3COM CORP
Form 10-Q
October 05, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended August 27, 2004

OR

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

For the transition period from to

Commission File No. 0-12867

3Com Corporation

(Exact name of registrant as specified in its charter)

Delaware	**94-2605794**

(State or other jurisdiction of incorporation or organization)	(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**

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

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

Yes ý No o

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

Yes ý No o

As of September 24, 2004, 379,437,437 shares of the registrant s Common Stock were outstanding.

This report contains a total of 43 pages of which this page is number 1.

3Com Corporation

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PART I. FINANCIAL INFORMATION

Item 1. **Financial Statements**

3Com Corporation

Condensed Consolidated Statements of Operations

(Unaudited)

(In thousands, except per share data)	Three Months Ended August 27, 2004	August 29, 2003
Sales	$ 162,349	$ 161,879
Cost of sales	100,254	111,935
Gross margin	62,095	49,944
Operating expenses:		
Sales and marketing	55,099	62,607
Research and development	22,435	26,927
General and administrative	15,672	24,139
Amortization and write down of intangibles	1,014	3,387
Restructuring charges	2,784	48,624
Total operating expenses	97,004	165,684
Operating loss	(34,909)	(115,740)
Gains on investments, net	433	58
Interest and other income, net	1,033	3,944
Loss from continuing operations before income taxes, equity interests and discontinued operations	(33,443)	(111,738)
Income tax provision (benefit)	(465)	(6,035)
Equity interest in loss of unconsolidated joint venture	(2,567)	
Loss from continuing operations before discontinued operations	(35,545)	(105,703)
Discontinued operations, net of taxes		(291)
Net loss	$ (35,545)	$ (105,994)
Basic and diluted net loss per share:		
Continuing operations	$ (0.09)	$ (0.29)
Discontinued operations		
Net loss	$ (0.09)	$ (0.29)
Shares used in computing net loss per share amounts (basic and diluted):	387,585	367,879

See notes to condensed consolidated financial statements.

3Com Corporation

Condensed Consolidated Balance Sheets

(Unaudited)

(In thousands, except par value)	**August 27, 2004**	**May 28, 2004**
ASSETS		
Current assets:		
Cash and equivalents	$ 439,776	$ 575,824
Short-term investments	823,857	807,532
Accounts receivable, net	63,423	66,372
Inventories	23,403	27,679
Other current assets	44,677	42,270
Total current assets	1,395,136	1,519,677
Investment in Huawei-3Com joint venture	140,324	142,891
Property and equipment, net	71,591	72,452
Property and equipment held for sale	44,758	42,147
Deposits and other assets	33,526	34,806
Deferred income taxes	2,890	2,937
Intangible assets, net	3,995	5,009
Goodwill	899	899
Total assets	$ 1,693,119	$ 1,820,818
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 67,962	$ 80,408
Accrued liabilities and other	215,628	226,161
Total current liabilities	283,590	306,569
Deferred revenue and long-term obligations	13,522	15,135
Stockholders equity:		
Preferred stock, $.01 par value, 10,000 shares authorized; none outstanding		
Common stock, $.01 par value, 990,000 shares authorized; shares issued: 393,545 and 392,738, respectively	2,266,898	2,262,223
Treasury stock, at cost, 14,195 and 0 shares, respectively	(69,506)	
Unamortized stock-based compensation	(5,701)	(2,577)
Retained deficit	(790,789)	(755,244)
Accumulated other comprehensive loss	(4,895)	(5,288)
Total stockholders equity	1,396,007	1,499,114
Total liabilities and stockholders equity	$ 1,693,119	$ 1,820,818

See notes to condensed consolidated financial statements.

3Com Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Three Months Ended August 27, 2004	August 29, 2003
Cash flows from operating activities:		
Loss from continuing operations	$ (35,545)	$ (105,703)
Adjustments to reconcile loss from continuing operations to cash (used in) operating activities:		
Loss from discontinued operations		(291)
Depreciation and amortization	12,388	26,637
Write down of intangibles		1,905
(Gains) loss on property and equipment	(2,680)	24,291
(Gains) on investments, net	(433)	(58)
Deferred income taxes	47	310
Stock-based compensation expense	652	298
Purchased in-process technology	1,675	
Equity interest in loss of unconsolidated joint venture	2,567	
Changes in current assets and liabilities:		
Accounts receivable	2,949	6,681
Inventories	2,053	(836)
Other assets	(1,523)	2,002
Accounts payable	(12,446)	(9,403)
Accrued liabilities and other	(19,660)	17,295
Income taxes payable	7,868	(4,170)
Net cash (used in) operating activities	(42,088)	(41,042)
Cash flows from investing activities:		
Purchase of investments	(231,987)	(226,854)
Proceeds from maturities and sales of investments	211,717	257,986
Purchase of property and equipment	(3,450)	(4,207)
Purchase of technology assets	(1,675)	
Proceeds from sale of property and equipment	203	37,233
Net cash provided by (used in) investing activities	(25,192)	64,158
Cash flows from financing activities:		
Issuance of common stock	4,758	9,378
Repurchase of common stock	(73,365)	
Collection of note receivable issued for warrants		4,211
Repayments of long-term borrowings		(173)
Net cash provided by (used in) financing activities	(68,607)	13,416
Effect of exchange rate changes on cash and cash equivalents	(161)	17
Increase (decrease) in cash and equivalents	(136,048)	36,549
Cash and equivalents, beginning of period	575,824	515,848

Cash and equivalents, end of period	$	439,776	$	552,397

See notes to condensed consolidated financial statements.

