077 |
| | | | | |
| Net loss per share-basic and diluted: | | | | |
| Continuing operations | $ (0.14) | $ (0.22) | $ (0.36) | $ (0.87) |
| Discontinued operations | | | | (0.01) |
| Net loss | $ (0.14) | $ (0.22) | $ (0.36) | $ (0.88) |

Employee stock options and restricted stock totaling 9.8 million shares and 11.0 million shares for the three months ended February 25, 2005 and February 27, 2004, respectively, and 4.9 million shares and 7.5 million shares for the nine months ended February 25, 2005 and February 27, 2004, respectively, were not included in the diluted weighted average shares calculation as the effects of these securities were anti-dilutive.

**Note 9.** **Inventories**

Inventories consist of the following (in thousands):

| | February 25, 2005 | May 28, 2004 |
|---|---|---|
| Finished goods | $ 22,710 | $ 25,869 |
| Work-in-process | 617 | 485 |
| Raw materials | 936 | 1,325 |
| | | |
| Total | $ 24,263 | $ 27,679 |

**Note 10.** **Property and Equipment**

Property and equipment, net, consist of the following (in thousands):

| | February 25, 2005 | May 28, 2004 |
|---|---|---|
| Land | $ 6,999 | $ 8,724 |
| Building and improvements | 38,286 | 38,325 |
| Machinery and equipment | 175,788 | 206,099 |
| Software | 98,343 | 105,943 |
| Furniture and fixtures | 25,756 | 26,880 |
| Leasehold improvements | 12,281 | 10,274 |
| Construction in progress | 2,187 | 1,664 |
| Total, gross | 359,640 | 397,909 |
| Accumulated depreciation and amortization | (288,294) | (325,457) |
| Total, net | $ 71,346 | $ 72,452 |

In February 2005, we completed the sale of certain properties in Hemel Hempstead, U.K. that was classified as held for sale. This property, consisting of approximately 111,000 square feet of office and research and development space, previously had been used in our administrative and research and development activities. Net proceeds from the sale resulted in a gain on the sale of $0.1 million that was recorded in restructuring charges in the third quarter of fiscal 2005.

In November 2004, we completed the sale of our property in Dublin that was classified as held for sale. This property, consisting of approximately 468,000 square feet of office and manufacturing space, previously had been used in our manufacturing, research and development, and administrative activities. Net proceeds from the sale resulted in a gain on the sale of $0.5 million that was recorded in restructuring charges in the second quarter of fiscal 2005.

In November 2003, we completed the sale of certain properties in Santa Clara, California that were classified as held for sale. These properties, consisting of approximately 876,000 square feet of office and manufacturing space and related furniture and fixtures, previously had been used in our administrative, manufacturing, research and development, and customer service activities. Net proceeds from the sale resulted in a loss on the sale of $1.4 million that was recorded in restructuring charges in the second quarter of fiscal 2004.

In July 2003, we completed the sale of our 511,000 square foot office and research and development facility in Rolling Meadows, Illinois. Net proceeds from the sale resulted in a loss on the sale of $1.1 million that was recorded in restructuring charges in the first quarter of fiscal 2004. As part of the terms of the transaction, we entered into an agreement to lease back approximately 43,000 square feet of space at then prevailing market rates.

The property and equipment held for sale of $42.1 million as of May 28, 2004 was sold as of February 25, 2005.

## Note 11. Intangible Assets, Net

The following table details our purchased intangible assets (in millions):

| **As of February 25, 2005** | | **Gross** | | **Accumulated Amortization** | | **Net** |
|---|---|---|---|---|---|---|
| Existing technology | $ | 74.6 | $ | (34.7) | $ | 39.9 |
| Maintenance contracts | | 19.0 | | (0.3) | | 18.7 |
| Other | | 12.2 | | (0.8) | | 11.4 |
| Total | $ | 105.8 | $ | (35.8) | $ | 70.0 |

| As of May 28, 2004 | | Gross | | Accumulated Amortization | | Net |
|---|---|---|---|---|---|---|
| Existing Technology | $ | 36.7 | $ | (31.7) | $ | 5.0 |
| Other | | 0.4 | | (0.4) | | |
| Total | $ | 37.1 | $ | (32.1) | $ | 5.0 |

Amortization expense of purchased intangible assets of $1.7 million and $1.0 were in the caption Amortization and write down of intangibles in the accompanying condensed consolidated statements of operations for the three months ended February 25, 2005 and February 27, 2004, respectively. Amortization expense of purchased intangible assets of $4.9 million and $5.6 million were in the caption Amortization and write down of intangibles in the accompanying condensed consolidated statements of operations for the nine months ended February 25, 2005 and February 27, 2004, respectively.

