

3COM CORP  
Form 10-K  
August 09, 2004

[QuickLinks](#) -- Click here to rapidly navigate through this document

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

---

**FORM 10-K**

(Mark one)

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

For the Fiscal Year Ended May 28, 2004

or

**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

---

**3Com Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**94-2605794**

(I.R.S. Employer  
Identification No.)

**350 Campus Drive**

**Marlborough, Massachusetts**  
(Address of principal executive offices)

**01752**

(Zip Code)

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

**Securities registered pursuant to Section 12(b) of the Act: NONE**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, \$0.01 par value; Preferred Stock Purchase Rights**

---

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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the registrant's Common Stock held by non-affiliates, based upon the closing sale price of the Common Stock on November 28, 2003, as reported by the Nasdaq National Market, was approximately \$2,309,395,022. Shares of Common Stock held by each executive officer and director and by each person who owns 5% or more of the outstanding Common Stock, based on Schedule 13G filings, have been excluded since such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of July 23, 2004, 393,570,128 shares of the registrant's common stock were outstanding.

The registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on September 22, 2004 is incorporated by reference in Part III of this Form 10-K to the extent stated herein.

---

---

---

**3Com Corporation**  
**Form 10-K Annual Report**  
**For the Fiscal Year Ended May 28, 2004**  
**Table of Contents**

		<u>Page</u>
<b>Part I</b>		
Item 1.	Business	1
Item 2.	Properties	15
Item 3.	Legal Proceedings	15
Item 4.	Submission of Matters to a Vote of Security Holders	15
	Executive Officers of 3Com Corporation	16
<b>Part II</b>		
Item 5.	Market for 3Com Corporation's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities	18
Item 6.	Selected Financial Data	18
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	47
Item 8.	Financial Statements and Supplementary Data	49
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	83
Item 9A.	Controls and Procedures	84
<b>Part III</b>		
Item 10.	Directors and Executive Officers of 3Com Corporation	85
Item 11.	Executive Compensation	85
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	85
Item 13.	Certain Relationships and Related Transactions	86
Item 14.	Principal Accountant Fees and Services	86
<b>Part IV</b>		
Item 15.	Exhibits, Financial Statement Schedule, and Reports on Form 8-K	87
	Exhibit Index	87
	Signatures	90
	Financial Statement Schedule	91

3Com, the 3Com logo, NBX, OfficeConnect, XRN, and SuperStack are registered trademarks and IntelliJack and VCX are trademarks of 3Com Corporation or its subsidiaries. CommWorks is a registered trademark of UTStarcom, Inc. Palm is a trademark of Palm Trademark Holding Company LLC. U.S. Robotics is a registered trademark of U.S. Robotics Corporation. Other product and brand names may be trademarks or registered trademarks of their respective owners.

## Edgar Filing: 3COM CORP - Form 10-K

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

Our target customers and the demand for our products;

Emerging trends in networking technology;

Our distributors;

Our product portfolio;

Our restructuring activities and future operating expenses;

Our future revenue growth and profitability;

Financial position and results of operations;

Cash position and cash requirements;

Sales and margins;

Sources, amounts, and concentration of revenue;

Costs and expenses;

Accounting estimates, including doubtful accounts, inventory, treatment of goodwill and intangible assets, equity securities and other investments, restructuring, warranty, and income taxes;

Operations, including international operations, supply chain, quality control, and manufacturing supply, capacity, and facilities;

Products and services (including the exiting of product lines), price of products, product lines, and product and sales channel mix;

Relationship with customers, suppliers and strategic partners, including increased reliance on strategic partners;

Acquisitions of companies or technologies;

Credit facility and ability to raise financial capital;

Real estate arrangements including the sale and sublease of properties;

## Edgar Filing: 3COM CORP - Form 10-K

Activities of 3Com Ventures;

Joint venture with Huawei Technologies, Ltd.

Global economic, social, and geopolitical conditions;

Industry trends and our response to these trends;

Tax position and audits;

Our restructuring and cost-reduction efforts, including workforce reductions and the effect on employees;

Sources of competition including Huawei Technologies, Ltd.;

Protection of intellectual property;

Outcome and effect of current and potential future litigation;

Research and development efforts, including our investment in new technologies;

## Edgar Filing: 3COM CORP - Form 10-K

Future lease obligations and other commitments and liabilities;

Outsourcing of some of our functions and dependence on contract manufacturing; and

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," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "intends," "potential," "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 this time. We undertake no obligation to update any forward-looking statements.

### **PRESENTATION OF DISCONTINUED OPERATIONS COMMWORKS**

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 our CommWorks division and transferred certain assets and liabilities to UTStarcom, Inc. pursuant to the terms of an Asset Purchase Agreement. As a result, we began reporting the CommWorks division as a discontinued operation in the fourth quarter of fiscal 2003 and restated all prior periods presented on a comparative basis.

**PART I**

**ITEM 1. Business**

**GENERAL**

3Com was incorporated on June 4, 1979. A pioneer in the computer networking industry, 3Com provides data and voice networking products and solutions, as well as support and customer services, for enterprises and public sector organizations of all sizes.

Building on our historical success in the networking infrastructure market, we deliver innovative, feature-rich networking products and solutions that support the increasingly complex and demanding application environments in today's businesses. Our products and solutions enable customers to manage business-critical information efficiently, enhance the productivity of their employees, and improve the effectiveness of their business relationships. At the same time, our products and solutions are based on open technology standards, and are designed and engineered to reduce reliance on proprietary systems, complexity and total cost of ownership. Thus, by enriching the user experience through innovative technology and high performance at an affordable cost, we provide practical solutions to meet the demanding real-world needs of customers today.

We believe that the leading enterprise networking company of the future will be the one that offers innovative, feature-rich products and solutions that excel at low cost of acquisition and ownership. Also, if that company demonstrates operational excellence, maintains a low cost structure and utilizes capital efficiently, it can generate attractive financial returns and deliver significant value to its shareholders. We aspire and intend to be that leading company, and we believe that our global presence, brand identity, intellectual property portfolio and strong balance sheet provide a sound foundation for growth and success in our targeted markets.

**INDUSTRY BACKGROUND**

During the 1980s and 1990s, we became a worldwide leader building enterprise networks and the equipment that connects computers to networks. In 1981, International Business Machines Corporation (IBM) introduced the personal computer (PC) and in 1983, we introduced the first network interface card (NIC) that connected the IBM PC to Ethernet networks.

In the early stages of enterprise networking, computers were initially connected to form local area networks (LANs) so that people in workgroups could more easily share information, such as spreadsheets, and resources, such as printers and servers. Later, network-based applications email, for example were developed, and these applications ignited the demand to connect workgroups together into enterprise-wide networks. More recently, going beyond self-contained enterprise networks, the emergence and pervasiveness of the Internet has led to substantial growth of network-based communications and transactions between commercial enterprises and their customers, partners and suppliers.

The increased use of self-contained enterprise computer networks for conducting day-to-day business operations, and related factors such as the development and proliferation of collaborative business software applications and the increased connectivity requirements of mobile employees, have created demand for networks that are increasingly more available, reliable, robust and capable of prioritizing network traffic. Also, the increased use of Internet-based applications for conducting business transactions with customers, partners and suppliers has created demand for networks that are capable of delivering high performance and quality, cost effectiveness and security.

The continued evolution of networking technology is now enabling convergence of data, voice and video over Internet Protocol (IP) networks. For example, traditionally, enterprises have deployed separate data networking and telephone infrastructures, with the attendant costs to install, operate and maintain the separate infrastructures. Now, in many cases, enterprises are finding that new IP

telephony networking technology can enable them to converge their data and voice traffic over a single infrastructure and achieve substantial cost savings in terms of initial purchase price as well as ongoing costs of operation and maintenance and provide new productivity-enhancing telephony features to their employees. Similarly, the evolution of networking technology is now enabling enterprise-class wireless solutions as well as enhanced security solutions for both wired and wireless environments.

## MARKETS AND CUSTOMERS

We offer enterprise networking products and solutions for enterprises and public sector organizations of all sizes. We understand that networking needs vary among customers and, therefore, we offer a broad line of networking solutions to fit the business needs of customers from the very small (10 to 100 users) to the very large (from one thousand to many thousands of users), in different industries, and around the world. We do this by delivering scalability, rich functionality, high performance, reliability, and security in networking solutions that are well suited for a variety of enterprise and public sector environments.

We have a large installed base of enterprise customers, and we deliver the performance, features, and flexibility demanded by these customers to meet their changing business needs. We also have developed and maintain a strong position in the small business marketplace, which stems from our understanding of the particular needs of small businesses and our ability to provide them with networking solutions that are easy to install, configure, use and manage, as well as reliable and affordable to own and operate.

We also target major customer groups who:

- view their networks as mission-critical tools that help them to deliver mandatory and/or value-add differentiated services to their customers or constituents;

- seek convergence-ready data/voice solutions and wireless solutions that are standards-based to reduce complexity and protect their investments; and

- value networking solutions that are affordable to acquire, operate and maintain, and expand.

These customers often larger organizations found in vertical markets such as education, government, retail banking, finance, healthcare, manufacturing and distribution generally have strict controls over capital and expense budgets and/or procurement policies that require open bidding processes. As a result of their business requirements and procurement practices, these customers are likely to purchase from a vendor that offers:

- networking products and solutions that are innovative and feature-rich;

- networking solutions that are affordable to acquire, maintain and operate, and expand; and

- global sales, support and customer service capabilities.

We believe that we offer these capabilities. Please refer to **COMPETITION** below for a further discussion of these and other competitive factors.

Our Ethernet connectivity products and solutions are targeted for worldwide distribution to enterprise customers via PC Original Equipment Manufacturers (OEMs) and value-added resellers (VARs). We sell directly to PC OEMs, who integrate our connectivity products primarily into their commercial PC product offerings. Our 3Com®-branded products are sold primarily through our two-tier distribution channel, which leverages the capabilities of our distributors and resellers.

As the market for Ethernet connectivity products has evolved, there has been a transition from higher priced NICs to lower priced application specific integrated circuits (ASICs) that are installed on the PC motherboard in a LAN-on-motherboard (LOM) configuration. Looking forward, connectivity products will increasingly reside in smaller and lower priced form factors, designed in coordination with the PC





motherboard itself. As this trend continues, this configuration will become the form factor of choice for connectivity products, significantly impacting and eroding the market for NICs. In addition to changing form factors, users are beginning to implement higher speed connectivity products. We anticipate that a growing number of connectivity products will be based on Gigabit Ethernet (GbE) line speed, or 10/100/1000 megabits per second (Mbps).

## PRODUCTS AND SOLUTIONS

Our portfolio of enterprise networking products and solutions includes the following offerings:

**LAN Switches** Fixed-configuration (fixed number of ports) and modular chassis (variable port capacity) devices called "switches" that are located in the network core and also at the network edge, serving as the foundation for transporting data over the network.

**IP Telephony** Voice over Internet Protocol (VoIP) solutions that enable customers to transport their standard voice traffic, as well as new IP-based voice-related applications, over their existing data networking infrastructure.

**Network Security** Advanced security technology that consolidates various security applications into a single hardware platform, thereby simplifying management of the security solution. Also, perimeter firewalls and host-based firewalls embedded into the network to protect against external and internal security breaches.

**Routers and Gateways** Devices that direct traffic flows on a network and direct incoming and outgoing traffic over the wide area network (WAN).

**Wireless LAN** Wireless network access points and adapter cards, based on Wi-Fi technology, giving wireless users the ability to connect to the network.

**Network Jack and IntelliJack Switches** A four-port switch in the form of a standard wall jack that offers Ethernet connectivity with more ports without the need to install additional cable.

**Connectivity Products** Adapter cards that enable client devices (for example, PCs) and servers to connect to the network.

**Network Management Software** Network management applications that enable IT managers to proactively manage the network through the software's alerts and reporting mechanisms, as well as more advanced features.

**Customer Services** Services provided by engineers, technicians and other support specialists who design, install and integrate networks, resolve customer issues and help customers plan for future upgrades and enhancements.

### *LAN Switches:*

Core Switching. We offer both fixed-configuration and modular chassis core solutions in our Switch 4000 series and SuperStack® 3 4900 series, delivering highly resilient (fault tolerant) and available Layer 2 and Layer 3 Fast Ethernet (100 Mbps) and GbE solutions for the core of the enterprise network. We offer an alternative to traditional modular chassis designs through the Switch 40x0 range. For enterprises requiring higher performance and flexibility, we offer Layer 4 traffic prioritization capabilities in the SuperStack 3 Switch 4400, as well as our innovative eXpandable Resilient Networking (XRN®) technology. XRN technology enables an enterprise to build a highly available network with multiple switches managed as one entity, providing ease of management and greater fault tolerance. Also, the scalability features of our XRN technology allows us to offer a "pay as you grow" approach to building portions of LANs.

## Edgar Filing: 3COM CORP - Form 10-K

During fiscal 2004, we introduced the 3Com Switch 7700, a high performance Layer 3 modular switch based on technology developed by Huawei Technologies, Ltd., with whom we have formed a joint venture as discussed below. This new product family, initially introduced in 4-slot, 7-slot and 8-slot versions with available 20-port interface modules, has broadened the markets and customers that we can serve to include the larger enterprise segment. The Switch 7700 enables us to compete at the network core, especially for medium-sized enterprises. Also, the Switch 7700 family has scaled up our switch offerings to create a new growth path for small-to-medium-sized businesses.

*Workgroup/Desktop Switching.* At the LAN workgroup/desktop, our fixed-configuration switches aggregate edge switches, larger server farms, and/or servers and desktops, optimizing and controlling data flow. We provide a full range of fixed-configuration switches to provide performance and flexibility at the edge of the network that includes the OfficeConnect series and the SuperStack 3 Baseline, 4200, 4300, and 4400 series of products.

For small-to-mid-sized networks and branch offices that do not require network management capabilities, we offer the OfficeConnect® series and SuperStack 3 Baseline series of switches that are cost-effective without sacrificing network performance or ease of use. These products are aggressively priced, compact and offered in many different port configurations; also, they can be installed and operated by non-technical IT managers. The SuperStack 3 Switch 4200 and 4300 series offer ease of configuration and robust network management software, as well as low cost of ownership.