3Com Corporation

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 1. Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments necessary for a fair presentation of our financial position as of August 27, 2004, and our results of operations and cash flows for the three months ended August 27, 2004 and August 29, 2003.

We use a 52 or 53-week fiscal year ending on the Friday nearest to May 31. The results of operations for the three months ended August 27, 2004 may not be indicative of the results to be expected for the fiscal year ending June 3, 2005. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in our Annual Report on Form 10-K for the fiscal year ended May 28, 2004.

Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 is effective for fiscal periods beginning after June 15, 2003; for us, EITF 00-21 became effective for the second quarter of fiscal 2004. The adoption of EITF 00-21 did not have a material effect on our financial position or results of operations.

In December 2003, the SEC released Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104). SAB 104 clarifies existing guidance regarding revenue for contracts which contain multiple deliverables to make it consistent with EITF No. 00-21. The adoption of SAB 104 did not have a material effect on our financial position or results of operations.

Note 2. Discontinued Operations

On March 4, 2003, we entered into an agreement (Asset Purchase Agreement) to sell selected assets and liabilities of our CommWorks division to UTStarcom, Inc. in exchange for $100.0 million in cash, subject to certain closing adjustments. On May 23, 2003, we completed the sale pursuant to the terms of the Asset Purchase Agreement. As a result, we reported the CommWorks division as a discontinued operation beginning in the fourth quarter of fiscal 2003 and restated all prior periods presented on a comparative basis. The loss from discontinued operations for the first quarter of fiscal 2004 resulted from adjustments to previous estimates of liabilities

related to the sale of the CommWorks division.

Note 3. Stock-Based Compensation

We have stock option plans under which employees and directors may be granted options to purchase common stock. Options generally are granted with exercise prices at not less than the fair market value at the date of the grant, vest annually over two to four years, and expire seven to ten years after the grant date. In September 2003, our stockholders approved the 2003 Stock Plan (the new plan), which replaced the 1983 Stock Option Plan, the 1994 Stock Option Plan, the Director Plan, and the Restricted Stock Plan (the prior plans) for all stock awards granted subsequent to the approval date. In connection with the approval of the new plan, we cancelled all shares available for issuance under the prior plans (other than those shares underlying outstanding awards), which included approximately 128 million shares at the time of approval; at the same time, 20 million shares were reserved for issuance under the new plan.

As discussed above, our 2003 Stock Plan replaced the Restricted Stock Plan for the issuance of restricted stock. Restricted stock represents shares of common stock that have been issued at no cost to key employees, and that vest generally over a one to four-year period and are subject to our right to reacquire those shares upon such person s termination of employment to the extent that such right has not lapsed. We also grant time accelerated restricted stock awards whereby shares with a specified time-based vesting period may be accelerated if specific performance milestones are achieved.

We also have an employee stock purchase plan (ESPP) under which eligible employees may authorize payroll deductions of up to ten percent of their compensation, as defined, to purchase common stock at a price of 85 percent of the lower of the fair market value as of the beginning or the end of the six-month offering period. In September 2003, our stockholders approved an increase of five million shares available for issuance under the ESPP.

As permitted under Statement of Financial Accounting Standards (SFAS) 123, Accounting for Stock-Based Compensation, we follow Accounting Principles Board (APB) Opinion 25 and related Interpretations in accounting for stock-based awards to employees. Under APB Opinion 25, compensation expense associated with employee stock awards is measured as the difference, if any, between the price to be paid by an employee and the fair value of the underlying common stock on the grant date, which usually is the measurement date for accounting purposes. Generally, we recognize no compensation expense with respect to stock-based option awards and stock issued under the ESPP. However, to the extent that we modify an employee s stock options in connection with our restructuring activities (for example, by extending the period of time permitted for exercising a stock option following an employee s involuntary termination), we record compensation expense attributable to the modifications at the time the related severance cost is recorded. Also, we record compensation expense related to restricted stock over the applicable vesting period; such compensation expense is measured as the fair market value of the restricted stock at the date of the grant. Total stock-based compensation expense was $0.7 million and $0.3 million for the fiscal quarters ended August 27, 2004 and August 29, 2003, respectively.

SFAS 123 requires disclosure of the pro forma effects on our reported net loss and net loss per share of applying the fair value recognition provisions of SFAS 123 to stock-based employee compensation. The following table illustrates such pro forma effects for the fiscal quarters ended August 27, 2004 and August 29, 2003:

	Three Months Ended			
(In thousands, except per share amounts)		**August 27, 2004**		**August 29, 2003**
Net loss as reported	$	(35,545)	$	(105,994)
Add: Stock-based compensation included in reported net loss		652		298
Deduct: Stock-based compensation determined under fair value-based method, net of related tax effects		(4,512)		(5,277)
Pro forma net loss	$	(39,405)	$	(110,973)
Net loss per share:				
As reported basic and diluted	$	(0.09)	$	(0.29)
Pro forma basic and diluted		(0.10)		(0.30)

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

The fair values of ESOs granted during the first quarters of fiscal 2005 and fiscal 2004 have been estimated as of the date of grant using the Black-Scholes option pricing model. The assumptions used

in preparing the estimates and the resulting fair values are shown below:

	Three Months Ended	
	August 27, 2004	August 29, 2003
Volatility	57%	67%
Risk-free interest rate	3.3%	2.6%
Dividend yield	0.0%	0.0%
Estimated average life (years after vesting date)	1.5	1.5
Fair value per share	$ 2.24	$ 2.66

During the first quarters of fiscal 2005 and fiscal 2004, there were no shares issued under the ESPP.