The estimated future amortization expense of purchased intangible assets for the next five years is as follows (in millions):

| As of February 25, 2005 | | Amount |
|---|---|---|
| 2005 (remaining three months) | $ | 3.9 |
| 2006 | | 15.3 |
| 2007 | | 13.6 |
| 2008 | | 11.3 |
| 2009 | | 9.7 |
| Thereafter | | 16.2 |
| Total | $ | 70.0 |

## Note 12. Accrued Liabilities and Other

Accrued liabilities and other consist of the following (in thousands):

| | | February 25, 2005 | | May 28, 2004 |
|---|---|---|---|---|
| Accrued payroll and related expenses | $ | 41,274 | $ | 37,995 |
| Accrued product warranty | | 40,073 | | 43,825 |
| Accrued rebates | | 27,216 | | 29,536 |
| Income and other taxes payable | | 47,055 | | 34,184 |
| Deferred revenue | | 19,635 | | 25,942 |
| Other | | 57,739 | | 54,679 |
| Total | $ | 232,992 | $ | 226,161 |

## Note 13. Accrued Warranty and Other Guarantees

Products are sold with varying lengths of warranty ranging from 90 days to the lifetime of the products. Allowances for estimated warranty costs are recorded in the period of sale, based on historical experience related to product failure rates and actual warranty costs incurred during the applicable warranty period. Also, on an ongoing basis, we assess the adequacy of our allowances related to warranty obligations recorded in previous periods and may adjust the balances to reflect actual experience or changes in future expectations.

The following table summarizes the activity in the allowance for estimated warranty costs for the nine months ended February 25, 2005 and February 27, 2004 (in thousands):

| | First nine months of fiscal 2005 | First nine months of fiscal 2004 |
|---|---|---|
| Accrued warranty, beginning of period | $ 43,825 | $ 44,775 |
| Cost of warranty claims processed during the period | (24,728) | (26,340) |
| Provision for warranties related to products sold during the period | 20,976 | 25,590 |
| Adjustments to preexisting warranties | | (23) |
| Accrued warranty, end of period | $ 40,073 | $ 44,002 |

In prior years, we entered into several agreements whereby we sold products to resellers who, in turn, sold the products to others, and we guaranteed the payments of the end users. However, since deferred revenue and other associated accruals related to such sales approximate the guaranteed amounts, any payments resulting from end user defaults would not have a material impact on our results of operations.

## Note 14. Stockholders Equity

In the first quarter of fiscal 2005, we repurchased approximately 15.0 million shares of our common stock at a total cost of $73.4 million. These repurchases were made pursuant to the stock repurchase program that was approved by our Board of Directors in March 2003, and that authorizes expenditures of up to $100.0 million during a two-year period through March 2005. We did not repurchase any shares during the second and third quarters of fiscal 2005. At February 25, 2005, approximately $26.6 million of the authorization remained available for future repurchases. As discussed in Note 17, this authorization was superseded on March 23, 2005.

## Note 15. Business Segment Information

Effective for fiscal 2004, we streamlined our management and operating structure and merged our previous multiple operating segments into a single, integrated enterprise networking business. As a result, effective for fiscal 2004, we present financial information related to our business on the basis of a single segment.

Sales by geographic region is reported based on the customer s designated delivery point and are as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
| Americas | $ 63,712 | $ 56,889 | $ 195,521 | $ 186,416 |
| Europe, Middle East, & Africa | 76,393 | 86,451 | 216,719 | 238,249 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Asia Pacific Rim | | 21,080 | | 28,429 | | 62,362 | | 90,874 |
| | $ | 161,185 | $ | 171,769 | $ | 474,602 | $ | 515,539 |

## Note 16. Litigation

We are a party to lawsuits in the normal course of our business. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. We believe that we have meritorious defenses in each of the cases set forth below in which we are named as a defendant and we are vigorously contesting each of these matters. An unfavorable resolution of one or more of these lawsuits could adversely affect our business, financial position, or results of operations. We cannot estimate the loss or range of loss that may be reasonably possible for any of the contingencies described and, accordingly, we have not recorded any associated liabilities in our consolidated balance sheets.