The SuperStack 3 Switch 4400PWR is an example of an intelligent edge switch for enterprises that are deploying new applications that require advanced functionality. This product, which combines the advanced features and high performance of the SuperStack 3 Switch 4400 family with standards-based Power-over-Ethernet (PoE) technology, can be used to pull power from the wiring closet and supply it over an Ethernet cable to any compliant device, including 3Com NBX® phones, wireless LAN access points, Network Jack, and IntelliJack products. The Switch 4400PWR and the other switches in the 4400 series also provide advanced, multi-layer packet classification designed to enhance network control, improve efficiency, and automatically identify and prioritize real-time or business-critical applications, an important feature for converged data and voice networks.

*Gigabit Switching.* Going forward, we believe that a growing number of networking products and solutions will be based on GbE technology as the demand for high-speed IP-based network infrastructures increases in enterprises of all sizes and prices continue to decrease. Also, we anticipate that GbE at the desktop will become more pervasive as GbE connectivity capability becomes standard on PCs. We expect that this will create greater demand for bandwidth in the cores of networks and at the aggregation points that, in turn, will create greater demand for 10 Gigabit products. Already, we have begun to see increased interest by enterprise customers in "10 Gigabit-ready" networks, as more enterprises develop strategic plans for scaling up in the core of the network.

To address the increasing market demand for Gigabit to the desktop applications, we recently introduced our SuperStack 3 Switch 3870 family of low cost, GbE workgroup switches. These stackable switches, offered in both 24- and 48-port models, deliver scalable Gigabit capability with advanced security features, along with ease of installation and high reliability. In addition, these switches include a built-in 10 Gigabit expansion slot, which means that a customer will be able to use a 10 Gigabit uplink module to boost performance by connecting to a 10 Gigabit core. Thus, these switches provide customers with increased performance over traditional 10/100 Mbps workgroup switches, as well as a migration path for connecting to 10 GbE core technology in the future. We plan to deliver additional 10 Gigabit switching products in the future to meet evolving enterprise requirements for bandwidth and higher density network cores.

***IP Telephony:***

The next phase of IP telephony deployment is taking shape in the enterprise market worldwide. Currently, many enterprise customers are focusing on leveraging their existing hybrid networks, comprising any number of legacy systems and new technology, to create applications and features that facilitate enhanced communication and efficiency as well as lower network operating costs. By deploying IP-based services in hybrid networks, enterprise customers are able to provide their legacy private branch exchange (PBX) users with many of the same enhanced telephony services that they provide to their pure IP-based telephony users. Enhanced IP-based voice mail and unified communications platforms, centrally managed from the data center, allow messaging benefits not available on legacy voice mail systems distributed at each site. Subscribers can access voice mail, fax and e-mail messages from multiple devices and locations.

As enterprises continue to transition away from their legacy networks, moving to IP-based telephony solutions can provide powerful new business benefits, including:

- reduced connectivity charges;
- reduced administration costs;
- lower costs for phone moves, adds, and changes;
- savings on teleconference costs;
- enhanced employee productivity tools;
- mobility solutions; and
- call center management.

We have been a leader in IP telephony since the introduction of our first-to-market IP-PBX system in 1998. The 3Com SuperStack 3 NBX Networked Telephony Solution is designed for central or branch offices that have from two to more than 1,000 phones per location. With fourth-generation 3Com NBX (R4.2) system software, the SuperStack 3 NBX Networked Telephony solution helps reduce costs and increase efficiencies by converging data and voice communications on a single network, simplifying third-party applications integration, and offering extensive multi-site IP connectivity options. Intuitive management tools with simple, web-based administration and user programming can further reduce costs and increase productivity. This solution is available in 61 countries, supporting several languages and dialects.

The 3Com Voice Core eXchange (VCX ) V7000 IP Telephony Solution delivers reliable, highly scaleable, comprehensive standards-based IP telephony for larger enterprises with up to thousands of users. Leveraging wired and wireless LANs and WANs, the solution offers enterprise-wide features and functionality that are intended to enhance communications and productivity while reducing costs. Designed for enterprise campus, multi-site, and multinational networks, the VCX V7000 IP Telephony Solution consists of modular software components that perform call control, signaling, application creation, and media control, independent of access medium and speed. Applications can be custom tailored to fit the demands of any enterprise, regardless of its size or number of sites. The VCX 7000 product line includes robust software application modules, facilitating an array of IP-based applications that run on off-the-shelf, high-performance servers.

***Network Security:***

Because of increasing security breaches and e-mail viruses, integrated enterprise security has become a business-critical imperative. Most security offerings today are based on inflexible point-products or technologies designed to address specific network threats. This specialized security appliance approach does not accommodate the need for security to be built into the fundamental fabric of an enterprise

network. Addressing security one component at a time creates higher costs, complexity and tactical fixes that could accentuate a future vulnerability.

We believe that a more centralized and standards-based approach to network and information security controls will be more effective in protecting against both insider threats as well as external threats, and we believe that solutions that consolidate various security applications and products onto a single security hardware platform will be attractive to enterprise customers.

Through our relationship with Crossbeam Systems, Inc., we offer a new security solution that is designed to consolidate security applications on a single platform, giving IT managers greater control and functionality. Our integrated security solution, the 3Com Security Switch 6200, is a high performance and cost effective enterprise-class security switch designed to address specific vulnerabilities or blended threats. The 3Com Security Switch 6200 supports multiple applications, such as intrusion detection and prevention, antivirus, content filtering and more. The 3Com Security Switch 6200 complements our existing security portfolio by delivering the security, performance and reliability required for larger enterprise deployments, such as regional or head office networks and data centers.

Additional security solutions that we offer are as follows:

The 3Com Embedded Firewall solutions are host-based firewalls embedded onto Peripheral Component Interconnect (PCI) cards for desktops and servers and PC cards for laptops. These tamper-resistant hardware firewalls allow IT managers to deploy a company-wide, policy-based client and server security scheme.

The SuperStack 3 Firewall is a high-performing, highly secure perimeter firewall and Virtual Private Network (VPN) solution.

The 3Com OfficeConnect VPN Firewall and the OfficeConnect Secure Router, a small office/home office (SOHO) router, are for smaller offices that utilize broadband connections (cable or digital subscriber line) or already have WAN service in place.

#### ***Routers and Gateways:***

Our WAN routers and gateways are the devices that connect businesses and other users over long distances and enable access to the Internet. The expansion of our product portfolio to include routers represents a significant step forward in offering our customers an end-to-end networking infrastructure solution, allowing them to connect multiple sites within an organization.

We focus on open standards and interoperability in all our solutions, including routing. The Tolly Group, a third party IT consulting group, tested and certified our router products to ensure complete functionality in standards-based networks with other vendors' routing technology. This enables us to offer enterprise customers our routing solutions when existing routers are already in-place in the network.

The 3Com Router 5000 product line is a series of branch office routers for enterprise customers. The 3Com Router 3000 series of small office routers provides the secure connections that are needed in small offices and remote sites. In the future, we plan to broaden our router product line with higher-end routers for larger enterprises. For small businesses and remote offices of enterprises, we offer the OfficeConnect solutions for small office WAN connectivity.

#### ***Wireless LAN:***

We deliver wireless networking products and solutions that enable users to stay connected to information while at their desks or while roaming within the enterprise. The productivity increase associated with this ease of information access is driving many businesses to deploy wireless networks.

We offer a large portfolio of standards-based wireless LAN solutions to meet a wide variety of application-specific needs.

We believe that standards will continue to play a major role in the increasing acceptance of wireless LANs, and we expect additional momentum in the trend toward integrated quality of service (QoS) in wireless LANs that may involve 802.11e, an emerging standard, to support bandwidth-intensive wireless applications such as voice and video. Simultaneously, wireless switching, has begun to emerge as a way to integrate management of wireless access points into a switch. Security concerns related to wireless technology have been addressed in standards-based ways already, including Advanced Encryption Service (AES), Wireless Equivalent Privacy (WEP) and Wireless Protected Access (WPA). We expect interest over the next year to be focused on eliminating compatibility issues by creating enterprise wireless networks that support all three Wi-Fi standards (802.11 a/b/g), removing the need for IT managers to choose one protocol over another.

Market shifts toward integrated solutions supporting all three Wi-Fi standards and new wireless data applications have already begun. Our next generation Wi-Fi-certified wireless LAN products include tri-mode and dual-mode access points and PC card solutions. Our wireless access point products support all 802.11 a/b/g wireless standards. This means that any user within a certain distance of the access point can access the network, regardless of which standard is supported by the user's client device. The 3Com Wireless Access Point 8750, 3Com Wireless Access Point 8250 and 3Com Wireless Access Point 7250 were designed for enterprise customers as a modular, upgradeable platform for configuration flexibility and investment protection. To ensure that users have secure access, our products support stringent security standards, such as Wireless Equivalent Privacy (WEP) to protect the wireless connection to users.

Our wireless LAN PC cards take advantage of the tri-mode 802.11 a/b/g Wi-Fi support. The cards can also be used with 3Com's OfficeConnect wireless products appropriate for small business customers. Our wireless PC adapters also work with competitors' access points, as long as the products are Wi-Fi standards compliant.

***Network Jack and IntelliJack Switches:***

As connectivity evolves, intelligent solutions at the edge of the network are adding increased value. We offer a series of products to capture this potential. 3Com Network Jack and IntelliJack switches provide a cost-saving way to expand LAN-port connectivity in almost any network environment. The Network Jack is a four port Ethernet switch that mounts conveniently into any common wall outlet area. It increases the number of network ports available at the desktop, without the cost and inconvenience of running additional cables through walls and ceilings. These switches are targeted for small-office or enterprise businesses, government offices, dormitories, hospitals, classrooms, laboratories, public kiosks, conference rooms, and shared office spaces, and they are particularly well suited for older or hard-to-wire structures.

A key feature of the NJ100 Network Jack is the ability to utilize power from either PoE or a local power supply. This product can also forward power to connected devices that comply with PoE standards. The NJ200 Network Jack has additional features such as network management, traffic prioritization, and virtual LAN support.

***Connectivity Products:***

Our desktop, mobile and server connectivity products enable computers and other devices to connect to Ethernet networks, thus allowing users to access information. Utilizing proprietary ASICs, hardware and software, we are one of the world's leading companies in providing 10/100/1000 Mbps Ethernet connectivity products. A major factor in our success has been our focus on ease of use, reliability, and

performance. Our customers have come to expect our connectivity products to install easily, operate reliably and provide excellent performance over the life of the system.

We also offer IP security NIC products that contain a dedicated processor capable of processing operations including 3DES (Data Encryption Standard) encryption. Our IP security NIC products provide an added layer of distributed, tamper-resistant protection at the client device level, protecting desktop and mobile PCs and servers against network attacks and unauthorized access from both internal and external security threats.

***Network Management Software:***

3Com Network Supervisor is a powerful, yet easy-to-use management application that discovers, maps, and displays network links and IP devices, including NBX telephones and some popular third-party products. It maps devices and connections for easy monitoring of stress levels, setting thresholds and alerts, viewing network events, launching device configuration tools and generating reports in user-defined formats. The detailed reports on inventory, ports used, and network topology make it easier to manage a network, and the software's advanced event processing reduces the time needed to resolve network problems. Automated operations, intelligent defaults, and the ability to detect network configuration errors and offer optimization suggestions give managers at all levels of experience support for robust network supervision. The 3Com Network Supervisor is included with most 3Com managed networking devices, and an advanced package is available for increased management functionality and capacity. This well-established, self-contained application has more than 60,000 registered customers worldwide.

The 3Com Network Director and 3Com Network Administrator are high-end applications that complement the 3Com Network Supervisor application in our suite of network management software applications. These applications are important for managing a network in order to ensure proper operation, verify authorization, anticipate and correct problems, and control changes in the network.

The 3Com Network Director is a network management application that enables faster change management of sophisticated networks and scales up to managing enterprises with 5,000 nodes. The application offers network topology-aware configuration, remote monitoring management support and performance reports, and historical reporting. It is a self-contained turnkey application requiring no additional management software to operate. The 3Com Network Administrator application, designed for enterprise customers who are using Hewlett Packard Corporation's OpenView as their management infrastructure, allows management of our products in a multi-vendor network and provides easier bulk administration in larger networks.

***Customer Services:***

Our maintenance offerings cover all aspects of support that customers need to keep their networks operating effectively, including telephone support, hardware replacement, software updates, and dedicated on-site engineers and spare parts. Because the new higher-end switches and routers that we have introduced over the past year require higher levels of service and support than our other products, we have expanded our service capabilities worldwide in the areas of technical support, training and professional services. We have recently introduced enhanced professional services to assist and support enterprise customers with planning, design, and implementation of our new higher-end products and solutions. We have also enhanced our training offerings to channel partners, so that they are better prepared to deliver a high quality service to their end customers. Channel partners can also purchase these support and professional services for resale.

We continue to support enterprise products from the past and have retained the technical and operational expertise to do so. We plan to augment this experience base in targeted growth areas such

as VoIP, wireless and security, and to leverage strategic partnerships to enable full global coverage and expansion for our portfolio of service offerings.

## SALES, MARKETING AND DISTRIBUTION

We have a broad distribution channel, allowing both reach and depth in terms of bringing our products and solutions to our customers. Our two-tier distribution channel comprises 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 VARs and other channel partners targeting the small and mid-sized enterprise businesses. Our resellers provide additional value to the end users through application, technology, or industry-specific expertise, and product and/or service offerings that complement our networking solutions.

Although a majority of our sales of enterprise networking products are made through our two-tier distribution channel, we also work with global systems integrators, service providers and direct marketers. For example, we have a strategic partnership with Electronic Data Systems Corporation (EDS), through which EDS gives its enterprise clients and customers the choice of 3Com data and VoIP networking solutions. We also maintain a field sales organization that works alongside our partners to assist them in achieving their sales goals. Our connectivity products are sold through Original Equipment Manufacturers (OEM) relationships with PC manufacturers, as well as through the two-tier distribution channel.

In addition, our marketing efforts focus on increasing 3Com awareness, consideration, and preference with our target enterprise, small business and public sector customers to create demand for our products with our channel partners. The marketing group supports activities to attract, retain and develop partner channels to ensure we have the right channel partners to support our business and to help their businesses to be successful. These activities include advertising and direct marketing activities, sales tools, collateral and training, and promotions and incentives.