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because our stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, our management believes that the existing models do not necessarily provide a reliable single measure of the fair value of our stock options.

Note 4. Restructuring Charges

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

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

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

Restructuring charges related to these various initiatives in the first quarters of fiscal 2005 and fiscal 2004 were $2.8 million and $48.6 million, respectively. Such charges were net of credits of $4.9 million and $0.8 million in the first quarters of fiscal 2005 and fiscal 2004, respectively, related primarily to revisions of previous estimates of employee separation expenses, lease obligation costs, and values on held for sale properties.

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

Fiscal 2005 Actions

The following table provides a summary of the components of accrued restructuring charges related to the restructuring actions initiated in the first quarter of fiscal 2005, together with changes in the accrued amounts during the first quarter of fiscal 2005 and the ending balances as of August 27, 2004 (in thousands):

	Employee Separation Expenses	Facilities-related Charges	Other Restructuring Costs	Total
Balance at May 28, 2004	$	$	$	$
Provision	5,439	59	333	5,831
Payments and non-cash charges	(2,192)	(59)	(333)	(2,584)
Balance at August 27, 2004	$ 3,247	$	$	$ 3,247

Employee separation expenses include severance pay, outplacement services, and medical and other related benefits. The reduction in workforce affected employees mainly in the sales and marketing, supply chain, and general and administrative functions. The total reduction in workforce associated with actions initiated during the first quarter of fiscal 2005 includes approximately 40 employees. Separation payments associated with actions initiated during the first quarter of fiscal 2005 totaled $3.2 million through August 27, 2004.

Facilities-related charges include costs associated with vacating leased offices in fiscal 2005. Other restructuring costs relate mainly to obligations associated with the termination of service agreements.

Fiscal 2004 Actions

The following table provides a summary of the components of accrued restructuring charges related to the restructuring actions initiated in fiscal 2004, together with changes in the accrued amounts during the first quarter of fiscal 2005 and the ending balances as of August 27, 2004 (in thousands):

	Employee Separation Expenses	Facilities-related Charges	Other Restructuring Costs	Total
Balance at May 28, 2004	$ 5,529	$ 530	$	$ 6,059
Provision (benefit)	(2,208)	(2,455)	192	(4,471)
Payments and non-cash charges	(2,596)	2,600	(192)	(188)
Balance at August 27, 2004	$ 725	$ 675	$	$ 1,400

The net benefit recorded in the first quarter of fiscal 2005 for employee separation expenses related to revisions of previous estimates of employee separation expenses. The reduction in workforce affected employees in the sales and marketing, customer support, manufacturing, research and development, and general and administrative functions. The total reduction in workforce associated with actions initiated during

fiscal 2004 included approximately 1,300 employees who had been separated. Since the inception of this restructuring initiative, $55.0 million of separation payments have been made through August 27, 2004.

Facilities-related charges in the first quarter of fiscal 2005 relating to restructuring actions initiated in fiscal 2004 were the result of revisions in estimates of lease obligation costs. Additionally, in the first quarter of fiscal 2005, we recorded a $2.6 million benefit related to fair value adjustments of properties classified as held for sale.

Fiscal 2003 Actions

The following table provides a summary of the components of accrued restructuring charges related to

the restructuring actions initiated in fiscal 2003, together with changes in the accrued amounts during the first quarter of fiscal 2005 and the ending balances as of August 27, 2004 (in thousands):

	Facilities-related Charges	Total
Balance at May 28, 2004	$ 2,566	$ 2,566
Provision	221	221
Payments and non-cash charges	(360)	(360)
Balance at August 27, 2004	$ 2,427	$ 2,427

Facilities-related charges in the first quarter of fiscal 2005 relating to restructuring actions initiated in fiscal 2003 were the result of revisions in estimates of lease obligation costs.

Fiscal 2001 and Fiscal 2002 Actions

The following table provides a summary of the components of accrued restructuring charges related to the restructuring actions initiated in fiscal 2001 and fiscal 2002, together with changes in the accrued amounts during the first quarter of fiscal 2005 and the ending balances as of August 27, 2004 (in thousands):

	Facilities-related Charges	Other Restructuring Costs	Total
Balance at May 28, 2004	$ 6,723	$ 82	$ 6,805
Provision	1,203		1,203
Payments and non-cash charges	(1,320)	(31)	(1,351)
Balance at August 27, 2004	$ 6,606	$ 51	$ 6,657

Additional facilities-related charges were the result of changes in estimates associated with various lease obligations. Other restructuring costs relate mainly to obligations associated with the termination of service agreements.

Note 5. Investment in Unconsolidated Joint Venture

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

At the time of formation, we contributed cash, assets related to our operations in China and Japan, and licenses related to certain intellectual property in exchange for 49 percent ownership interest. We recorded our initial investment in H-3C at $160.1 million, reflecting the carrying value of the assets contributed. Huawei contributed its enterprise networking business assets including Local Area Network (LAN) switches and routers; engineering, sales, and marketing resources and personnel; and licenses to its related intellectual property in exchange for a 51 percent ownership interest. Huawei s contributed assets were valued at $178.2 million at the time of formation. Two years after formation of H-3C, we have the one-time option to purchase an additional two percent ownership interest from Huawei for an amount not to exceed $28 million. Three years after formation of H-3C, we and Huawei each have the right to purchase all of the other partner s ownership interest through a bid process.