On April 28, 1997, Xerox Corporation (Xerox) filed suit against U.S. Robotics Corporation and U.S. Robotics Access Corporation in the United States District Court for the Western District of New York. 3Com completed its acquisition of these defendant companies on June 12, 1997. The case is now captioned *Xerox Corporation v. 3Com Corporation, U.S. Robotics Corporation, U.S. Robotics Access Corporation, Palm Computing, Inc., and Palm, Inc.* (Civil Action Number 97-CV-6182T). Xerox alleged willful infringement of one of its United States patents. Xerox sought to recover damages and to permanently enjoin the defendants from infringing the patent in the future. In 2000, the District Court dismissed the case, ruling that there was no infringement. On appeal, the Court of Appeals for the Federal Circuit affirmed-in-part, reversed-in-part and remanded the case to the District Court for further action. On December 20, 2001, the District Court granted Xerox s motion for summary judgment ruling that the patent is valid, enforceable, and infringed. The defendants filed a Notice of Appeal. On February 22, 2002, the District Court denied Xerox s motion for an injunction seeking to prohibit further alleged infringement during the appeal and ordered the defendants to post a bond in the amount of $50 million. Xerox appealed the denial of the injunction. On February 20, 2003, the Court of Appeals issued its decision affirming-in-part and reversing-in-part the order of the trial court. The Court of Appeals affirmed the grant of summary judgment of infringement, reversed the grant of summary judgment of validity and remanded the case to the trial court to conduct a complete validity analysis. In connection with the separation of Palm from 3Com, pursuant to the terms of the Indemnification and Insurance Matters Agreement dated February 26, 2000 between 3Com and Palm, Palm (since renamed palmOne) agreed to indemnify and hold 3Com harmless for any damages or losses that might arise out of the Xerox litigation. On May 21, 2004, the District Court awarded summary judgment to the defendants, holding that Xerox s patent was invalid, and dismissed the remaining claims. On February 16, 2005, the District Court denied Xerox s motion for reconsideration.

On December 5, 2001, TippingPoint and two of its current and former officers and directors, as well as the managing underwriters in TippingPoint s initial public offering were named as defendants in a purported class action lawsuit filed in the United States District Court for the Southern District of New York. The lawsuit, which is part of a consolidated action that includes over 300 similar actions, is captioned In re Initial Public Offering Securities Litigation, Brian Levey vs. TippingPoint Technologies, Inc., et al., No. 01 CV 10976. The principal allegation in the lawsuit is that the defendants participated in a scheme to manipulate the initial public offering and subsequent market price of TippingPoint s stock by knowingly assisting the underwriters requirement that certain of their customers had to purchase stock in a specific initial public offering as a condition to being allocated shares in the initial public offerings of other companies. The purported plaintiff class for the lawsuit is comprised of all persons who purchased TippingPoint stock from March 17, 2000 through December 6, 2000. The suit seeks rescission of the purchase prices paid by purchasers of shares of TippingPoint common stock. On September 10, 2002, TippingPoint s counsel and counsel for plaintiffs entered into an agreement pursuant to which the plaintiffs dismissed, without prejudice, TippingPoint s former and current officers and directors from the lawsuit. In May 2003, a memorandum of understanding was executed by counsel for plaintiffs, issuer-defendants and their insurers setting forth terms of a settlement that would result in the termination of all claims brought by plaintiffs against the issuer-defendants and individual defendants named in the lawsuit. In August 2003, TippingPoint s Board of Directors approved the settlement terms described in the memorandum of understanding. In May 2004, TippingPoint signed a settlement agreement on behalf of itself and its current and former directors and officers with the plaintiffs. This settlement agreement formalizes the previously approved terms of the memorandum of understanding and, subject to certain conditions, provides for the complete dismissal, with prejudice, of all claims against TippingPoint and its current and former directors and officers. Any direct financial impact of the settlement is expected to be borne by TippingPoint s insurers. The settlement is subject to numerous conditions, including final approval by the court. There can be no assurance that such conditions will be met or that the court will approve the terms of the settlement agreement. If the court rejects the settlement agreement, in whole or in part, or the settlement does not occur for any other reason and the litigation against TippingPoint continues, we intend to defend this action vigorously, and to the extent necessary, to seek indemnification and/or contribution from the underwriters in TippingPoint s initial public offering pursuant to its underwriting agreement with the underwriters. However, there can be no assurance that indemnification or contribution will be available to TippingPoint or enforceable against the underwriters.