## COMPETITION

We compete in the enterprise networking infrastructure and Ethernet connectivity markets providing a broad portfolio of data, voice and connectivity products. Our principal competitors today include Allied Telesyn, Inc., Avaya Inc., Cisco Systems, Inc., D-Link Systems, Inc. (D-Link), Dell Inc., Enterasys Networks, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Hewlett-Packard Company, Huawei Technologies Co., Ltd., Mitel Networks Corporation, Nortel Networks Corporation, and NETGEAR, Inc.

The primary competitive factors in the enterprise networking infrastructure market are as follows:

Tier-One capability and presence, which we define as encompassing:

- Ability to deliver a broad line of networking solutions, including data, voice, security, and wireless solutions;
- Broad distribution channels;
- Financial strength;
- A globally recognized and preferred brand;
- Substantial intellectual property portfolio;
- Strong service and support capabilities; and
- Global reach.

Innovative, feature-rich products and solutions, including:

- Ability to provide converged data and voice solutions for large, multi-site environments;
- Convergence ready data, voice and wireless solutions built on an open architecture to protect network investments that support evolutionary migrations, heterogeneous networks, and ease of integration for new applications; and





## Edgar Filing: 3COM CORP - Form 10-K

An innovative product roadmap for GbE and 10 GbE switching, IP telephony, security, and wireless technologies.

Networking solutions that are affordable to acquire, maintain and grow, including:

Ability to price lower than the competition by leveraging industry standards and an innovative, cost-efficient business model;

Ease of setup, network and application management through product and network management software design, including auto-configuration and auto-diagnostic capabilities; and

Lower total cost of ownership.

In addition to delivering the performance, availability and functionality required of today's networks, we are focused on ensuring our solutions are easy to install, use and operate, as well as affordable to own.

In the Ethernet connectivity market, companies tend to be U.S.-based silicon providers that generally focus on the corporate market segment and Taiwan-based manufacturers that generally focus on the consumer market segment. Our principal competitors in this market include Accton Technology Corporation, Broadcom Corporation, D-Link and Intel Corporation (Intel). In this market, the migration away from the use of stand-alone Ethernet connectivity products as discussed in the **MARKETS AND CUSTOMERS** section above is expected to continue. Intel is well positioned in the Ethernet connectivity market due to the trend towards the use of integrated silicon products. Intel has used proprietary interfaces and its strength in processors to create a strong competitive position.

Going forward, we expect to utilize our strong brand, installed base and market share positions, as well as our intellectual property portfolio, to maximize the profitability and cash flows from our Ethernet connectivity products and solutions. We are well positioned to license our strong intellectual property portfolio in connectivity, which provides the potential to realize future royalty streams with minimal overhead investment. Also, we plan to leverage our existing alliances, which provide cost effective product development and manufacturing, allowing for the effective extension of connectivity products.

### **RESEARCH AND DEVELOPMENT**

Our research and development approach focuses internal investments upon those core activities that are necessary to deliver differentiated products and solutions and drive reductions in product costs. This is particularly true for newer technologies and emerging growth markets, where it is important to develop intellectual property and platforms for future product offerings. Areas of focus include potential high growth areas such as data and voice convergence, wireless networking, security, and 10 GbE switching. For non-core activities that may include mature technologies or widely available components, we leverage contract developers for development work and third parties for sourcing components. This two-part approach increases our ability to bring products to market in a timely and low cost manner and ensures that we are focused upon those product attributes that matter most to our customers.

Research and development investments in ASICs and software remain a high priority for us. In certain applications, ASICs can provide powerful features, higher performance and cost advantages. Along with our ASICs, our software provides differentiation across our product lines. In many cases, sophisticated software underlies the reliability and ease of use that our customers have grown to associate with our products. Examples include self-configuration capabilities in our wireless LAN access points and switches, and automatic prioritization of networked telephony traffic when our NBX and VCX telephony solutions are used in combination with our SuperStack 3 Switch 4400 product.

In fiscal year 2004, we opened a design and engineering center in Taiwan and contracted with a third-party to provide design and engineering services in India. Our design and engineering center in Taiwan focuses on our switching and wireless networking products and also works with Original Design

Manufacturers located in Taiwan. The design and engineering center located in India focuses on high-end VoIP software development, working with our research and development groups based in the United States to provide additional VoIP offerings.

For fiscal years 2004, 2003, and 2002, our total research and development expenditures were \$95.2 million, \$113.1 million, and \$198.0 million, respectively.

#### **JOINT VENTURE WITH HUAWEI**

Our joint venture with Huawei Technologies Ltd., a leading Chinese communications equipment provider, began operations on November 17, 2003. The Huawei-3Com Joint Venture (H-3C) is domiciled in Hong Kong, and its principal operating centers are in Hangzhou and Beijing, China. 3Com president and chief executive officer, Bruce Claflin, is chairman of H-3C's board of directors and Ren Zhengfei, president and chief executive officer of Huawei, is chief executive officer of H-3C.

At the time of H-3C's formation, Huawei contributed its enterprise networking business assets valued at \$178.2 million in exchange for a 51 percent ownership interest; the contributed assets consisted of LAN switches and routers; engineering, sales, and marketing resources; and licenses to related intellectual property. We contributed cash of \$160.0 million, assets related to our operations in China and Japan with a carrying value of \$0.1 million, and licenses related to certain intellectual property in exchange for a 49 percent ownership interest. On the second anniversary date of the formation of H-3C, provided we hold at least 49 percent of the net outstanding shares, we will have the one-time option to purchase from Huawei a number of shares equal to two percent of the net outstanding shares. The aggregate purchase price of these shares will be subject to negotiation between Huawei and us at the time of such purchase, but will not be greater than \$28 million. On the third anniversary of the formation of H-3C, each shareholder will have the right to purchase all of the equity equivalents held by the other shareholder and its affiliates through a bid process.

We expect H-3C to provide three key benefits to our business – an expanded product line, access to low cost and highly effective engineering talent, and a significant presence in the China and Japan markets. These three benefits are discussed in greater detail below:

Expanded Product Line. H-3C's product line complements and enhances our position in fixed-configuration products by providing modular Layer 2 and 3, 10/100/1000 Mbps switches. H-3C also provides a full line of enterprise routers. We currently market several H-3C product lines globally, including the 3Com Router Series 5000 and 3000 for medium and small enterprises, as well as the 3Com Switch 7700 for medium-to-large core enterprise applications. These products offer a rich feature set meeting a wide variety of wiring closet, core networking, and wide-area networking needs.

Access to Low Cost and Highly Effective Engineering Talent. H-3C's highly skilled and low-cost engineering team provides a foundation for a lower total cost of ownership for H-3C solutions. We also plan to leverage H-3C's lower cost engineering talent for new, feature rich product development.

Significant Presence in the China and Japan Markets. 3Com's and Huawei's geographic footprints are highly complementary, which reduces Huawei's and 3Com's costs of expansion into new markets through H-3C. We have a strong presence in the Americas and Europe, while Huawei has an established sales network, strong brand name and excellent reputation in China and Japan. We provide our resellers with access to the full line of H-3C networking products, which are sold under the 3Com brand everywhere in the world except China and Japan, where the H-3C products are sold under H-3C's brand. In China and Japan, H-3C will continue to sell its own products as well as 3Com and Huawei branded products.

## **SIGNIFICANT CUSTOMERS AND PRODUCTS**

For the fiscal year ended May 28, 2004, Ingram Micro, Inc. and Tech Data Corp. accounted for 20 percent and 13 percent of our total sales, respectively. For the fiscal year ended May 30, 2003, Ingram Micro, Inc. and Tech Data Corp. accounted for 21 percent and 12 percent of our total sales, respectively. For the fiscal year ended May 31, 2002, Ingram Micro accounted for 18 percent of our total sales, and Tech Data accounted for ten percent of our total sales.

Although we operate as a single, integrated business, certain product groups accounted for a significant portion of our sales. For the fiscal years ended May 28, 2004, May 30, 2003, and May 31, 2002, our fixed-configuration 10/100 Mbps switching products accounted for 48%, 47%, and 42% of sales, respectively. For the fiscal years ended May 28, 2004, May 30, 2003, and May 31, 2002, our fixed-configuration Gigabit switching products accounted for 12%, 8%, and 5% of sales, respectively. For the fiscal years ended May 28, 2004, May 30, 2003, and May 31, 2002, our wired LAN connectivity products accounted for 16%, 26%, and 36% of sales, respectively.

## **INTERNATIONAL OPERATIONS**

We market our products in all significant global markets, primarily through subsidiaries, sales offices, joint ventures, and relationships with OEMs and distributors with local presence. Outside the U.S., we have several research and development groups, with the most significant group being in the U.K. We maintain sales offices in 41 countries outside the U.S.

Although the U.S. represents our largest geographic marketplace, approximately 71 percent of 3Com's net sales in fiscal 2004 came from sales to customers outside the U.S. Gross margin on sales of our products in foreign countries, and sales of product that include components obtained from foreign suppliers, can be adversely affected by international trade regulations, including tariffs and antidumping duties, and by fluctuations in foreign currency exchange rates. Information concerning our sales by geographic region can be found in Note 18 to the Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K.

## **BACKLOG**

From time to time, based upon our forecasts of worldwide customer demand, we procure inventories from our contract manufacturers in advance of receiving firm product orders from our customers. Generally, orders are placed by our customers on an as-needed basis and may be canceled or rescheduled by the customers without significant penalty. Accordingly, backlog as of any particular date is not necessarily indicative of our future sales. As of May 28, 2004 and May 30, 2003, we had backlog of approximately \$23.2 million and \$32.1 million, respectively. We do not have backlog orders that cannot be filled within the next fiscal year.

## **MANUFACTURING**

During fiscal 2004, we ceased in-house manufacturing of our products. We now use independent contract manufacturers to produce all of our products. We have contract manufacturing arrangements with several companies, of which Flextronics International and Jabil Circuits were the two most significant during fiscal 2004. Based on current and forecasted demand, our contract manufacturers are expected to have an adequate supply of components required in the production of our products.

## **INTELLECTUAL PROPERTY AND RELATED MATTERS**

Through our research and development activities over many years, we have developed a substantial portfolio of patents covering a wide variety of networking technologies. This ownership of core networking technologies creates opportunities to leverage our engineering investments and develop more integrated, powerful, and innovative networking solutions for customers.

We rely on U.S. and foreign patents, copyrights, trademarks, and trade secrets to establish and maintain proprietary rights in our technology and products. We have an active program to file applications for and obtain patents in the U.S. and in selected foreign countries where potential markets for our products exist. Our general policy has been to seek to patent those patentable inventions that we expect to incorporate in our products or that we expect will be valuable otherwise. As of May 28, 2004, we had 1,135 U.S. issued patents (including 1,102 utility patents and 33 design patents) and 362 foreign issued patents. Numerous patent applications that relate to our research and development activities are currently pending in the U.S. and other countries. We also have patent cross license agreements with other companies. During fiscal 2004, we continued our patent licensing program, whereby we identify potential sources of licensing revenue, including investigation of situations in which we believe that other companies may be improperly using our patented technology. We have entered into a number of licensing agreements, are in litigation against two other companies with respect to infringement of 3Com patents, and have identified a number of other companies that we believe require a license under specified 3Com patents.

We have registered 65 trademarks in the U.S. and have registered 101 trademarks in one or more of 61 foreign countries, for a total of 867 worldwide registrations. Numerous applications for registration of domestic and foreign trademarks are currently pending.

#### **EMPLOYEES**

As of May 28, 2004, we had approximately 1,925 regular employees, of whom approximately 392 were employed in research and development, 741 in sales and marketing, 382 in manufacturing and customer services, and 410 in administration. Our employees are not represented by a labor organization, and we consider our employee relations to be satisfactory.

#### **SALE OF COMMWORKS**

On March 4, 2003, we entered into an agreement (Asset Purchase Agreement) to sell selected assets and liabilities of our CommWorks division to UTStarcom 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.

Prior to the sale, the CommWorks division was engaged in developing and deploying carrier-class, IP-based multi-service access and service creation platforms for telecommunications service providers.

#### **RESTRUCTURING CHARGES**

In recent fiscal years, we have undertaken several initiatives involving significant changes in our business strategy and cost structure. Restructuring charges related to these initiatives in fiscal 2004, 2003, and 2002 were \$159.7 million, \$184.9 million, and \$109.0 million, respectively. These initiatives and charges are discussed further in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Part II, Item 7 of this Annual Report on Form 10-K.

#### **AVAILABLE INFORMATION**

We file our annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 with the SEC electronically. The public may read or copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is <http://www.sec.gov>.

## Edgar Filing: 3COM CORP - Form 10-K

A free copy of our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports may be obtained as soon as reasonably practicable after we file such reports with the SEC by visiting our corporate internet website at <http://www.3Com.com>, or by contacting our Investor Relations Department by calling (508) 323-1198 or sending an e-mail message to [investor\\_relations@3Com.com](mailto:investor_relations@3Com.com).

**ITEM 2. Properties**

We operate in a number of locations worldwide. The following table summarizes our significant real estate properties as of May 28, 2004:

Location	Sq. Ft.	Owned/Leased	Primary Use
United States Boston Area	168,000	Leased	Corporate headquarters, office, research and development, and customer service.
United States San Francisco Bay Area	120,000	Owned	Office, research and development, and customer service.
United States San Francisco Bay Area	132,000	Leased	Subleased to third-party tenant.
United States Chicago Area	43,000	Leased	Office, research and development, and customer service.
United States Salt Lake Area	78,000	Leased	Office and research and development.
Europe Ireland	468,000	Owned	Property is vacant and held for sale.
Europe U.K.	230,000	Owned	Office, research and development and customer service. A portion of the property is vacant and held for sale.
Europe U.K.	45,000	Leased	Property is vacant.

As part of our initiatives to maximize our efficiency, we are consolidating our operations wherever feasible and are actively engaged in efforts to dispose of excess facilities, including facilities located in Dublin, Ireland and Hemel Hempstead, U.K. reflected in the table above. As of May 28, 2004, we lease and sublease to third-party tenants approximately 132,000 square feet of office space in our Mountain View, California leased facility and approximately 60,000 square feet in various other facilities throughout North America and Europe. These agreements expire at various times between 2004 and 2015.