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

income or loss based on H-3C s financial statements for the most recent calendar quarter, two months in arrears. In determining our share of H-3C s net income or loss, we make certain adjustments to H-3C s reported results. Such adjustments are made primarily to recognize the value and related amortization expense associated with Huawei s contributed assets, as well as to defer H-3C s sales and gross profit on sales of products sold to us that remained in our inventory at the end of the accounting period. During the first quarter of fiscal 2005, we recorded a loss of $2.6 million related to our share of H-3C s net loss, as adjusted as described above, for the quarter ended June 30, 2004; this loss is included in the accompanying Condensed Consolidated Statement of Operations under the caption Equity interest in loss of unconsolidated joint venture. The carrying value of our investment in H-3C as of August 27, 2004 was $140.3 million.

Summarized financial information for H-3C as of and for the quarter ended June 30, 2004, as adjusted as described above, is as follows (in thousands):

		June 30, 2004
Balance Sheet:		
Current assets	$	241,197
Non-current assets		158,428
Current liabilities		85,780
Non-current liabilities		8,866
Statement of Operations:		
Sales	$	62,700
Gross margin		24,590
Net loss		5,239

We and H-3C are parties to agreements providing for the sale of certain products between the two companies. During the first quarter of fiscal 2005, we reported sales of products to H-3C of $3.6 million and made purchases of products from H-3C of $1.9 million. As of August 27, 2004, our accounts receivable and accounts payable included $1.9 million and $1.9 million, respectively, related to transactions with H-3C. Also, as of August 27, 2004, we had deferred approximately $0.1 million related to sales of products to H-3C that had not yet been shipped to H3-C s end customers.

Note 6. Comprehensive Loss

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

	Three Months Ended			
		August 27, 2004		August 29, 2003
Net loss	$	(35,545)	$	(105,994)
Other comprehensive income (loss):				
Net unrealized gain (loss) on available-for-sale securities		264		(1,023)
Net unrealized gain on cash flow hedges		288		
Change in accumulated translation adjustments		(161)		17

Total comprehensive loss	$	(35,154)	$	(107,000)

Note 7. Net Loss Per Share

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

	Three Months Ended	
	August 27, 2004	August 29, 2003
Loss from continuing operations	$ (35,545)	$ (105,703)
Loss from discontinued operations		(291)
Net loss	$ (35,545)	$ (105,994)
Weighted average shares-basic	387,585	367,879
Effect of dilutive securities:		
Employee stock options		
Restricted stock		
Weighted average shares-diluted	387,585	367,879
Net loss per share-basic and diluted:		
Continuing operations	$ (0.09)	$ (0.29)
Discontinued operations		
Net loss	$ (0.09)	$ (0.29)

Employee stock options and restricted stock, totaling 3.6 million and 2.6 million shares for the three months ended August 27, 2004 and August 29, 2003, respectively, were not included in the diluted weighted average shares calculation because the effects of these securities were antidilutive.

Note 8. Inventories

Inventories consist of (in thousands):

	August 27, 2004	May 28, 2004
Finished goods	$ 21,835	$ 25,869
Work-in-process	609	485
Raw materials	959	1,325
Total inventory	$ 23,403	$ 27,679

Note 9. Property and Equipment

Property and equipment held for sale as of August 27, 2004 and May 28, 2004 includes land, buildings and equipment in Ireland and the U.K.

In July 2003, we completed the sale of our 511,000 square foot office and research and development facility in Rolling Meadows, Illinois. Net proceeds from the sale were $35.8 million, resulting in a loss on the sale of $1.1 million that was recorded in restructuring charges in the first quarter of fiscal 2004. As part of the terms of the transaction, we entered into an agreement to lease back approximately 43,000 square feet of space at then-prevailing market rates.

Note 10. Intangible Assets, Net

Intangible assets, net, consist of (in thousands):

	August 27, 2004	May 28, 2004
Intangible assets, gross	$ 37,156	$ 37,156
Accumulated amortization	(33,161)	(32,147)
Total intangible assets, net	$ 3,995	$ 5,009

In the first quarter of fiscal 2004, we recorded an impairment of intangible assets, consisting mainly of developed and core technology, associated with our acquisition of the Gigabit Ethernet network interface card business of Alteon Websystems in fiscal 2001. We determined the amount of the impairment by comparing the carrying value of the intangible assets against the fair value, which was estimated as the present value of expected future net cash flows discounted at a rate of ten percent per year. The impairment resulted from reduced sales and gross margin projections as compared to the initial projections at the time of the acquisition, due to the earlier-than-expected discontinuance of an acquired product. As a result of the impairment analysis, we recorded a write down of $1.9 million, which is included in the caption amortization and write down of intangibles in the condensed consolidated statements of operations.

Based on the carrying value of our intangible assets as of August 27, 2004, amortization expense is expected to be $2.3 million for the remainder of fiscal 2005 and $1.7 million for fiscal 2006.