## Note 17. Subsequent Event

At its meeting on March 23, 2005, our Board of Directors approved a new stock repurchase program providing for expenditures of up to $100.0 million through March 31, 2007. Under the new stock repurchase program, we may repurchase shares of our common stock having an aggregate purchase price of up to $100.0 million in the open market, in privately negotiated transactions with shareholders or using derivate transactions; provided, however, that all repurchases must be pre-approved by the Audit and Finance Committee of the Board of Directors. This new stock repurchase program superseded the stock repurchase program that was approved in March 2003 and expired in March 2005. There is no requirement that we repurchase shares under the program and the program may be discontinued at any time.

**3Com Corporation**

## *Item 2.* Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the condensed consolidated financial statements and the related notes that appear elsewhere in this document.

This quarterly report on Form 10-Q contains forward-looking statements. These forward-looking statements include, without limitation, predictions regarding the following aspects of our future:

- Our prospects and opportunities for future growth;
- Sales through our largest distributors;
- Our joint venture with Huawei Technologies, Ltd.
- Expected benefits from our acquisition of TippingPoint Technologies, Inc.
- The environment for enterprise networking equipment;
- Our goals for sales growth, gross margin expansion and profitability;
- The competitive pricing environment;
- The advanced nature and ready availability of merchant silicon, which allows low-end competitors to deliver feature rich products;
- Our projections for sales and gross margin for the fourth quarter of fiscal 2005;
- Our projections for a net loss and negative cash flow for the fourth quarter of fiscal 2005;
- Execution of our business plan to grow sales;
- The dependence of our future success on sales of our enterprise networking products;
- Expansion of our product lines targeting mid- to large-sized enterprise customers, our largest growth opportunities;
- Our focus on our customer facing capabilities;
- Our objective of being a leading provider of secure, converged network solutions for small, medium and large enterprises;
- Future restructurings of our business;
- The decline in sales of our desktop, mobile and server connectivity products;
- Cash flow from operating activities and our ability to satisfy anticipated cash requirements for the next twelve months;
- Improvements in our net cash flow from operations resulting from our restructuring actions;
- Our future contractual commitments;
- Strategic investments, including capital call payments to certain venture capital funds;
- Sources of competition, including Huawei Technologies, Ltd.;
- Our restructuring and cost-reduction efforts, including workforce reductions and the effect on employees;
- Acquisitions of companies or technologies;
- Our reliance on strategic relationships, including our joint venture with Huawei Technologies, Ltd.;
- Outsourcing of some of our functions and dependence on contract manufacturing;
- Industry trends and our response to those trends;
- Outcome and effect of current and potential and future litigation;
- Protection and enforcement of intellectual property rights; and

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Our common stock, including trading price, dividends, and repurchases.

You can identify these and other forward-looking statements by the use of words such as may, can, will, should, expects, plans, anticipa believes, estimates, predicts, intends, continue, or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements.

Actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under Business Environment and Industry Trends. All forward-looking statements included in this document are based on our assessment of information available to us at the time this report is filed. We undertake no obligation to update any forward-looking statements.

**BASIS OF PRESENTATION**

The following information relates to the continuing operations of 3Com Corporation and our consolidated subsidiaries (3Com).

On May 23, 2003, we completed the sale of the CommWorks division and transferred certain assets and liabilities to UTStarcom, Inc. pursuant to the terms of the Asset Purchase Agreement. As a result of the sale, we reported the CommWorks division as a discontinued operation beginning in the fourth quarter of fiscal 2003. Accordingly, the condensed consolidated financial statements and the related notes that appear elsewhere in this document reflect the CommWorks division as a discontinued operation for all periods presented. Unless otherwise indicated, the following discussion relates to our continuing operations.

**BUSINESS OVERVIEW**

We provide secure, conversed data and voice networking solutions with integrated network management capabilities and global services for enterprises of all sizes and public sector organizations. We are a company with a global presence, strong brand identity, large intellectual property portfolio and strong balance sheet. We believe that our relationships with strategic partners, broad product portfolio and significant distribution channels provide us with a strong foundation for future growth.

We generally sell our products through a two-tier distribution channel comprised of distributors and resellers. Distributors are the first tier of the channel providing global distribution, logistics, market development and other services. Distributors generally sell to the second tier of the channel, comprising value added resellers (VARs) and other channel partners targeting enterprises of all sizes. Although a majority of our sales are made through our two-tier distribution channel, we also work closely with systems integrators, major telecommunications service providers, and direct marketing resellers. We also maintain a field sales organization that works alongside our channel partners to assist them in achieving their sales goals.