During fiscal 2004, we concluded several significant real estate sales as described below:

During the first quarter of fiscal 2004, we sold our 490,000 square foot facility in Rolling Meadows, Illinois. The existing tenant lease associated with this facility was assigned to the new owner as of the closing date of the sale. Also, at the time of the sale, we leased back 43,000 square feet of office space from the new owner.

During the second quarter of fiscal 2004, we sold six buildings comprising 876,000 square feet in Santa Clara, California. The existing tenant lease associated with this facility was assigned to the new owner as of the closing date of the sale.

During the fourth quarter of fiscal 2004, we sold three buildings comprising 306,000 square feet and undeveloped land in Santa Clara, California.

See Note 8 to the Consolidated Financial Statements included in Item 8 of Part II of this Annual Report on Form 10-K for additional information related to significant property and equipment transactions.

**ITEM 3. Legal Proceedings**

The material set forth in Note 20 to the Consolidated Financial Statements included in Item 8 of Part II of this Annual Report on Form 10-K is incorporated herein by reference.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

None.





**Executive Officers of 3Com Corporation**

The following table lists the names, ages and positions held by all executive officers of 3Com as of July 23, 2004. There are no family relationships between any director or executive officer and any other director or executive officer of 3Com. Executive officers serve at the discretion of the Board of Directors.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Bruce L. Claflin	52	President and Chief Executive Officer
Dennis Connors	50	Executive Vice President, Worldwide Operations
Nick V. Ganio	45	Executive Vice President, Worldwide Sales
Mark Slaven	47	Executive Vice President, Finance and Chief Financial Officer
Susan H. Bowman	51	Senior Vice President, Human Resources
Neal D. Goldman	53	Senior Vice President, Legal, General Counsel, and Secretary
Anik Bose	41	Vice President, Corporate Business Development

BRUCE L. CLAFLIN has been 3Com's President and Chief Executive Officer since January 2001 and President and Chief Operating Officer since August 1998. Prior to joining 3Com, Mr. Claflin worked for Digital Equipment Corporation (DEC) from October 1995 to June 1998. From July 1997 to June 1998, he was Senior Vice President and General Manager, Sales and Marketing at DEC and prior to that he served as Vice President and General Manager of DEC's Personal Computer Business Unit from October 1995 to June 1997. From April 1973 to October 1995, Mr. Claflin held a number of senior management and executive positions at IBM. Mr. Claflin serves as a director of Advanced Micro Devices, Inc.

DENNIS CONNORS has been 3Com's Executive Vice President, Worldwide Operations since April 2003. Prior to that time, Mr. Connors was President of CommWorks Corporation from June 2002 to May 2003, President of 3Com Business Connectivity Company from June 2001 to June 2002, Senior Vice President of e-Commerce Group from June 2000 to June 2001, and Senior Vice President of Global Customer Service from November 1999 to June 2000. Prior to joining 3Com, Mr. Connors was the Executive Vice President and General Manager of Business Operations and Services for Ericsson, Inc. Mr. Connors also served as Ericsson's Vice President and Global Business Manager for WorldCom in 1997. During his tenure in Private Radio Systems in the Ericsson/General Electric joint venture, Mr. Connors was the Vice President of Global Product Development and Operations from 1995 through 1997, and Vice President of Marketing and Research and Development from 1993 to 1995.

NICK V. GANIO has been 3Com's Executive Vice President, Worldwide Sales since July 2003. Before joining 3Com, Mr. Ganio was President of Bell Microproducts' Enterprise Division from March 2002 to May 2003. Prior to being named to that position, Mr. Ganio was Group Vice President of Worldwide Sales, Marketing and Services at Computer Network Technology (CNT) from March 1998 to March 2002. Prior to CNT, Mr. Ganio was employed at DEC from 1987 to 1998. Mr. Ganio was Vice President and General Manager of DEC's Networking Business Unit for the Americas. Mr. Ganio also worked in the office of the President at DEC and subsequently managed DEC's operations in Japan. Mr. Ganio also held positions in sales, marketing, and operations since beginning his career at IBM in 1981 through 1987.

MARK SLAVEN has been 3Com's Executive Vice President, Finance and Chief Financial Officer since March 2003 and 3Com's Senior Vice President, Finance and Chief Financial Officer from June 2002 to

March 2003. Prior to his appointment to this role, Mr. Slaven served as Vice President of Treasury, Tax, Trade and Investor Relations. Prior to that time, Mr. Slaven had been Vice President and Treasurer since August 2000. Prior to that, Mr. Slaven was Vice President of Finance for Supply Chain Operations since joining the company through 3Com's acquisition of U.S. Robotics in June 1997, where he was Vice President of Finance for U.S. Robotics' manufacturing division. Before joining U.S. Robotics, Mr. Slaven was Chief Financial Officer of the personal printer division at Lexmark International Inc. Mr. Slaven serves as a director of Terayon Communication Systems, Inc.

SUSAN H. BOWMAN has been 3Com's Senior Vice President, Human Resources since September 2003. Prior to joining 3Com, Ms. Bowman was the Executive Vice President, Human Resources for Genuity, Inc., an Internet services company, from July 2000 to April 2003. Before joining Genuity, Ms. Bowman served as Vice President, Human Resources at GTE Internetworking, now Verizon, from September 1997 to July 2000.

NEAL D. GOLDMAN has been 3Com's Senior Vice President, Legal, General Counsel and Secretary since September 2003. Prior to joining 3Com, Mr. Goldman worked for Polaroid Corporation from August 1997 to September 2003. From March 2003 to September 2003, he was Executive Vice President, Business Development and Chief Legal Officer of Polaroid and prior to that Mr. Goldman served as Executive Vice President, Chief Administrative and Legal Officer from July 2001 to June 2002. From August 1997 to July 2001, Mr. Goldman held a number of senior management and executive positions at Polaroid, including Senior Vice President, General Counsel and Secretary and Deputy General Counsel. Before joining Polaroid, Mr. Goldman served as Vice President, General Counsel and Secretary at Nets, Inc. from March 1996 to June 1997. Before joining Nets, Inc., Mr. Goldman held a number of positions with Lotus Development Corporation, including Vice President and General Counsel from November 1995 to February 1996 and Deputy General Counsel and Assistant Secretary from April 1990 to November 1995.

ANIK BOSE has been 3Com's Vice President, Corporate Business Development since July 2000. Prior to joining 3Com, Mr. Bose was a partner at Deloitte Consulting in the firm's High Tech Strategy Practice from November 1999 to June 2000. From October 1995 to November 1999, he was Vice President, Business Development at Monsanto Company. Before joining Monsanto, Mr. Bose was a Principal at Gemini Consulting from August 1991 to September 1995.

## PART II

**ITEM 5. Market for 3Com Corporation's Common Stock, Related Stockholder Matters and Issuer Purchases of Equity Securities**

<b>Fiscal 2004</b>	<b>High</b>	<b>Low</b>	<b>Fiscal 2003</b>	<b>High</b>	<b>Low</b>
First Quarter	\$ 5.77	\$ 4.61	First Quarter	\$ 5.38	\$ 4.03
Second Quarter	8.00	5.57	Second Quarter	5.20	3.87
Third Quarter	9.09	6.87	Third Quarter	5.22	4.15
Fourth Quarter	7.46	5.82	Fourth Quarter	5.73	4.08

Our common stock has been traded on the Nasdaq National Market under the symbol COMS since our initial public offering on March 21, 1984. The preceding table sets forth the high and low closing sale prices as reported on the Nasdaq National Market during the last two fiscal years. As of July 23, 2004, we had approximately 5,160 stockholders of record. We have not paid, and do not anticipate that we will pay, cash dividends on our common stock.

During the fourth quarter of fiscal 2003, our Board of Directors approved a new stock repurchase program that authorizes expenditures of up to \$100.0 million and is effective for a two-year period through March 2005. We did not repurchase shares of our common stock pursuant to this authorization in fiscal 2003 or 2004. However, we began repurchasing shares of our common stock pursuant to this authorization in the first quarter of fiscal 2005, and we may use cash to repurchase additional shares in future periods. In addition, upon vesting of restricted stock awards, employees are permitted to return to us a portion of the newly vested shares to satisfy the tax withholding obligations that arise in connection with such vesting.

The following table summarizes repurchases of our stock, including shares returned to satisfy tax withholding obligations, in the quarter ended May 28, 2004:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1)</b>	<b>Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs</b>
February 28, 2004 through March 27, 2004	1,984	\$ 6.85		\$ 100,000,000
March 28, 2004 through April 27, 2004	1,289	7.01		\$ 100,000,000
April 28, 2004 through May 28, 2004				\$ 100,000,000
<b>Total</b>	<b>3,273</b>	<b>\$ 6.91</b>		<b>\$ 100,000,000</b>

- (1) Our current stock repurchase program was announced on March 19, 2003 and permits expenditures of up to \$100.0 million through March 2005. We did not repurchase shares of our common stock pursuant to this authorization in fiscal 2003 or 2004. However, we began repurchasing shares of our common stock pursuant to this authorization in the first quarter of fiscal 2005, and we may use cash to repurchase additional shares in future periods.

**ITEM 6. Selected Financial Data**

The following selected financial information has been derived from the audited consolidated financial statements. The information set forth below is not necessarily indicative of results of future operations and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related notes thereto included elsewhere in this Annual Report on Form 10-K.

Edgar Filing: 3COM CORP - Form 10-K

On May 23, 2003, we completed the sale of our CommWorks division. Also, on July 27, 2000, we distributed the Palm, Inc. common stock we owned to our stockholders in the form of a stock dividend. Accordingly, the information set forth in the table below has been restated to reflect the CommWorks division and Palm, Inc. as discontinued operations.

	Fiscal Years Ended				
	May 28, 2004	May 30, 2003	May 31, 2002	June 1, 2001	June 2, 2000
(In thousands, except per share and employee data)					
Sales	\$ 698,884	\$ 932,866	\$ 1,258,969	\$ 2,421,165	\$ 3,756,175
Net income (loss)	(349,263)	(283,754)	(595,950)	(965,376)	674,303
Income (loss) from continuing operations before cumulative effect of accounting change	(346,863)	(230,093)	(453,652)	(790,166)	559,458
Income (loss) per share from continuing operations before cumulative effect of accounting change					
Basic	\$ (0.92)	\$ (0.64)	\$ (1.30)	\$ (2.29)	\$ 1.61
Diluted	(0.92)	(0.64)	(1.30)	(2.29)	1.56
Number of employees	1,900	3,300	3,500	6,600	9,100

The provisions of Statement of Financial Accounting Standards (SFAS) 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," are applicable to disposals occurring after our adoption of SFAS 144, effective June 1, 2002. In accordance with such provisions, the table below has not been restated to reflect the CommWorks division as a discontinued operation.

	Balances as of				
	May 28, 2004	May 30, 2003	May 31, 2002	June 1, 2001	June 2, 2000
(In thousands)					
Total assets	\$ 1,820,818	\$ 2,062,360	\$ 2,526,792	\$ 3,456,872	\$ 6,617,774
Assets, net of discontinued operations of Palm	1,820,818	2,062,360	2,526,792	3,456,872	5,559,537
Working capital, net of discontinued operations of Palm(1)	1,213,108	1,314,012	1,159,822	1,397,977	3,181,420
Long-term obligations	15,135	4,595	73,365	10,536	141,285
Retained earnings (deficit)	(755,244)	(405,981)	35,814	771,639	1,982,079
Stockholders' equity	1,499,114	1,718,597	1,950,205	2,505,421	4,043,064

(1) Working capital is defined as total current assets less total current liabilities.



**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes thereto included in Item 8 of Part II of this Annual Report on Form 10-K.

On May 23, 2003, 3Com 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, 3Com 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. Accordingly, the Consolidated Financial Statements 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**

3Com provides innovative, practical and high-value data and voice networking products, services and solutions 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 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 the small and mid-sized enterprise businesses. Although a majority of our product sales are made through our two-tier distribution channel, we also work closely with systems integrators, major telecom service providers, and direct marketers. 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 has been 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 for the years ended May 28, 2004, May 30, 2003 and May 31, 2002, respectively.

	Fiscal Years Ended		
	May 28, 2004	May 30, 2003	May 31, 2002
Ingram Micro, Inc.	20%	21%	18%
Tech Data Corporation	13	12	10
<b>Total</b>	<b>33%</b>	<b>33%</b>	<b>28%</b>

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 information technology (IT) and other functions;

outsourcing of all manufacturing activity;

selling excess facilities; and

forming the Huawei-3Com Joint Venture (H-3C).

## Edgar Filing: 3COM CORP - Form 10-K

We believe an overview of these significant recent events is helpful to an understanding of our operating results.

### *Significant Events*

In the fourth quarter of fiscal 2001, we undertook several broad initiatives in an attempt to return 3Com to profitability. These initiatives included exiting certain product lines that were not expected to yield a satisfactory return on investment. During fiscal 2002, we continued to experience declining revenue. In response to this decline, we undertook additional measures to further reduce costs, including headcount reductions, long term asset retirements, and outsourcing manufacturing operations.

In fiscal 2003, as our revenue and overall financial performance continued to decline, we undertook several additional broad initiatives to achieve further cost savings. The first of these actions included the integration of certain central functions of our business units in order to achieve cost savings. This integration did not substantially change our management and operating structure. Other actions pursued in fiscal 2003 were headcount reductions, outsourcing of certain IT functions, and continuing efforts to consolidate and sell excess facilities. All of these actions generated restructuring charges, but also resulted in reductions of sales and marketing, research and development, and general and administrative expenses.

During fiscal 2004, we undertook a number of actions, affecting both revenue and expenses, with the objective of restoring 3Com to profitability. We expanded our product portfolio to include more Layer 3-plus and higher-end products, additional modular switches and routers, and a higher-end Voice-over-Internet Protocol (VoIP) offering. We believe that such an expanded product portfolio will allow us to deliver converged data and voice networking solutions not only to our traditional customers but also to larger and multi-site enterprises. We consolidated our company's operations into a single integrated business organized along functional lines, and we relocated headquarters and key management positions and functions from our Santa Clara, California location to our Marlborough, Massachusetts location as a more effective way to run this simplified business model. Also, we consolidated our operations into fewer facilities, disposed of excess real estate, relocated transaction processing activities to lower cost locations, outsourced our Dublin, Ireland manufacturing operations to our contract manufacturers, and upgraded and modified our IT infrastructure and systems to more cost-effective alternatives. In addition, during fiscal 2004, we reduced our overall workforce by approximately forty percent.