Note 11. Accrued Warranty and Other Guarantees

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

The following table summarizes the activity in the allowance for estimated warranty costs for the three months ended August 27, 2004 and August 29, 2003 (in thousands):

	First three months of fiscal 2005	First three months of fiscal 2004
Accrued warranty, beginning of period	$ 43,825	$ 44,775
Provision for warranties related to products sold during the period	7,896	8,881

Cost of warranty claims processed during the period	(9,124)	(8,495)
Adjustments to preexisting warranties		130
Accrued warranty, end of period	$ 42,597	$ 45,291

Prior to fiscal 2003, we entered into several agreements whereby we had sold products to resellers who had, in turn, sold the products to others, and we guaranteed the payments of the end users. If all end users under these agreements were to default on their payments as of August 27, 2004, we would be required to pay approximately $2.4 million. However, 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.

In connection with the development of our Rolling Meadows facility, we guaranteed a municipal bond in

the amount of $2.5 million for site improvements. Our obligation pursuant to the guarantee had been accrued as of May 30, 2003, and was repaid in connection with the completion of the sale of the Rolling Meadows facility in the first quarter of fiscal 2004. As of August 27, 2004, our liabilities included $2.8 million for similar obligations related to various other facilities that we have vacated.

Note 12. Stockholders Equity

In the first quarter of fiscal 2005, we repurchased approximately 15.0 million shares of our common stock at a total cost of $73.4 million. These repurchases were made pursuant to the stock repurchase program that was approved by our Board of Directors in March 2003, and that authorizes expenditures of up to $100.0 million during a two-year period through March 2005. At August 27, 2004, approximately $26.6 million of the authorization remains available for future repurchases.

Note 13. Business Segment Information

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

Although we operate as a single, integrated business as discussed above, certain product groups accounted for a significant portion of our sales. For the three months ended August 27, 2004 and August 29, 2003, sales of significant products were as follows:

	Three Months Ended August 27, 2004		Three Months Ended August 29, 2003	
Products	**Sales**	**Sales %**	**Sales**	**Sales %**
Fixed-configuration 10/100 Mbps switching	$ 72,303	45%	$ 70,583	44%
Fixed-configuration Gigabit switching	30,474	19	19,999	12
Server, desktop, and mobile connectivity	15,471	10	31,188	19
	$ 118,248	74%	$ 121,770	75%

Sales by geographic region are as follows (in thousands):

	Three Months Ended	
	August 27, 2004	**August 29, 2003**
Americas	$ 73,831	$ 68,603
Europe, Middle East, and Africa	67,382	63,819
Asia Pacific Rim	21,136	29,457
	$ 162,349	$ 161,879

Sales information by geography is reported based on the customer s designated delivery point. For the three months ended August 27, 2004 and August 29, 2003, sales to customers in the United States (Americas region) totaled $58.6 million, or 36 percent of total sales, and $54.8 million, or 34 percent of total sales, respectively. There were no other individual countries for which sales exceeded ten percent of total sales.

Note 14. Litigation

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

On March 4, 2003, we filed suit against PCTEL, Inc. (PCTEL) in the United States District Court for the Northern District of Illinois, Civil Action Number 03C 1582, alleging infringement of United States Patents Numbered 5,872,836, 5,646,983, 5,724,413, 6,097,794, 6,696,660, 5,532,898 and 5,777,836. On March 5, 2003, PCTEL filed suit against us in the United States District Court for the Northern District of California, Civil Action Number C 03 0982, alleging infringement of United States Patent Number 4,841,561 entitled Operating default group selectable data communication equipment seeking damages and injunctive relief, and further seeking a declaration that PCTEL does not infringe our Patents Numbered 5,872,836, 5,646,983, 5,724,413, 6,097,794, 6,696,660, 5,532,898 and 5,777,836, and that such patents are void and invalid. The action which we initiated in the District Court for the Northern District of Illinois was transferred to the District Court for the Northern District of California on June 11, 2003 and assigned Civil Action Number C 03 2710. On August 18, 2003, that action was consolidated for certain purposes with the action PCTEL initiated against us in the Northern District of California.

In November 2000, a shareholder derivative and class action lawsuit, captioned *Shaev v. Claflin, et al.*, No. CV794039, was filed in California Superior Court. The complaint alleges that our directors and officers breached their fiduciary duties to 3Com in connection with the adjustment of employee and director stock options in connection with the separation of 3Com and Palm, Inc. (since renamed palmOne). On May 13, 2003, the Court dismissed the Second Amended Complaint. The plaintiff has appealed the Court s decision. On June 21, 2004, the Court of Appeal for the State of California, Sixth Appellate District, upheld the Court s dismissal of the lawsuit without leave to amend or refile. The plaintiff filed a Petition for Review with the California Supreme Court on July 29, 2004 which was denied by the Court on September 28, 2004.