A substantial portion of our sales is derived from a limited number of distributors, the largest of which are Ingram Micro Inc. and Tech Data Corporation. We expect that these distributors will continue to represent a significant percentage of our sales for the foreseeable future. The table below sets forth the percentage of sales derived from these major distributors during the third quarter and first nine months of fiscal 2005 and 2004.

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
| Ingram Micro, Inc. | 19% | 21% | 21% | 21% |
| Tech Data Corporation | 12 | 15 | 14 | 13 |
| Total | 31% | 36% | 35% | 34% |

We have undergone significant changes in recent years, including:

- exiting product lines that were not expected to yield a satisfactory return on investment;
- significant headcount reductions;
- outsourcing of certain information technology (IT) and other functions;
- significant changes to our executive leadership;
- outsourcing of all manufacturing activity;
- selling excess facilities;
- forming the Huawei-3Com Joint Venture (H-3C);
- acquiring TippingPoint Technologies, Inc.;
- introducing new product lines targeted at mid- to large-sized enterprises; and
- realigning our sales and marketing channels and expenditures.

We believe an overview of some of these significant changes is helpful to understanding our operating results.

*Significant Events*

On November 17, 2003, we formed our joint venture, Huawei-3Com (H-3C), which is domiciled in Hong Kong and has its principal operating centers in Hangzhou and Beijing, China. We contributed $160 million in cash, assets related to our operations in China and Japan, and licenses to intellectual property related to those operations in exchange for a 49 percent ownership interest of the joint venture. In the first quarter of fiscal 2005, we expanded the joint venture s market to include Hong Kong in addition to China and Japan. We expect this venture to provide three key benefits to us an expanded product line, access to low cost and highly effective engineering talent, and a significant presence in the China, Japan and Hong Kong markets.

During the first nine months of fiscal 2005, we undertook several additional actions that we believe will enhance our competitiveness, execution and profitability over the longer term. We are implementing a strategy to compete in all sizes of the enterprise networking market, through the following:

- continued advances in products;
- increased focus on our customer facing capabilities in the areas of sales and marketing; and
- service platform improvements.

We have introduced multiple new products targeted at the large enterprise market, including modular switches and routers sourced from H-3C, as well as Voice over Internet Protocol (VoIP), security and wireless solutions. We also continue to develop solutions for the small to medium enterprise market, including VoIP, smart switches, and Power Over Ethernet (POE) technology.

We have also increased our focus on sales and marketing activities. Current initiatives include developing an expanded set of enterprise class channels to support effective sales into the large enterprise market, and implementing marketing programs that we believe will improve our effectiveness and productivity in our existing channels, particularly those that target small and mid-sized businesses. In the second quarter of fiscal 2005, we entered an agreement with Siemens Business Services to provide expanded service offerings on a global basis for enterprise customers.

On January 31, 2005, we acquired TippingPoint Technologies, Inc., a provider in network-based intrusion prevention systems (IPS). We expect to derive a number of benefits from the acquisition of TippingPoint. We believe IPS is one of the fastest growing segments of the network security market. Also, both 3Com and TippingPoint have begun to cross sell into each other s customer base. We believe TippingPoint s technologies are uniquely qualified to sell into a converged voice and data environment, allowing us to design reliable VOIP and security solution for enterprise customers.

*Summary of Financial Performance for the Third Quarter of Fiscal 2005*

Our sales for the third quarter of fiscal 2005 were $161.2 million, a decrease of $10.6 million, or 6 percent compared to sales for the third quarter of fiscal 2004 of $171.8 million.

Our gross margin increased to 35.6% for the third quarter of fiscal 2005 from 35.1% for the third quarter of fiscal 2004.

Our operating expenses for the third quarter of fiscal 2005 were $113.7 million, compared to $143.8 million for the third quarter of fiscal 2004, a net decrease of $30.2 million or 21.0 percent. Operating expenses for the third quarter of fiscal 2005 and fiscal 2004 included restructuring charges of $9.1 million and $39.5 million, respectively.

Our net loss for the third quarter of fiscal 2005 was $53.0 million compared to a net loss for the third quarter of fiscal 2004 of $85.6 million, an improvement of $32.6 million.

Our balance sheet remains strong with cash and equivalents and short-term investment balances at the end of the third quarter of fiscal 2005 of $882.8 million, compared to cash and equivalents and short-term investment balances of $1,273.9 million at the end of the second quarter of fiscal 2005.