On November 17, 2003, we formed and began operations of 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 related intellectual property in exchange for 49 percent ownership interest of the joint venture. We expect this venture to provide three key benefits to 3Com - an expanded product line, access to low cost and highly effective engineering talent, and a significant presence in the China and Japan markets.

### *Summary of Fiscal 2004 Financial Performance*

Our revenue for fiscal 2004 was \$698.9 million, a 25% decrease from fiscal 2003 revenue of \$932.9 million. Revenue from our enterprise networking products for fiscal 2004 was \$585.9 million, a 15% decrease from fiscal 2003 revenue of \$690.2 million.

Our gross margin decreased from 45.2% in fiscal 2003 to 34.8% in fiscal 2004.

Our operating expenses in fiscal 2004 were \$580.9 million, compared to \$646.4 million in fiscal 2003, a net decrease of \$65.5 million. Operating expenses in fiscal 2004 and 2003 included restructuring charges of \$159.7 million and \$184.9 million, respectively.



Our net loss in fiscal 2004 was \$349.3 million compared to a net loss in fiscal 2003 of \$283.8 million.

Our balance sheet remains strong with cash and short-term investment balances at the end of fiscal 2004 of \$1,383.4 million, compared to cash and short-term investment balances of \$1,484.6 million at the end of fiscal 2003.

*Business Environment and Future Trends*

We believe that the actions that we have taken are consistent with our goals of increasing revenue and reducing expenses in order to achieve profitability over the longer term. However, we expect that some of the steps that we are taking to improve our business over the longer term will result in ongoing downward pressure on profitability in the near term. For example, as we complete the transition of our business in China and Japan to H-3C, there could be continuing adverse impacts on volumes, as well as lower average selling prices since the pricing of products sold to H-3C under an original equipment manufacturer (OEM) agreement is lower than the pricing of products sold through our distribution channels.

However, we believe that we have begun to see the positive impacts of some of our fiscal 2004 growth-related and restructuring initiatives. In the fourth quarter of fiscal 2004, total revenue and revenue from enterprise networking products increased five percent and 22 percent, respectively, compared to the same period of fiscal year 2003. Also, as a result of the aforementioned fiscal 2004 restructuring actions and related charges, and based on our current projections for revenue, costs and expenses, which are subject to significant uncertainty, we expect that operating expenses will be reduced by approximately \$4 million per quarter, from the amount reported for the fourth quarter of fiscal 2004. Approximately \$3 million of this reduction is expected to be realized during the first quarter of fiscal 2005; the full reduction is expected to be realized in the fourth quarter of fiscal 2005.

During fiscal 2005, we continue to face significant challenges with respect to revenue growth, gross margin and profitability. Future revenue growth for our company depends on increased sales of our enterprise networking products, and our largest growth opportunity continues to be linked to the expansion of our product lines targeting mid to large enterprise customers. These product lines include modular switching and routing products sourced from H-3C, as well as products such as VoIP, wireless and security. In order to achieve our revenue goals for fiscal 2005, it is imperative that we continue to enhance the features and capabilities of these products in a timely manner in order to expand our distribution channels and compete more effectively in the market. Also, we expect a very competitive, difficult pricing environment for the foreseeable future; this will exert downward pressure on our revenue, gross margin and profitability. Based on our current projections for revenue and gross margin, which are subject to significant uncertainty, we believe that we must hold total operating expenses including restructuring charges to an amount less than \$100 million per quarter in order to achieve profitability. Our total operating expenses including restructuring charges were approximately \$99.6 million in the fourth quarter of fiscal 2004.

Our planned actions for fiscal 2005 are based on certain assumptions concerning the overall economic outlook for the markets in which we operate, the expected demand for enterprise networking products, our ability to compete effectively and gain market share, and the cost and expense structure of our business. These assumptions could prove to be inaccurate. If current economic conditions deteriorate, or if our planned actions are not successful in achieving our goals, there could be additional adverse impacts on our financial position, revenue, profitability or cash flows. In that case, we might need to modify our strategic focus and restructure our business again to realign our resources and achieve additional cost and expense savings.

## CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are outlined in Note 2 to the Consolidated Financial Statements, which appear in Part II, Item 8 of this Annual Report on Form 10-K. Some of those accounting policies require us to make estimates and assumptions that affect the amounts reported by us. The following items require the most significant judgment and often involve complex estimation:

*Revenue recognition:* We recognize a sale when the product has been delivered and risk of loss has passed to the customer, collection of the resulting receivable is reasonably assured, persuasive evidence of an arrangement exists, and the fee is fixed or determinable. The assessment of whether the fee is fixed or determinable considers whether a significant portion of the fee is due after our normal payment terms. If we determine that the fee is not fixed or determinable, we recognize revenue at the time the fee becomes due, provided that all other revenue recognition criteria have been met. Also, sales arrangements may contain customer-specific acceptance requirements for both products and services. In such cases, revenue is deferred at the time of delivery of the product or service and is recognized upon receipt of customer acceptance.

For arrangements that involve multiple elements, such as sales of products that include maintenance or installation services, revenue is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element have been met. We use the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and vendor-specific objective evidence of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of fair value of one or more undelivered elements does not exist, revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established.

We assess collectibility based on a number of factors, including general economic and market conditions, past transaction history with the customer, and the creditworthiness of the customer. If we determine that collection of the fee is not reasonably assured, then we defer the fee and recognize revenue upon receipt of payment. We do not typically request collateral from our customers.

A significant portion of our sales is made to distributors and VARs. Revenue is generally recognized when title and risk of loss pass to the customer, assuming all other revenue recognition criteria have been met. Sales to these customers are recorded net of appropriate allowances, including estimates for product returns, price protection, and excess channel inventory levels.

For sales of products that contain software that is marketed separately, we apply the provisions of AICPA Statement of Position 97-2, "Software Revenue Recognition" as amended. Sales of services, including professional services, system integration, project management, and training, are recognized upon delivery and completion of performance. Other service revenue, such as that related to maintenance and support contracts, is recognized ratably over the contract term, provided that all other revenue recognition criteria have been met. Royalty revenue from licensing is recognized as earned.

*Allowance for doubtful accounts:* We continuously monitor payments from our customers and maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When we evaluate the adequacy of our allowances for doubtful accounts, we take into account various factors including our accounts receivable aging, customer creditworthiness, historical bad debts, and geographic and political risk. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances might be required. As of May 28, 2004, our net accounts receivable balance was \$66.4 million.

*Inventory:* Inventory is stated at the lower of standard cost, which approximates cost, or net realizable value. Cost is determined on a first-in, first-out basis. We perform detailed reviews related to the net

realizable value of inventory on an ongoing basis, for both inventory on hand and inventory that we are committed to purchase, giving consideration to deterioration, obsolescence, and other factors. If actual market conditions differ from those projected by management and our estimates prove to be inaccurate, additional write-downs or adjustments to cost of sales might be required; alternatively, we might realize benefits through cost of sales for sale or disposition of inventory that had been previously written off. As of May 28, 2004, our inventory balance was \$27.7 million.

*Goodwill and intangible assets:* We review the value of our long-lived assets, including goodwill, in accordance with the applicable accounting literature for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. As of May 28, 2004, we had \$5.0 million of net intangible assets and \$0.9 million of goodwill remaining on the balance sheet, which we believe to be realizable based on the estimated future cash flows of the associated products and technology. However, it is possible that the estimates and assumptions used in assessing the carrying value of these assets, such as future sales and expense levels, may need to be reevaluated in the case of continued market deterioration, which could result in further impairment of these assets.

*Equity securities and other investments:* As of May 28, 2004, we had \$159.8 million of equity securities and other investments, including \$142.9 million related to our investment in H-3C. We account for non-marketable equity securities and other investments at historical cost or, if we have the ability to exert significant influence over the investee, by the equity method. Investments accounted for by the equity method include investments in limited partnership venture capital funds and our investment in H-3C. In accounting for these investments by the equity method, we record our proportionate share of the fund's net income or loss, or H-3C's net income or loss, based on the most recently available quarterly financial statements. Since H-3C has adopted a calendar year basis of reporting, we report our equity in H-3C's net income or loss based on H-3C's most recent quarterly financial statements, two months in arrears.

We review all of our investments for impairment whenever events or changes in business circumstances indicate that the carrying amount of the investment may not be fully recoverable. The impairment review requires significant judgment to identify events or circumstances that would likely have a significant adverse effect on the fair value of the investment. Investments identified as having an indication of impairment are subject to further analysis to determine if the impairment is other than temporary; in the event that the indicated impairment is other than temporary, we write the investment down to its impaired value.

*Restructuring charges:* Over the last several years we have undertaken significant restructuring initiatives. These initiatives have required us to record restructuring charges related to severance and outplacement costs, lease cancellations, accelerated depreciation and write-downs of held for sale properties, write-downs of other long-term assets, and other restructuring costs. Given the significance of our restructuring activities and the time required for execution and completion of such activities, the process of estimating restructuring charges is complex and involves periodic reassessments of estimates made at the time the original decisions were made. The accounting for restructuring costs and asset impairments requires us to record charges when we have taken actions or have the appropriate approval for taking action, and when a liability is incurred. Our policies require us to continually evaluate the adequacy of the remaining liabilities under our restructuring initiatives. As we continue to evaluate the business, we might be required to record additional charges for new restructuring activities as well as changes in estimates to amounts previously recorded.

*Warranty:* A limited warranty is provided on our products for periods ranging from 90 days to the lifetime of the product, depending upon the product, and allowances for estimated warranty costs are recorded during the period of sale. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. If actual

return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to recognize additional cost of sales might be required.

*Income taxes:* We are subject to income tax in a number of jurisdictions. A certain degree of estimation is required in recording the assets and liabilities related to income taxes, and it is reasonably possible that such assets may not be recovered and that such liabilities may not be paid or that payments in excess of amounts initially estimated and accrued may be required. We assess the likelihood that our deferred tax assets will be recovered from our future taxable income and, to the extent we believe that recovery is not likely, we establish a valuation allowance. We consider historical taxable income, estimates of future taxable income, and ongoing prudent and feasible tax planning strategies in assessing the amount of the valuation allowance. Based on various factors, including our recent losses, retained deficit, operating performance in fiscal 2004, and estimates of future profitability, we have concluded that future taxable income will, more likely than not, be insufficient to recover our U.S. net deferred tax assets as of May 28, 2004. Accordingly, we have established an appropriate valuation allowance to offset such deferred tax assets. Adjustments could be required in the future if we determine that the amount to be realized is greater or less than the valuation allowance we have recorded.

## **RESTRUCTURING ACTIVITIES**

During the past several fiscal years, we have undertaken several initiatives involving significant changes in our business strategy and cost structure. Restructuring charges related to these initiatives in fiscal 2004, 2003, and 2002 were \$159.7 million, \$184.9 million, and \$109.0 million, respectively. These restructuring initiatives and charges are discussed further in **BUSINESS OVERVIEW** and **CRITICAL ACCOUNTING POLICIES** above and in Note 4 to the Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K.

Accrued liabilities related to restructuring activities are classified as current as of May 28, 2004 because we intend to satisfy such liabilities within the next 12 months. We expect to incur additional restructuring charges in the first half of fiscal 2005 related to our ongoing cost reduction efforts; however, based on actions taken or decided to date, such additional charges are not expected to be significant. Also, as of May 28, 2004, property and equipment classified as held for sale totaled approximately \$42.1 million; additional write-downs could result from future changes in the net realizable values of those properties.

## **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 of \$160.0 million, assets related to our operations in China and Japan with a carrying value of \$0.1 million, and licenses related to certain intellectual property in exchange for a 49 percent ownership interest in H-3C. Huawei contributed assets valued at \$178.2 million in exchange for a 51 percent ownership interest; Huawei's contributed assets included its enterprise networking business assets, including Local Area Network (LAN) switches and routers, engineering and sales and marketing resources and personnel, and licenses to its related intellectual property.

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, both partners have the right to purchase all of the other partner's ownership interest through a bid process.

In China and Japan, H-3C sells its own products, as well as products it purchases directly from Huawei and us. Outside of China and Japan, we resell H-3C's products under the 3Com® brand. Through this

reseller agreement, we are expanding our product line to include router products and modular switching products. The addition of these products to our product portfolio increases the size of the market opportunity for which we can compete.

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 quarterly financial statements of H-3C. Since H-3C has adopted a calendar year basis of reporting, we have reported our equity in H-3C's net loss for H-3C's fiscal period from the date of formation (November 17, 2003) through March 31, 2004 in our results of operations for fiscal 2004. Our proportionate share of the reported loss from operations for the period from the date of formation through March 31, 2004 was \$4.6 million, and is included in our results of operations for fiscal 2004 under the caption "Equity interest in loss of unconsolidated joint venture" in our consolidated financial statements. Also, at the time of formation of H-3C, we recorded a charge of \$12.6 million representing our ownership share (49 percent) of the value attributed to in-process technology contributed to H-3C by Huawei that had not yet reached technological feasibility and had no alternative future use. This charge also was included in our results of operations for fiscal 2004 under the caption "Equity interest in loss of unconsolidated joint venture." In fiscal 2004, our total reported loss related to H-3C was \$17.2 million. Prospectively, we will continue to report our equity in H-3C's net income or loss based on H-3C's most recent financial statements, two months in arrears. We do not expect H-3C's results to significantly affect our results of operations in the near term.

For additional information concerning our investment in H-3C, see Note 5 to the Consolidated Financial Statements included in Part II, Item 8 of this Annual Report on Form 10-K.

**RESULTS OF OPERATIONS**

As mentioned above, effective for fiscal 2004, we now manage and report our operations as a single, integrated business. The following discussion reflects the results of operations of the business as it was organized and managed during fiscal 2004.

The following table sets forth, for the fiscal years indicated, the percentage of total sales represented by the line items reflected in our consolidated statements of operations. Information related to the fiscal year ended May 31, 2002 has been restated to account for the CommWorks division as a discontinued operation.