On April 28, 1997, Xerox Corporation (Xerox) filed suit against U.S. Robotics Corporation and U.S. Robotics Access Corporation in the United States District Court for the Western District of New York. We completed our acquisition of these companies on June 12, 1997. The case is now captioned *Xerox Corporation v. 3Com Corporation, U.S. Robotics Corporation, U.S. Robotics Access Corporation, Palm Computing, Inc., and Palm, Inc.* (Civil Action Number 97-CV-6182T). Xerox alleged willful infringement of United States Patent Number 5,596,656, entitled Unistrokes for Computerized Interpretation of Handwriting. Xerox sought to recover damages and to permanently enjoin the defendants from infringing the patent in the future. In 2000, the District Court dismissed the case, ruling that there was no infringement. On appeal, the Court of Appeals for the Federal Circuit affirmed-in-part, reversed-in-part and remanded the case to the District Court for further action. On December 20, 2001, the District Court granted Xerox s motion for summary judgment that the patent is valid, enforceable, and infringed. The defendants then filed a Notice of Appeal. On February 22, 2002, the District Court denied Xerox s motion for an injunction prohibiting further alleged infringement during the appeal and ordered the defendants to post a bond in the amount of $50 million. Xerox then appealed the denial of the injunction. On February 20, 2003, the Court of Appeals issued its decision affirming in part and reversing in part the order of the trial court. The Court of Appeals affirmed the grant of summary judgment of infringement, reversed the grant of summary judgment of validity and remanded the case to the trial court to conduct a complete validity analysis. In connection with the separation of Palm from 3Com, pursuant to the terms of the Indemnification and Insurance Matters Agreement dated February 26, 2000 between 3Com and Palm, Palm agreed to indemnify and hold 3Com harmless for any damages or losses that might arise out of the Xerox litigation. On May 21, 2004, the District Court awarded summary judgment to the defendant, holding that Xerox s patent was invalid, and dismissed the remaining claims. Xerox has appealed the decision.

3Com Corporation

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

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

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

The environment for enterprise networking equipment;

Our goals for sales growth, gross margin expansion and profitability;

The competitive pricing environment;

The impact of Industry conditions on component suppliers and contract manufacturers;

New competitors entering the market for higher end, enterprise core routing and switching products;

Aggressive actions by competitors targeted at gaining share in the small to medium-sized enterprise market;

The advanced nature and ready availability of merchant silicon, which allows low-end competitors to deliver feature rich products;

Our projections for sales and gross margin for the second quarter of fiscal 2005;

Our projections for a net loss and negative cash flow for the second quarter of fiscal 2005;

Execution of our business plan to grow sales by improving our product lines and the effectiveness of our existing sales channels and the development of new sales channels;

The dependence of our future success on sales of our enterprise networking products;

Expansion of our product lines targeting mid- to large-sized enterprise customers, our largest growth opportunities;

The trend towards standardization of routing and switching technology;

The evolution of networking technology enabling convergence of data, voice and video over Internet Protocol (IP) networks and the expected benefits of converged networks;

Our goal of growth and profitability over the long term;

Cash flow from operating activities and our ability to satisfy anticipated cash requirements for the next twelve months;

Improvements in our net cash flow from operations resulting from our restructuring actions;

Activities of 3Com Ventures, including capital call payments to certain venture capital funds;

Sources of competition, including Huawei Technologies, Ltd.;

The decline in sales of our desktop, mobile and server connectivity products;

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

Acquisitions of companies or technologies;

Our reliance on strategic relationships, including our joint venture with Huawei Technologies, Ltd.;

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

Industry trends and our response to those trends;

Outcome and effect of current and potential and future litigation;

Protection and enforcement of intellectual property rights; and

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, b estimates, predicts, intends, potential, continue, or the negative of such terms, or other comparable terminology. Forward-looking statement 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.

Overview

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

BUSINESS OVERVIEW

We provide 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 sales are made through our two-tier distribution channel, we also work closely with systems integrators, major telecommunications 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.

In previous periods, 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 first quarters of fiscal 2005 and fiscal 2004, respectively.

	Three Months Ended	
	August 27, 2004	August 29, 2003
Ingram Micro, Inc.	23%	22%
Tech Data Corporation	14	13
Total	37%	35%

We have undergone significant changes in recent years, including:

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

We believe an overview of these significant changes 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 sales. In response to this decline, we undertook additional measures to further reduce costs, including headcount reductions, long term asset retirements, and outsourcing manufacturing operations. During fiscal 2003, as our sales and overall financial performance continued to decline, we undertook several additional broad initiatives to achieve further cost savings. The first of these initiatives involved the integration of certain central functions of our business units in order to achieve cost savings. Other actions included 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 in sales and marketing, research and development, and general and administrative expenses.

During fiscal 2004, we undertook a number of actions, affecting both sales 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 connection with these various actions, we reduced our overall workforce by approximately forty percent.

On November 17, 2003, we formed our joint venture, Huawei-3Com (H-3C), which is domiciled in Hong Kong and has its principal operating centers in Hangzhou and Beijing, China. We contributed $160 million in cash, assets related to our operations in China and Japan, and licenses to related intellectual property in exchange for 49 percent ownership interest of the joint

venture. In the first quarter of fiscal 2005, we expanded the joint venture s market to include Hong Kong in addition to China and Japan. We expect this venture to provide three key benefits to us an expanded product line, access to low cost and highly effective engineering talent, and a significant presence in the China, Japan and, beginning in the first quarter of fiscal 2005, Hong Kong markets.

During the first quarter of fiscal 2005, we undertook several additional actions that we believe will enhance our competitiveness, execution and profitability over the longer term. We introduced new products targeted at market segments that we expect will grow in the future; these products include modular routers and switches sourced from H-3C, as well as voice, security and wireless solutions. Also, we are increasing our focus on sales and marketing activities. Current initiatives include developing an expanded set of enterprise class channels to handle our expanded product line, and implementing marketing programs that we believe will improve our effectiveness and productivity in our existing channels, particularly those that target small and mid-sized businesses. For example, we are decreasing volume rebates and replacing them with even higher levels of funding in the form of market development funds, which will allow us to create more end user demand for both us and our partners. To further lower our costs and expenses, we reduced our total workforce by approximately four percent. Some of these reductions in our workforce will be backfilled in the future in connection with selective hiring consistent with our strategy and focus for example, by increases in our direct field sales organization targeting mid- to large-sized businesses.