*Business Environment and Future Trends*

Networking industry analysts and participants differ widely in their assessments concerning the prospects for near-term industry growth. Industry factors and trends also present significant challenges in the medium term with respect to our goals for sales growth, gross margin maintenance and profitability. Such factors and trends include:

Intense competition in the market for higher end, enterprise core routing and switching products;

Aggressive product pricing by competitors targeted at gaining share in market segments where we have had a strong position historically, such as the small to medium-sized enterprise market; and

The advanced nature and ready availability of merchant silicon, which allows low-end competitors to deliver feature rich products and makes it increasingly difficult for us to differentiate our products.

Based on our current projections for the fourth quarter of fiscal 2005 sales growth to be in the mid- to high single digits on a sequential percentage basis and gross margins to be approximately 35 percent we expect that we will incur a net loss and negative cash flow from operations for the quarter. Although there are signs of progress with our enterprise networking strategy, we must accelerate the pace of improvement. Our key focus for the remainder of fiscal 2005 is on execution of our business plan to enhance our go-to market capabilities and grow sales. Our future success is highly dependent on increased sales of our enterprise networking products, and our largest growth opportunities continue to be linked to the expansion of our product lines targeting mid- to large-sized enterprise customers. As our portfolio of products and solutions has filled in, our focus increasingly turns to our customer facing capabilities sales, marketing and service.

We are committed to our objective of being a leading provider of secure, converged network solutions for small, medium and large enterprises. We believe that our recent initiatives and our business strategy are consistent with our goals of growth and profitability over the longer term. However, in light of our results of operations and cash flows for the first nine months of fiscal 2005, we may need to continue to restructure our business or realign our resources to promote growth in sales and achieve additional cost and expense savings.

**Critical Accounting Policies**

Our critical accounting policies are described in our Annual Report on Form 10-K for the fiscal year ended May 28, 2004.

**Effects of Recent Accounting Pronouncements**

In March 2004, the Emerging Issues Task Force (EITF) of the FASB issued EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB issued Staff Position EITF 03-1-1, which delays the effective date until additional guidance is issued for the application of the recognition and measurement provisions of EITF 03-1 to investments in securities that are impaired. We do not believe that adoption of EITF 03-1 will have a material impact on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123R, Share-Based Payment (SFAS 123R), which requires companies to measure and recognize compensation expense for all stock-based payments at fair value. SFAS 123R is effective for all interim periods beginning after June 15, 2005 and, thus, will be effective for us beginning with the second quarter of fiscal 2006. Retroactive application of the provisions of SFAS 123R to the beginning of the fiscal year that includes the effective date is permitted, but not required. We are currently evaluating the impact of SFAS 123R on our financial position and results of operations. See Note 3 of notes to condensed consolidated financial statements included in Part I, Item 1 of this report for information related to the pro forma effects on our reported net loss and net loss per share of applying the fair value recognition provisions of the previous Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

**Results of Operations**

The following table sets forth, for the periods indicated, the percentage of total sales represented by the line items reflected in our condensed consolidated income statements:

| | Three months ended | | Nine months ended | |
|---|---|---|---|---|
| | February 25, 2005 | February 27, 2004 | February 25, 2005 | February 27, 2004 |
| Sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 64.4 | 64.9 | 63.7 | 67.6 |
| Gross margin | 35.6 | 35.1 | 36.3 | 32.4 |
| Operating expenses: | | | | |
| Sales and marketing | 36.8 | 36.0 | 36.6 | 36.9 |
| Research and development | 15.2 | 13.8 | 14.2 | 14.5 |
| General and administrative | 8.7 | 10.3 | 9.3 | 12.3 |
| Amortization and write down of intangibles | 1.1 | 0.6 | 1.0 | 1.1 |
| In-process research and development | 3.1 | 0.0 | 1.4 | 0.0 |
| Restructuring charges | 5.6 | 23.0 | 3.5 | 28.5 |
| Total operating expenses | 70.5 | 83.7 | 66.0 | 93.3 |
| Operating loss | (35.0) | (48.6) | (29.7) | (60.9) |
| Gain (loss) on investments, net | 1.0 | 0.5 | 0.4 | (2.2) |
| Interest and other income, net | 3.0 | 2.1 | 2.2 | 2.2 |
| Loss from continuing operations before income taxes and equity interest in loss of unconsolidated joint venture | (30.9) | (46.0) | (27.1) | (60.9) |
| Income tax benefit (provision) | (0.6) | (1.0) | (0.3) | 0.6 |
| Equity interest in loss of unconsolidated joint venture | (1.4) | (2.4) | (1.5) | (3.3) |
| Loss from continuing operations | (32.9) | (49.4) | (28.9 | |