	<b>Fiscal Years Ended</b>		
	<b>May 28, 2004</b>	<b>May 30, 2003</b>	<b>May 31, 2002</b>
Sales	100.0 %	100.0 %	100.0 %
Cost of sales	65.2	54.8	70.8
<b>Gross margin</b>	<b>34.8</b>	<b>45.2</b>	<b>29.2</b>
Operating expenses:			
Sales and marketing	35.0	26.0	21.7
Research and development	13.6	12.1	15.7
General and administrative	10.6	10.2	8.9
Amortization and write down of intangibles	1.0	1.1	6.9
Restructuring charges	22.9	19.8	8.7
Loss on land and facilities, net		0.1	0.1
<b>Total operating expenses</b>	<b>83.1</b>	<b>69.3</b>	<b>62.0</b>
Operating loss	(48.3)	(24.1)	(32.8)
Loss on investments, net	(1.6)	(3.9)	(1.4)
Interest and other income, net	2.3	2.2	5.3
Loss from continuing operations before income taxes, equity interests, and cumulative effect of change in accounting principle	(47.6)	(25.8)	(28.9)
Income tax provision (benefit)	(0.5)	(1.1)	7.1
Equity interest in loss of unconsolidated joint venture	(2.5)		
Loss from continuing operations before cumulative effect of change in accounting principle	(49.6)	(24.7)	(36.0)
Discontinued operations, net of taxes	(0.4)	(0.9)	(11.3)
Loss before cumulative effect of change in accounting principle	(50.0)	(25.6)	(47.3)
Cumulative effect of change in accounting principle		(4.8)	
<b>Net loss</b>	<b>(50.0)%</b>	<b>(30.4)%</b>	<b>(47.3)%</b>

*Comparison of fiscal years ended May 28, 2004 and May 30, 2003*

Sales

Fiscal 2004 sales totaled \$698.9 million, a decrease of 25 percent from fiscal 2003 sales of \$932.9 million.

## Edgar Filing: 3COM CORP - Form 10-K

Sales of enterprise networking products in fiscal 2004 were \$585.9 million, a decrease of 15 percent from fiscal 2003 sales of \$690.2 million. The decrease in revenue was driven by a reduction in average selling prices (ASPs) resulting from significant price competition, particularly for our 10/100 Mbps switching products as the industry migrates to Gigabit switching solutions, and by an unfavorable shift

in mix towards lower-priced products. Although sales of enterprise networking products declined overall, sales of certain products in targeted high-growth technology areas increased; such products included fixed-configuration Gigabit switches, wireless LAN, and modular switches and routers sourced from H-3C. Increased sales of these products was largely due to higher unit volumes, resulting from both the industry shift towards Gigabit switching solutions mentioned above, as well as enhanced sales and marketing efforts targeting enterprise customers. Enterprise networking products represented 84 percent of total sales in fiscal 2004 compared to 74 percent of total sales in fiscal 2003.

Sales of our desktop, mobile and server connectivity products in fiscal 2004 were \$112.9 million, a decrease of 53 percent from fiscal 2003 sales of \$242.6 million. The decrease in sales was due largely to lower volumes, with unit shipments decreasing 47 percent compared to fiscal 2003, as well as to lower overall ASPs. We believe the lower volumes resulted from a continuing shift in technology from traditional network interface card (NIC), personal computer (PC) card, and mini-peripheral component interconnect (Mini-PCI) form factors to PC chipsets with embedded networking technology for which we have lower market share. Additionally, the decline in sales was partially attributable to the recognition in fiscal 2003 of \$15.0 million of royalty revenue from a paid-up license resulting from settlement of patent litigation with Xircom, Inc. Sales of connectivity products represented 16 percent of total sales in fiscal 2004 compared to 26 percent of total sales in fiscal 2003. We expect sales from connectivity products to decline again in fiscal 2005 due to both reduced demand for our products and continued pricing pressures.

*By Geography.*

U.S. sales represented approximately 29 percent of total sales in fiscal 2004, compared to approximately 35 percent in fiscal 2003, and decreased 37 percent when compared to fiscal 2003. The major factor contributing to the decrease in sales from year to year was lower sales of connectivity products as discussed above. International sales in fiscal 2004 decreased 19 percent when compared to fiscal 2003. The major factor contributing to this decrease was lower sales of connectivity products; other important factors contributing to the decrease were lower sales of our 10/100 Mbps switching products, as well as a decline in sales to customers in China and Japan following H-3C's assumption of responsibility for sales of enterprise networking products into these countries.

Gross Margin

Gross margin as a percentage of sales declined 10.4 percentage points from 45.2 percent of sales in fiscal 2003 to 34.8 percent of sales in fiscal 2004. Significant components of the decrease in gross margins were as follows:

Decrease in standard-related margin	(4.6)%
Volume-related impacts	(0.9)
Transition related costs associated with closure of the Dublin manufacturing facility	(1.0)
Duty refunds and proceeds from inventory previously written off	(1.8)
Impact of royalty revenue	(0.9)
Other	(1.2)
	(10.4)%
Total	(10.4)%

The decrease in standard-related margin was primarily the result of lower ASPs, and, to a lesser extent, an unfavorable shift in product mix. These unfavorable factors were partially offset by product cost reductions.



Volume-related impacts include higher post-sale technical support costs, manufacturing overhead costs, and warranty costs as a percent of sales. Since a portion of these costs is not directly variable with sales, these costs did not decline at the same rate as sales.

We recorded charges related to manufacturing assets and other transition-related costs in fiscal 2004 as a result of our decision to outsource our remaining manufacturing operations in Dublin.

Gross margin in fiscal 2004 did not benefit to any significant degree from duty refunds or proceeds from the sale of inventory that was previously written off. However, gross margin in fiscal 2003 included benefits related to such items.

Sales in fiscal 2003 included royalty revenue of \$15.0 million related to the settlement of litigation with Xircom. This revenue did not have any associated cost of sales.

### Operating Expenses

Operating expenses in fiscal 2004 were \$580.9 million, compared to \$646.4 million in fiscal 2003, a net decrease of \$65.5 million. Included in the net decrease in operating expenses were decreases in research and development expenses of approximately \$17.9 million, general and administrative expenses of \$20.3 million, amortization and write down of intangibles of \$3.3 million, restructuring charges of approximately \$25.1 million, and loss on land and facilities of \$0.9 million. Partially offsetting these decreases was an increase in sales and marketing expenses of \$2.0 million.

As a percent of sales, total operating expenses in fiscal 2004 were 83.1 percent, compared to 69.3 percent in fiscal 2003. In aggregate, sales and marketing, research and development, and general and administrative expenses were 59.2 percent of sales in fiscal 2004, compared to 48.3 percent in fiscal 2003, and decreased a net \$36.2 million in fiscal 2004 compared to fiscal 2003. To a significant degree, these expenses are controllable and discretionary over time, but they are not directly variable with sales levels within a particular period.

The most significant component of the decrease of \$36.2 million was a reduction of IT-related expenses. We allocate and report both IT and facilities-related expenses as a component of cost of sales and operating expenses. On an overall basis, total operating expenses in fiscal 2004 reflected a decrease of \$30.0 million in IT-related expenses compared to fiscal 2003, largely as a result of employee reductions and asset write offs associated with our IT outsourcing initiatives during fiscal 2003. Partially offsetting the decrease in IT-related expenses was a net increase of \$4.6 million in facilities-related expenses. Although our facilities consolidation efforts have resulted in lower gross facilities spending, these savings have been more than offset by a reduction in rental and sublease income received. Such rental and sublease income totaled \$8.9 million and \$23.8 million in fiscal 2004 and 2003, respectively, and is recorded as an offset to the associated facilities-related expenses.

A more detailed discussion of the factors affecting each major component of total operating expenses is provided below.

*Sales and Marketing.* Sales and marketing expenses in fiscal 2004 were relatively flat compared to fiscal 2003, increasing \$2.0 million. Sales and marketing expenses as a percent of sales increased to 35.0 percent in fiscal 2004, compared to 26.0 percent in fiscal 2003. The most significant factors in the increase were higher workforce-related and travel and entertainment expenses and an increase in facilities-related expenses. Largely offsetting these increases were reduced IT expenses, as well as reduced marketing expenses as a result of a shift in spending towards more focused, product and channel specific programs.

*Research and Development.* Research and development expenses in fiscal 2004 decreased \$17.9 million, or 16 percent, compared to fiscal 2003. Research and development expenses as a percent of sales increased to 13.6 percent in fiscal 2004 compared to 12.1 percent in fiscal 2003. The most significant

factors in the decrease were reduced IT expenses, reduced workforce expenses as a result of restructuring activities and movement towards lower cost geographies, lower depreciation expense related to engineering assets reflecting write-downs and disposals associated with our restructuring initiatives, and decreased spending for project tools and materials. Partially offsetting these reductions were increased use of third parties for development work, as well as an increase in facilities-related expenses.

*General and Administrative.* General and administrative expenses in fiscal 2004 decreased \$20.3 million, or 21 percent, from fiscal 2003. As a percent of sales, general and administrative expenses were relatively flat, increasing to 10.6 percent in fiscal 2004 from 10.2 percent in fiscal 2003. The most significant factors in the decrease were reduced workforce-related expenses due to our restructuring initiatives, reduced legal and professional services costs related to the formation of H-3C, and reduced IT expenses. Partially offsetting these reductions was the impact of sales tax refunds in fiscal 2003 that did not recur at the same level in fiscal 2004, as well as lower credits in fiscal 2004 relating to bad debt expense.

*Amortization and Write Down of Intangibles.* Amortization and write down of intangibles were \$7.0 million and \$10.3 million for fiscal 2004 and 2003, respectively, a decrease of \$3.3 million. Amortization and write down of intangibles decreased due to a lower base of intangible assets as a result of an impairment charge during the first quarter of fiscal 2004, as well as reduced impairment charges. In fiscal 2004, we recorded an impairment charge of \$1.9 million related to developed and core technology associated with the acquisition of assets from Alteon in fiscal 2001. Additionally, there were impairment charges of \$0.4 million and \$3.2 million in fiscal 2004 and fiscal 2003, respectively, related to developed and core technology associated with the fiscal 1999 acquisition of NBX.

*Restructuring Charges.* Restructuring charges in fiscal 2004 and fiscal 2003 were \$159.7 million and \$184.9 million, respectively. Restructuring charges in fiscal 2004 were composed primarily of charges for actions taken in fiscal 2004, including facilities-related charges of \$89.7 million, severance and outplacement costs of \$59.2 million, and long-term asset write downs and other costs of \$3.2 million. Facilities-related charges in fiscal 2004 included \$47.7 million for an impairment and accelerated depreciation of a Santa Clara facility due to our plan to vacate the facility and move to a smaller Santa Clara facility already owned, offset by a \$0.4 million gain on the sale of this vacated facility later in fiscal 2004; \$25.1 million for an impairment and accelerated depreciation of our Dublin manufacturing facility; an \$11.2 million impairment and \$1.4 million loss on sale of certain other Santa Clara properties; a loss of \$1.1 million related to the sale of our Rolling Meadows, Illinois facility; charges of \$2.7 million related to fair value adjustments of properties classified as held for sale prior to fiscal 2004; and \$0.9 million related to estimated lease termination costs. Restructuring charges for fiscal 2004 were the result of reductions in workforce, outsourcing of our remaining manufacturing operations in Dublin, and continued efforts to consolidate and dispose of excess facilities. Additionally, in fiscal 2004 we incurred charges of \$7.6 million relating to the completion of restructuring activities initiated in fiscal years 2001, 2002, and 2003.

Restructuring charges in fiscal 2003 were composed primarily of charges for actions taken in fiscal 2003 relating to accelerated depreciation and write downs of facilities of \$151.4 million, severance and outplacement costs of \$20.5 million, and long-term asset write downs and other costs of \$4.0 million. Facilities charges in fiscal 2003 included \$85.4 million for write-downs of facilities located in Rolling Meadows; Santa Clara; Ireland; and the U.K.; accelerated depreciation of \$34.3 million on certain Santa Clara facilities; a \$29.4 million loss on the sale of our Marlborough, Massachusetts facility; and lease termination costs of \$2.3 million. Restructuring charges in fiscal 2003 were the result of the consolidation of our real estate portfolio, the integration of the support infrastructure of our former Connectivity and Enterprise Networking segments, IT outsourcing efforts, and continued cost reduction

actions. Additionally, in fiscal 2003 we incurred charges of \$8.9 million relating to the completion of restructuring activities initiated in fiscal years 2001 and 2002.

Further actions may be taken if our business activity continues to decline and additional cost reduction efforts are necessary. In addition, a number of our facilities are classified as held for sale as a result of our restructuring program. Although these properties are being carried at their estimated net realizable values, additional write downs could result from changes in such values. As of May 30, 2004, the aggregate net realizable value of properties held for sale was \$42.1 million, and included properties located in Ireland and the U.K.

#### Loss on Investments, Net

During fiscal 2004, net losses on investments were \$10.9 million, reflecting \$16.1 million of write downs of long term equity investments partially offset by a gain of \$4.3 million recognized upon the sale of an investment in a privately-held company. In fiscal 2003, net losses on investments were \$36.1 million, including \$28.7 million of net losses recognized due to fair value adjustments of investments in limited partnership venture capital funds and write downs of investments in private companies for other-than-temporary declines in value and \$7.4 million of net losses realized on sales of publicly traded equity securities and investments in limited partnership venture capital funds.

#### Interest and Other Income, Net

Interest and other income, net, was \$15.9 million in fiscal 2004, a decrease of \$4.3 million compared to \$20.2 million in fiscal 2003. A decline in interest income accounted for \$14.3 million of this decline, primarily driven by lower interest rates applicable to short-tem investments and lower interest income relating to income tax refunds. We collected \$1.4 million and \$5.1 million of interest income in fiscal 2004 and 2003, respectively, relating to income tax refunds received in those years. Partially offsetting the decrease in interest income was lower interest expense that resulted from the repayment of borrowings, as well as lower charges related to warrants issued to Broadcom Corporation (Broadcom). In fiscal 2003, we recorded a charge of \$1.7 million in interest and other income, net, related to a one-year extension of the expiration date for the Broadcom warrants that was agreed in connection with our settlement of litigation with Broadcom. These warrants expired unexercised in December 2003.