Summary of Financial Performance for the First Quarter of Fiscal 2005

Our sales for the first quarter of fiscal 2005 were $162.3 million, essentially flat compared to sales for the first quarter of fiscal 2004 of $161.9 million.

Our gross margin increased to 38.2% for the first quarter of fiscal 2005 from 30.9% for the first quarter of fiscal 2004.

Our operating expenses for the first quarter of fiscal 2005 were $97.0 million, compared to $165.7 million for the first quarter of fiscal 2004, a net decrease of $68.7 million or 41.5%. Operating expenses for the first quarter of fiscal 2005 and fiscal 2004 included restructuring charges of $2.8 million and $48.6 million, respectively.

Our net loss for the first quarter of fiscal 2005 was $35.5 million compared to a net loss for the first quarter of fiscal 2004 of $106.0 million, an improvement of $70.5 million.

Our balance sheet remains strong with cash and short-term investment balances at the end of the first quarter of fiscal 2005 of $1,263.6 million, compared to cash and short-term investment balances of $1,383.4 million at the end of the fourth quarter of fiscal 2004.

Business Environment and Future Trends

We believe that we have begun to see the positive impacts of some of our growth-related and restructuring initiatives undertaken in recent periods. In the first quarter of fiscal 2005, sales from our enterprise networking products the focus of our strategy were $146.8 million, an increase of 12 percent over the amount reported for the first quarter of fiscal 2004. Although reported sales for the first quarter of fiscal 2004 were negatively impacted by a change in our channel inventory model, sales from enterprise networking products grew on a year-over-year basis, even considering the impact of this change. Also, we achieved significant improvements in gross margin, costs and expenses and profitability on a year-over-year basis.

Despite these positive developments, we are facing a difficult and uncertain environment. Networking industry analysts and participants differ widely in their assessments concerning the prospects for near-term industry growth. We have observed signs of growth in certain industry segments over the past few months, but such growth has been modest and may not be sustained in the months ahead. Other industry factors and trends also present significant challenges with respect

to our goals for sales growth, gross margin expansion and profitability in the short term. Such factors and trends include:

The impact of the uncertain industry environment on product pricing;

The impact of the uncertain industry environment on component suppliers and contract manufacturers, and the related issues of component and capacity availability and costs;

New, formidable competitors entering the market for higher end, enterprise core routing and switching products;

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

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

Based on our current projections for sales and gross margin for the second quarter of fiscal 2005 $170 million to $180 million and 38 percent, respectively we believe that we will incur a net loss and negative cash flow from operations for the quarter. Accordingly, although there are signs of progress with our enterprise networking strategy, we must accelerate the pace of improvement. Our key focus for the remainder of fiscal 2005 is on execution of our business plan to grow sales both in terms of improving the breadth and depth of our product lines as well as improving the effectiveness of our existing channels while developing new channels. Our future success is highly dependent on increased sales of our enterprise networking products, and our largest growth opportunities continue to be linked to the expansion of our product lines targeting mid- to large-sized enterprise customers. We believe that, through our expanding portfolio of products and solutions, we can offer such customers a number of advantages, including the following:

Within the industry, there is a trend towards increased standardization of routing and switching technology. 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.

Traditionally, enterprises have deployed separate data networking and telephone infrastructures, with the attendant costs to install, operate and maintain the separate infrastructures. However, the continued evolution of networking technology is enabling convergence of data, voice and video over Internet Protocol (IP) networks. Now, in many cases, enterprises are finding that new IP telephony networking technology can enable them to converge their 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. Our convergence ready data, voice and wireless are solutions built on an open architecture to protect network investments that support evolutionary migrations, heterogeneous networks, and ease of integration for new applications.

In summary, we believe that our recent initiatives and our planned actions for fiscal 2005 are consistent with our goals of growth and profitability over the longer term. However, these initiatives and actions 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, sales, 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 described in Note 2 to the Consolidated Financial Statements, which are included in our Annual Report on Form 10-K for the fiscal year ended May 28, 2004. Some of those accounting policies require us to make assumptions and estimates that affect the amounts reflected in our financial statements. The following accounting policies are those which often require significant judgment and 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 August 27, 2004, our net accounts receivable balance was $63.4 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 August 27, 2004, our net inventory balance was $23.4 million.

Goodwill and intangible assets: We review the value of our long-lived assets, including goodwill, 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 August 27, 2004, we had $4.0 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 August 27, 2004, we had $156.4 million of equity securities and other investments, including $140.3 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 our business, we might be required to record additional charges for new restructuring activities as well as changes in estimates to

amounts previously recorded.

Warranty: We provide a limited warranty on our products for periods ranging from 90 days to the lifetime of the product, depending upon the product, and we record allowances for estimated warranty costs 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 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 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 August 27, 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.

Effects of Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 is effective for fiscal periods beginning after June 15, 2003; for us, EITF 00-21 became effective for the second quarter of fiscal 2004. The adoption of EITF 00-21 did not have a material effect on our financial position or results of operations.