#### Income Tax Provision (Benefit)

Our income tax benefit was \$3.1 million in fiscal 2004, compared to an income tax benefit of \$10.5 million in fiscal 2003. Included in our fiscal 2004 income tax benefit was an \$8.5 million benefit of a foreign net operating loss carryback. Offsetting this benefit was a tax provision for tax in certain foreign and domestic state jurisdictions. Included in our fiscal 2003 income tax benefit was a \$17.7 million benefit of a net operating loss carryback made possible by the Job Creation and Worker Assistance Act of 2002, and a \$15.6 million benefit that was recorded to offset the net tax provision for discontinued operations. Offsetting these benefits was a tax provision for certain foreign and domestic state jurisdictions.

#### Equity Interest in Loss of Unconsolidated Joint Venture

As described more fully above, we account for our investment in H-3C by the equity method. In fiscal 2004, we recorded a charge of \$4.6 million representing our share of the net loss from operations incurred by H-3C from the date of formation through March 31, 2004. In addition, at the time of formation of H-3C, we recorded a charge of \$12.6 million representing our ownership share (49 percent) of the value attributed to in-process technology contributed to H-3C by Huawei that had not yet reached technological feasibility and had no alternative future use. In fiscal 2004, our total reported loss related to H-3C was \$17.2 million.

### Discontinued Operations

Discontinued operations in fiscal 2004 and fiscal 2003 related to our CommWorks division that was sold in the fourth quarter of fiscal 2003. We recorded a loss of \$2.4 million in fiscal 2004 due to adjustments to previous estimates of liabilities related to the sale of CommWorks. Discontinued operations in fiscal 2003 included a gain on the sale of CommWorks of \$88.9 million, which was offset by \$17.1 million of taxes. Also included in fiscal 2003 were losses from operations of \$81.5 million, which were offset by a \$1.5 million tax benefit.

### *Comparison of fiscal years ended May 30, 2003 and May 31, 2002*

### Sales

Fiscal 2003 sales totaled \$932.9 million, a decrease of 26 percent from fiscal 2002 sales of \$1,259.0 million.

Sales of enterprise networking offerings in fiscal 2003 of \$682.2 million decreased 14 percent from sales in fiscal 2002 of \$791.6 million. The decrease resulted from a decline in sales of wireline data products, partially offset by moderate increases in sales of voice and wireless products. Within the wireline data product line, LAN revenue decreased by \$87.3 million, due to lower sales of shared hubs due to competition from low priced switches, and lower sales of our 3300 fixed-configuration switches which have matured. Also affecting the wireline data product line was a decline of \$25.0 million in sales of digital subscriber line (DSL) router products due to our withdrawal from this product line at the end of fiscal 2002. Sales of voice products were up \$8.3 million due to the overall growth in the market. Sales of wireless products experienced growth of \$5.0 million due to an increased demand for home office products. Service revenue declined by \$22.3 million due to fewer maintenance contract renewals.

Sales of desktop, mobile and server connectivity products in fiscal 2003 of \$242.6 million decreased 47 percent compared to sales in fiscal 2002 of \$456.9 million. The decline in sales as compared to the prior year was due largely to lower volumes, with unit shipments decreasing 45 percent compared to fiscal 2002, as well as to lower overall ASPs.

Factors that reduced volumes were a shift in the market from network interface card, personal computer (PC) card, and mini-peripheral component interconnect form factors to PC chipsets with embedded networking technology for which we have lower market share, as well as lower sales to our OEM partners. In addition to lower volumes, our overall ASPs decreased in fiscal 2003. Declining ASPs resulted primarily from intense price competition, but were mitigated to some degree by a favorable product mix shift towards Gigabit and security fiber products that carry higher ASPs, and a decrease in sales to OEMs, which normally have lower ASPs. Additionally, the decline in sales in fiscal 2003 was partially offset by the recognition of \$15.0 million of royalty revenue from a paid-up license resulting from settlement of patent litigation with Xircom, Inc.

### *By Geography*

U.S. sales represented approximately 35 percent of total sales in fiscal 2003, compared to approximately 37 percent in fiscal 2002, and decreased 31 percent when compared to fiscal 2002. International sales in fiscal 2003 decreased 23 percent when compared to fiscal 2002. The decline in sales of enterprise networking products described above was experienced primarily in the U.S. and in the Europe, Middle East, and Africa region, whereas the decline in sales of connectivity products was experienced primarily in the U.S. and in the Asia Pacific region.

Gross Margin

Gross margin as a percentage of sales increased 16.0 percentage points from 29.2 percent of sales in fiscal 2002 to 45.2 percent of sales in fiscal 2003. Significant components of the increase in gross margins were as follows:

Increase in standard-related margin	9.1%
Volume-related impacts	3.1
Duty refunds	1.3
Excess and obsolete inventory	2.2
Impact of royalty revenue	0.9
Other	(0.6)
	_____
Total	16.0%
	_____

The increase in standard-related margin was due largely to reductions in materials costs resulting from design changes and component cost improvements, and a mix shift towards higher margin products. Included in the mix shift was an increase in sales of connectivity products through the distribution channel versus sales to OEM customers, which generally have lower ASPs.

Volume-related impacts include lower manufacturing overhead costs due to reduced unutilized capacity and lower post-sale technical support costs as a percent of sales.

Year over year, gross margin in fiscal 2003 benefited from duty refunds of \$11.8 million. Gross margin in fiscal 2002 did not benefit from such items to any significant degree.

Year over year, gross margin in fiscal 2003 benefited from sales of inventory that had been written off in prior periods (\$4.9 million) and from lower provisions for excess and obsolete inventory (\$15.6 million). These provisions in fiscal 2002 were due largely to reduced demand for and discontinuance of certain desktop, mobile and server connectivity products.

Sales in fiscal 2003 included royalty revenue of \$15.0 million related to the settlement of litigation with Xircom. This revenue did not have any associated cost of sales.

Operating Expenses

Operating expenses in fiscal 2003 were \$646.4 million compared to \$780.5 million in fiscal 2002, or a net decrease of \$134.1 million. Included in the net decrease in operating expenses were decreases in research and development expenses of \$84.9 million, amortization and write down of intangibles expenses of \$76.3 million, sales and marketing expenses of \$30.8 million, general and administrative expenses of \$17.4 million, and loss on land and facilities of \$0.5 million. Partially offsetting these declines was an increase in restructuring charges of \$75.8 million.

As a percent of sales, total operating expenses in fiscal 2003 were 69.3 percent, compared to 62.0 percent in fiscal 2002. In aggregate, sales and marketing, research and development, and general and administrative expenses were 48.3 percent of sales in fiscal 2003, compared to 46.3 percent fiscal 2002, and decreased by \$133.2 million, net in fiscal 2003 compared to fiscal 2002. To a significant degree, these expenses are controllable and discretionary over time, but they are not directly variable with sales levels within a particular period. The most significant components of the decrease of \$133.2 million were reductions of \$58.5 million of direct employee and alternative workforce expenses, \$33.8 million of project and research related expenses such as project materials and depreciation on engineering assets, \$27.2 million of IT-related expenses, and \$5.0 million of spending on marketing and advertising. These decreases were the result of cost reduction actions primarily related to our restructuring initiatives, which included headcount reductions, IT outsourcing, long term asset write

offs, a decline in the number of research projects, and general spending reductions. Offsetting these decreases was an increase of \$6.8 million for legal and professional services.

A more detailed discussion of the factors affecting each major component of total operating expenses is provided below.

*Sales and Marketing.* Sales and marketing expenses in fiscal 2003 decreased \$30.8 million, or 11 percent, from fiscal 2002. Sales and marketing expenses as a percent of sales increased to 26.0 percent in fiscal 2003 compared to 21.7 percent in fiscal 2002. The largest factor in the decrease was direct employee-related expenses, and the second largest factor was IT-related expenses. Together, these two factors accounted for a majority of the reduction of sales and marketing expenses. The reduction in spending on marketing and advertising noted above was the third most significant contributing factor to the decrease in expenses.

*Research and Development.* Research and development expenses in fiscal 2003 decreased \$84.9 million, or 43 percent, compared to fiscal 2002. Research and development expenses as a percent of sales decreased to 12.1 percent in fiscal 2003 compared to 15.7 percent in fiscal 2002. The largest factor in the decrease was lower project and research related expenses such as project materials and depreciation on engineering assets, and the second largest factor was a decline in direct employee-related expenses. Together, these two factors accounted for a majority of the decrease in research and development expenses. The third most significant factor contributing to the decrease was IT-related expenses.

*General and Administrative.* General and administrative expenses in fiscal 2003 decreased \$17.4 million, or 16 percent, from fiscal 2002. As a percent of sales, general and administrative expenses increased to 10.2 percent in fiscal 2003 compared to 8.9 percent in fiscal 2002. A decline in direct employee-related expenses was the primary factor contributing to the \$17.4 million decrease. Reductions in IT-related spending were offset by increases in expenditures for legal and professional services in connection with litigation that we settled during the year and start-up activities related to H-3C.

*Amortization and Write Down of Intangibles.* Amortization and write down of intangibles were \$10.3 million and \$86.6 million for fiscal 2003 and 2002, respectively. Charges in 2003 included a \$3.2 million write down for the impairment of intangible assets related to the NBX acquisition, and \$7.1 million for amortization. Charges in 2002 included \$50.9 million of write downs for impairments of intangibles relating to the goodwill and developed product technology associated with the acquisition of Alteon, and \$35.7 million for amortization. Due to the adoption of Statement of Financial Accounting Standard (SFAS) 142 on June 1, 2002, we stopped amortizing goodwill in fiscal 2003. Fiscal 2002 included amortization of \$25.2 million relating to continuing operations. (Fiscal 2002 also included goodwill amortization of \$6.8 million that related to discontinued operations.)

*Restructuring Charges.* Restructuring charges in fiscal 2003 and fiscal 2002 were \$184.9 million and \$109.0 million, respectively. Restructuring charges for fiscal 2003 were composed primarily of charges for actions taken in fiscal 2003 relating to accelerated depreciation and write downs of facilities of \$151.4 million, severance and outplacement costs of \$20.5 million, and long-term asset write downs and other costs of \$4.1 million. Facilities charges in fiscal 2003 included \$59.2 million related to accelerated depreciation and impairments of facilities in Santa Clara, \$45.8 million relating to the impairment of our Rolling Meadows facility, a \$29.4 million loss on the sale of our Marlborough facility, write downs of properties in Ireland and the U.K. of \$7.5 million and \$7.2 million, respectively, and lease terminations of \$2.3 million. Restructuring charges for fiscal 2003 were the result of the consolidation of our real estate portfolio, the integration of the support infrastructure of our former Connectivity and Enterprise Networking segments, IT outsourcing efforts, and continued cost reduction actions. Additionally, in fiscal 2003, we incurred charges of \$8.9 million relating to the completion of restructuring activities initiated in fiscal years 2001 and 2002.

Restructuring charges for fiscal 2002 included \$47.8 million for facility-related charges, comprised of \$24.4 million in write downs of property held for sale, \$13.2 million for the loss on the sale of our Singapore manufacturing facility, and \$10.2 million for other facility charges; \$43.4 million for severance and outplacement costs; \$13.6 million for long-term asset write-downs; and \$4.4 million for other restructuring charges. These charges were the result of cost reduction actions we took to restructure our operations that were announced on December 21, 2000, as well as consolidation of our manufacturing facilities and the discontinuation of our consumer cable and DSL modem product lines as announced during June 2001. We also recorded a \$0.2 million benefit in fiscal 2002 relating to revisions of previous estimates of a restructuring initiative that had begun in the fourth quarter of fiscal 2000.

*Loss on Land and Facilities, Net.* The net loss on land and facilities in fiscal 2003 and fiscal 2002 was \$0.9 million and \$1.4 million, respectively. The net loss in both periods represented write downs of our Salt Lake City, Utah facility that was sold in the second quarter of fiscal 2003. This facility was classified as held for sale prior to the inception of our restructuring programs and, therefore, the related net losses were not the result of restructuring actions and were not recorded as a part of restructuring charges.

#### Loss on Investments, Net

During fiscal 2003, net losses on investments were \$36.1 million, including \$28.7 million of net losses recognized due to fair value adjustments of investments in limited partnership venture capital funds and write downs of investments in private companies for other-than-temporary declines in value and \$7.4 million of net losses realized on sales of publicly traded equity securities and investments in limited partnership venture capital funds. In fiscal 2002, net losses on investments were \$17.9 million, composed of \$30.5 million of net losses recognized due to fair value adjustments of investments in limited partnership venture capital funds and write downs of investments in private companies for other-than-temporary declines in value, offset by \$12.6 million of net gains realized on sales of publicly traded equity securities.

#### Interest and Other Income, Net

Interest and other income, net, was \$20.2 million in fiscal 2003, a decrease of \$47.2 million compared to \$67.4 million in fiscal 2002. A decline in interest income accounted for \$37.7 million of this decline, primarily driven by lower interest rates, and lower interest income relating to our fiscal 2002 income tax refund. We collected \$5.1 million and \$12.1 million of interest income in fiscal 2003 and 2002, respectively, relating to our fiscal 2002 income tax refund. Additionally, borrowing-related costs increased \$5.1 million in fiscal 2003 due mainly to higher average outstanding balances on our term loan and revolving line of credit as well as higher amortization of deferred loan costs, which included accelerated amortization relating to the early repayment of the term loan. Also, in fiscal 2003, we recorded a charge of \$1.7 million related to the one-year extension of the expiration date for the warrants issued to Broadcom.

#### Income Tax Provision (Benefit)

Our income tax benefit was \$10.5 million in fiscal 2003, compared to an income tax provision of \$89.9 million in fiscal 2002. Included in our fiscal 2003 income tax benefit was a \$17.7 million benefit of a net operating loss carryback made possible by the Job Creation and Worker Assistance Act of 2002, and a \$15.6 million benefit that was recorded to offset the net tax provision for discontinued operations. Offsetting these benefits was a tax provision for tax in certain foreign and domestic state jurisdictions. The fiscal 2002 tax provision was the result of write downs of the domestic deferred tax asset that had been previously supported by the appreciation in our real estate portfolio, as well as a provision for income taxes in foreign and domestic state jurisdictions.

Discontinued Operations

Discontinued operations in fiscal 2003 and fiscal 2002 related to our CommWorks business. Discontinued operations in fiscal 2003 included a gain on the sale of CommWorks of \$88.9 million, which was offset by \$17.1 million of taxes. Also included in fiscal 2003 were losses from operations of \$81.5 million, which were offset by a \$1.5 million tax benefit. The loss from operations in fiscal 2002 was \$142.3 million, net of taxes of \$1.4 million.

Cumulative Effect of Change in Accounting Principle

As a result of our adoption of SFAS 142, we conducted a transitional goodwill impairment evaluation of the \$66.5 million of goodwill recorded as of May 31, 2002 and wrote off goodwill totaling \$45.4 million relating to continuing operations as a change in accounting principle effective June 1, 2002. We also wrote off \$20.2 million of goodwill relating to the CommWorks business unit, which is included in discontinued operations.

**LIQUIDITY AND CAPITAL RESOURCES**

Cash and equivalents and short-term investments at May 28, 2004 were \$1,383.4 million, a decrease of approximately \$101.2 million compared to the balance of \$1,484.6 million at May 30, 2003.

Net cash used in operating activities was \$175.3 million for fiscal 2004, primarily reflecting our loss from continuing operations of \$346.9 million. We expect that cash flows from operating activities will continue to be negative during the first half of fiscal 2005, and possibly longer, primarily due to continuing net losses. There are no assurances that we can reduce our net losses and negative cash flow in the foreseeable future, or that we can raise capital as needed to fund our operations on an ongoing basis. However, based on current business conditions and our current operating and financial plans, but subject to the discussion in Business Environment and Industry Trends below, we believe that our existing cash and equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for at least the next 12 months. As a result of the aforementioned fiscal 2004 restructuring actions and related charges, and based on our current projections for revenue, costs and expenses, which are subject to significant uncertainty, we expect net cash flow from operations to be improved by approximately \$5 million per quarter from the levels reported for the fourth quarter of fiscal 2004. This improvement excludes the impact of cash disbursements to be made in settlement of liabilities accrued as of May 28, 2004.

Significant commitments that will require the use of cash in future periods include obligations under lease, contract manufacturing, royalty and patent licensing, IT outsourcing, and guarantee agreements, as shown in the following table (in thousands):

Contractual Obligations	Payments due by Period				
	Total	Less than one year	1-3 years	3-5 years	More than 5 years
Operating leases	\$ 56,648	\$ 19,020	\$ 27,542	\$ 4,331	\$ 5,755
Purchase commitments with contract manufacturers(1)	94,300	94,300			
Royalty and patent licenses	22,100	10,100	12,000		
IT outsourcing agreements(2)	49,300	5,646	11,293	9,896	22,465
Guarantees(3)	4,085	3,951	134		
<b>Total</b>	<b>\$ 226,433</b>	<b>\$ 133,017</b>	<b>\$ 50,969</b>	<b>\$ 14,227</b>	<b>\$ 28,220</b>

- (1) We have entered into purchase agreements with our contract manufacturers. Pursuant to these agreements, if our actual orders and purchases fall below forecasted levels, we may be required to



## Edgar Filing: 3COM CORP - Form 10-K

purchase finished goods inventory manufactured to meet our requirements. In addition, we may be required to purchase raw material and work in process inventory on-hand that is unique to our products, and we may be required to compensate the contract manufacturers with respect to their non-cancelable purchase orders for such inventory. The amount shown in the table above represents our estimate of inventory held by contract manufacturers at May 28, 2004 that we could be required to purchase within the next 12 months. We do not expect any such required purchases to exceed our requirements for inventory to meet expected sales of our products to our customers.

(2)

Under our IT outsourcing agreements, we are subject to service level commitments providing for annual minimum payments that vary depending on the service levels we choose. The amounts shown in the table above represent the amounts that would be payable, based on current service levels, through the expiration of the agreements. However, the agreements may be terminated at any time upon 120 days notice, subject to early termination penalties that decline over time. If we were to terminate the agreements at the end of the first quarter of fiscal 2005, such penalties would be approximately \$3.4 million.

(3)

We have several agreements whereby we have sold products to resellers who have, in turn, sold the products to end users, and we have guaranteed the payments of the end users to our customers. Since deferred revenue and accrued liabilities 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.

Net cash provided by investing activities was \$106.1 million for fiscal 2004, including \$147.2 million of net proceeds related to sales, maturities and purchases of debt and equity securities, and \$118.8 million of net proceeds related to sales and purchases of fixed assets, partially offset by our \$160.0 million investment in H-3C. For the fiscal years ended May 28, 2004 and May 30, 2003, we made investments totaling \$904.9 million and \$1,283.5 million, respectively, in municipal and corporate bonds and government agency instruments, as well as investments totaling \$4.0 million and \$6.8 million, respectively, in equity securities. For the fiscal years ended May 28, 2004 and May 30, 2003, proceeds from maturities and sales of municipal and corporate bonds and government agency instruments were \$1,047.1 million and \$1,009.2 million, respectively, and proceeds from the sales of equity investments totaled \$9.0 million and \$9.2 million, respectively.

Our investments in equity securities include investments made by 3Com Ventures. Through 3Com Ventures, we selectively make strategic investments in privately held companies and in limited partnership venture capital funds, which in turn invest in privately held companies. These investment activities are entered into with the intention of complementing our business strategies and research and development efforts, and may include a strategic commercial or technology relationship, such as a component supply agreement or technology license arrangement, with these privately held companies. We made strategic investments of \$3.9 million in fiscal 2004 and have committed to make additional capital contributions to venture capital funds totaling \$9.0 million. We are contractually obligated to provide funding upon calls for capital. The expiration dates for such capital calls are generally five to eight years from the inception of the fund, and the amounts and timing of such calls during that period are at the discretion of the funds' general partners. Based upon projections provided by the funds' general partners, we estimate that we will pay approximately \$5.1 million over the next 12 months as capital calls are made.

During fiscal 2004, we collected \$134.9 million from sales of property and equipment, primarily relating to the sale of our Rolling Meadows facility and certain properties in Santa Clara. Also, during this same period, we made \$16.0 million in capital expenditures. As of May 28, 2004, capital expenditure commitments outstanding were not material.

Net cash provided by financing activities was \$128.5 million for fiscal 2004, which included proceeds of \$120.4 million from the issuance of common stock and \$8.4 million from collection of the final

installments due under a note receivable related to the sale of warrants to Broadcom during fiscal 2002, offset by \$0.3 million for payments due under capital leases. During fiscal 2004, there were no borrowings or repayments under our revolving line of credit. As of May 28, 2004, total available borrowings under the revolving line of credit were \$23.5 million, net of bank-issued standby letters of credit and guarantees that are supported by this credit arrangement. As of May 28, 2004, such bank-issued standby letters of credit and guarantees totaled \$9.2 million, including \$8.3 million relating to potential foreign tax, custom, and duty assessments.

During fiscal 2004, we issued approximately 24.9 million shares of our common stock in connection with our employee stock purchase and option plans. As indicated above, total proceeds from such issuances were \$120.4 million. As of May 28, 2004, our outstanding stock options as a percentage of outstanding shares were 14 percent. This potential dilution is mainly the result of our distribution of Palm, Inc. common stock in the first quarter of fiscal 2001. As a result of the distribution, the number of shares of 3Com common stock subject to option grants was adjusted to preserve the intrinsic value of the stock options, resulting in an increase of 134 million options, and bringing the total option shares outstanding to 169 million at the time of the distribution. We have closely managed new options grants during recent fiscal years with the goal of reducing the potential dilution associated with outstanding stock options. As a result of these efforts, as well as the effects of option exercises and cancellations, the total number of outstanding options has been reduced approximately 66 percent since the Palm distribution. In addition, the total number of options available for future grants was reduced by 108 million shares due to approval of a proposal submitted to our stockholders at our annual stockholder meeting in September 2003.

Our current stock repurchase authorization permits expenditures of up to \$100.0 million through March 2005. We did not repurchase shares of our common stock under this program in fiscal 2004. However, we began repurchasing shares of our common stock pursuant to this authorization in the first quarter of fiscal 2005, and we may use cash to repurchase additional shares in future periods.

#### **EFFECTS OF RECENT ACCOUNTING PRONOUNCEMENTS**

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation Number 46 (FIN 46), "Consolidation of Variable Interest Entities". FIN 46 establishes accounting guidance for consolidation of a variable interest entity, formerly referred to as a special purpose entity. In December 2003, the FASB issued FIN 46(R), which deferred the effective date of FIN 46 for certain variable interest entities created before February 1, 2003 to the first interim or annual reporting period that ends after March 15, 2004. We determined that FIN 46 and FIN 46(R) are not applicable to any of our investments.

#### **BUSINESS ENVIRONMENT AND INDUSTRY TRENDS**

Industry trends and specific risks may affect our future business and results. The matters discussed below could cause our future results to differ from past results or those described in forward-looking statements and could have a material adverse effect on our business, financial condition, results of operations and stock price.

*We have incurred significant net losses in recent fiscal periods, including \$349 million, \$284 million and \$596 million in fiscal years 2004, 2003 and 2002, respectively, and we may not be able to return to profitability.*

We incurred a net loss of \$349 million for fiscal 2004, and net losses of \$284 million and \$596 million in fiscal 2003 and 2002, respectively. Although we are taking steps designed to improve our results of operations, we cannot assure you that we will return to profitability.

## Edgar Filing: 3COM CORP - Form 10-K

We have faced a number of challenges that have affected our operating results over the last several fiscal years. Specifically, we have experienced, and may continue to experience, the following:

declining revenue due to price competition and reduced incoming order rate;

increased risk of excess and obsolete inventories;

excess facilities;

operating expenses that, as a percentage of revenue, have exceeded our desired financial model; and

disruptions resulting from our workforce reductions and employee attrition.

***We entered into a joint venture in China with Huawei that, if not successful, could materially and adversely impact our business, business prospects and operating results.***

In November 2003, we announced the formation of a joint venture for enterprise networking products with Huawei, a leading Chinese company. 3Com currently has a 49 percent minority interest in H-3C, which is domiciled in Hong Kong has its principal operations in Hangzhou and Beijing, China. Pursuant to the joint venture agreements, 3Com has the right to market and support the H-3C products under the 3Com brand in all countries except China and Japan. In China and Japan, the joint venture will sell products sourced internally as well as from 3Com and Huawei under H-3C's brand as well as the 3Com brand and the Huawei brand. H-3C commenced operations in November 2003. We began reflecting our share of the operating results of H-3C in our operating results in the third quarter of fiscal 2004.

The business of H-3C is subject to all of the operational risks that normally arise for a technology company with global operations pertaining to research and development, manufacturing, sales, service, marketing, and corporate functions. In addition, there could be disagreements between 3Com and Huawei with respect to important strategic and operational decisions. A key factor in the success of H-3C is that product sourced from it remains competitive over time particularly with respect to features, performance, quality and cost. For example, one factor that could affect cost competitiveness is future adverse exchange rate movements between H-3C's local currency of operations and the U.S. Dollar. In addition, competition in the enterprise networking market will involve challenges from numerous, well-established companies with substantial resources and significant market share.

Our business, business prospects and operating results have dependencies upon the success of H-3C. In particular, our product development activities will become increasingly interdependent with those of H-3C. If H-3C and our transactions with it are not successful, we may not introduce new products needed to broaden our high-end enterprise networks product line, which may adversely affect our revenue and overall results of operations. Even if H-3C is successful, there may be disruption to our existing distribution channels and conflicts with our current channel partners resulting from the establishment of H-3C's operations and distribution arrangements.

***Our competition with Huawei in the enterprise networking market could have a material adverse affect on our revenue and our results of operations.***

As Huawei expands its international operations, there will be increasing instances where we compete directly with Huawei in the enterprise networking market. We expect to be able to compete effectively with Huawei in this market as a result of our strengths in a number of areas including our brand identity, breadth of products and solutions offerings, and professional services capabilities. We also are free to engineer derivative models of products sourced from H-3C that would not be available to Huawei or other H-3C customers. However, as a co-owner and OEM customer of H-3C, Huawei will have access to many of H-3C's products just as we do, thereby enhancing Huawei's current ability to

compete directly with us in markets outside of China and Japan. If this occurs, we could lose a competitive advantage in those markets, which could have a material adverse effect on our revenue and overall results of operations.

***Our strategy of outsourcing functions and operations may fail to reduce cost and may disrupt our operations.***

We continue to look for ways to decrease cost and improve efficiency by contracting with other companies to perform functions or operations that we, in the past, have performed ourselves. We rely on outside vendors to meet a significant portion of our IT and manufacturing needs. In the third quarter of fiscal 2004, we completed the outsourcing of all manufacturing of our products. To achieve more cost savings or operational benefits, we may expand our outsourcing activities where we believe a third party may be able to provide those services in a more efficient manner. Although we believe that outsourcing will result in lower costs and increased efficiencies, this may not be the case. Because these third parties may not be as responsive to our needs as we would be ourselves, outsourcing increases the risk of disruption to our operations. In addition, our agreements with these third parties sometimes include substantial penalties for terminating such agreements early or failing to maintain minimum service levels. Because we cannot always predict how long we will need the services or how much of the services we will use, we may have to pay these penalties or incur costs that are no longer competitive if our business conditions change.

***We may not be able to compensate for lower revenue or unexpected cash outlays with cost reductions sufficient to generate positive net income or cash flow.***

Although we have implemented strict cost and expense reductions, if we are unable to achieve our growth objectives, we will need to further reduce costs which may in turn reduce our revenue. If we are not able to effectively reduce our costs and expenses commensurate with, and at the same pace as, any further deterioration in our revenue, we may not be able to generate positive net income or cash flow from operations. If we continue to experience negative cash flow from operations over a prolonged period of time, our liquidity and ability to operate our business effectively could be adversely affected. For example, our ability to raise financial capital may be hindered due to the possibility of continuing net losses and negative cash flow in the future. An inability to raise financial capital would limit our operating flexibility.

We are unable to predict the exact amount of cost reductions required for us to generate positive net income or cash flow from operations because we cannot accurately predict the amount of our future revenue. Our future revenue depends, in part, on future economic and market conditions, which we are unable to forecast accurately. Although we cannot accurately predict the amount of our future revenue overall, we expect that revenue from sales of desktop, mobile and server connectivity products, which represented approximately 16 percent of total revenue for fiscal 2004, will decline further due to pricing pressures and technological changes and trends in the networking industry.

***Our increasing reliance on***