In December 2003, the SEC released Staff Accounting Bulletin No. 104, Revenue Recognition (SAB 104). SAB 104 clarifies existing guidance regarding revenue for contracts which contain multiple deliverables to make it consistent with EITF No. 00-21. The adoption of SAB 104 did not have a material effect on our financial position or results of operations.

Results of Operations

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

	Quarter Ended	
	August 27, 2004	**August 29, 2003**
Sales	100.0%	100.0%
Cost of sales	61.8	69.1
Gross margin	38.2	30.9
Operating expenses:		
Sales and marketing	33.9	38.7
Research and development	13.8	16.6
General and administrative	9.7	14.9
Amortization and write down of intangibles	0.6	2.1
Restructuring charges	1.7	30.1
Total operating expenses	59.7	102.4
Operating loss	(21.5)	(71.5)
Gains on investments, net	0.3	0.1
Interest and other income, net	0.6	2.4
Loss from continuing operations before income taxes, equity interests and discontinued operations	(20.6)	(69.0)
Income tax provision (benefit)	(0.3)	(3.7)
Equity interest in loss of unconsolidated joint venture	(1.6)	
Loss from continuing operations	(21.9)	(65.3)
Discontinued operations, net of taxes		(0.2)
Net loss	(21.9)%	(65.5)%

<u>Sales</u>

Sales in the first quarter of fiscal 2005 totaled $162.3 million, and were essentially flat when compared to the same quarter one year ago. However, in the first quarter of fiscal 2004, we reduced our channel inventory model to approximately 4.5 weeks of supply to reflect our improved supply chain processes and efficiency. This change decreased sales reported in the first quarter of fiscal 2004.

Sales of our enterprise networking products in the first quarter of fiscal 2005 were $146.8 million, an increase of 12 percent from the first quarter of fiscal 2004 sales of $130.5 million. The increase was due primarily to substantial growth in sales of our Gigabit switching solutions, reflecting increasing demand for Gigabit products as the industry continues its transition from 10/100 Mbps products. Also contributing to the increase were higher sales of voice products and modular switches and routers sourced from H-3C, reflecting enhanced sales and marketing efforts targeting mid- to large-sized enterprise customers. Enterprise networking products represented 90 percent of total sales in the first quarter of fiscal 2005 compared to 81 percent in the same quarter one year ago.

Sales of our desktop, mobile and server connectivity products in the first quarter of fiscal 2005 were $15.5 million, a decrease of 50 percent from the first quarter of fiscal 2004 sales of $31.2 million. The decrease in sales of connectivity products is the result of lower unit demand for these products, reflecting the continued 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, as well as lower average selling prices (ASPs).

By Geography. U.S. sales in the first quarter of fiscal 2005 grew approximately 7% over the first quarter of fiscal 2004, and represented approximately 36 percent of total sales compared to approximately 34 percent of total sales in the prior year quarter. The growth in U.S. sales was attributable to higher sales of Gigabit switching solutions, voice products, and modular switches and routers sourced from H-3C. These increases were offset, in part, by a decrease in sales of connectivity products.

International sales in the first quarter of fiscal 2005 decreased 3 percent when compared to the same quarter one year ago. The major factors contributing to these decreases were lower sales of connectivity products, and to a lesser extent, 10/100 Mbps switching products. These decreases were offset, in part, by increases in sales of Gigabit switching solutions and modular switches and routers sourced from H-3C.

Gross Margin

Gross margin as a percentage of sales was 38.2 percent in the first quarter of fiscal 2005 compared to 30.9 percent in the first quarter of fiscal 2004. Gross margin improved due to several factors, as follows:

	Current quarter
Outsourced manufacturing and facility closure	3.4%
IT and facility-related expenses	2.3
Standard-related margin	0.9
Warranty provision	0.6
Impact of freight rates	0.4
Other	(0.3)
Total	7.3%

Gross margin benefited by 3.4 percentage points compared to the prior year quarter due to effects associated with our decision to outsource our remaining manufacturing operations in Dublin during fiscal 2004. Such effects include lower operating costs ($2.7 million) and the absence of impairment and transition costs incurred in the prior year quarter ($2.7 million).

We allocate and report both IT and facilities-related expenses as a component of cost of sales and operating expenses. On a year-to-year basis, the portion of such expenses allocated to cost of sales decreased by $3.7 million.

Standard-related margin is a measure of product selling prices less direct manufacturing costs. The increase in standard-related margin as compared to the same quarter one year ago was primarily related to product cost reductions.

Warranty costs decreased in the first quarter of fiscal 2005 compared to the prior year quarter, primarily due to a reduction in returned materials.

Freight costs decreased in the first quarter of fiscal 2005 compared to the prior year quarter, primarily due to reduced rates.

Operating Expenses

Operating expenses in the first quarter of fiscal 2005 were $97.0 million compared to $165.7 million in the first quarter of fiscal 2004, or a net decrease of $68.7 million. Sales and marketing, research and development, and general and administrative expenses in the first quarter of fiscal 2005 decreased by $7.5 million, $4.5 million, and $8.5 million, respectively from the prior year quarter. Additionally, amortization and write-down of intangibles and restructuring charges in the first quarter of fiscal 2005 decreased by $2.4 million and $45.8 million, respectively, from the prior year quarter.

As a percent of sales, total operating expenses in the first quarter of fiscal 2005 were 59.7 percent, compared to 102.4 percent in the first quarter of fiscal 2004. In aggregate, sales and marketing, research and development and general and administrative expenses were 57.4 percent of sales in the first quarter