3COM CORP
Form 10-Q
January 05, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended November 26, 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 December 24, 2004, 380,376,591 shares of the registrant s Common Stock were outstanding.

3Com Corporation

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3Com is a registered trademark and Exercise Choice is a trademark of 3Com Corporation or its subsidiaries. CommWorks is a registered trademark of UTStarcom, Inc. Huawei is a registered trademark of Huawei Technologies Co. Ltd. Palm is a registered trademark of Palm Trademark Holding Company LLC. Other product and brand names may be trademarks or registered trademarks of their respective owners.

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 November 26, 2004**	**Three Months Ended November 28, 2003**	**Six Months Ended November 26, 2004**	**Six Months Ended November 28, 2003**
Sales	$ 151,068	$ 181,891	$ 313,417	$ 343,770
Cost of sales	98,377	124,941	198,631	236,876
Gross margin	52,691	56,950	114,786	106,894
Operating expenses:				
Sales and marketing	59,394	65,637	114,493	128,244
Research and development	22,164	24,421	44,599	51,348
General and administrative	14,385	21,784	30,057	45,923
Amortization and write down of intangibles	2,175	1,095	3,189	4,482
Restructuring charges	4,497	58,892	7,281	107,516
Total operating expenses	102,615	171,829	199,619	337,513
Operating loss	(49,924)	(114,879)	(84,833)	(230,619)
Gain (loss) on investments, net	(351)	(12,252)	82	(12,194)
Interest and other income, net	4,781	3,808	5,814	7,752
Loss from continuing operations before income taxes and equity interest in loss of unconsolidated joint venture	(45,494)	(123,323)	(78,937)	(235,061)
Income tax provision (benefit)	1,008	1,500	543	(4,535)
Equity interest in loss of unconsolidated joint venture	(2,309)	(12,593)	(4,876)	(12,593)
Loss from continuing operations	(48,811)	(137,416)	(84,356)	(243,119)
Discontinued operations, net of taxes		(1,565)		(1,856)
Net loss	$ (48,811)	$ (138,981)	$ (84,356)	$ (244,975)
Basic and diluted loss per share:				
Continuing operations	$ (0.13)	$ (0.37)	$ (0.22)	$ (0.65)
Discontinued operations, net of taxes				(0.01)

Net loss	$ (0.13)	$ (0.37)	$ (0.22)	$ (0.66)
Shares used in computing per share amounts:				
Basic and diluted	378,694	375,332	383,140	371,606

See notes to condensed consolidated financial statements.

3Com Corporation

Condensed Consolidated Balance Sheets

(Unaudited)

(In thousands, except par value)	**November 26, 2004**	**May 28, 2004**
ASSETS		
Current assets:		
Cash and equivalents	$ 458,669	$ 575,824
Short-term investments	815,204	807,532
Accounts receivable, less allowance for doubtful accounts ($14,786 and $16,276, respectively)	64,401	66,372
Inventories	22,344	27,679
Other current assets	41,317	42,270
Total current assets	1,401,935	1,519,677
Investment in Huawei-3Com joint venture	138,015	142,891
Property and equipment, net	71,108	72,452
Property and equipment held for sale	12,238	42,147
Deposits and other assets	32,718	34,806
Deferred income taxes	2,986	2,937
Intangible assets, net	1,820	5,009
Goodwill	899	899
Total assets	$ 1,661,719	$ 1,820,818
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 75,078	$ 80,408
Accrued liabilities and other	222,750	226,161
Total current liabilities	297,828	306,569
Deferred revenue and long-term obligations	12,466	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: 380,366 and 392,738, respectively	2,266,398	2,262,223
Treasury stock, at cost, 13,068 and 0 shares, respectively	(63,986)	
Unamortized stock-based compensation	(4,550)	(2,577)
Retained deficit	(841,222)	(755,244)
Accumulated other comprehensive loss	(5,215)	(5,288)
Total stockholders equity	1,351,425	1,499,114
Total liabilities and stockholders equity	$ 1,661,719	$ 1,820,818

See notes to condensed consolidated financial statements.

3Com Corporation

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	**Six Months Ended November 26, 2004**	**November 28, 2003**
Cash flows from operating activities:		
Loss from continuing operations	$ (84,356)	$ (243,119)
Adjustments to reconcile loss from continuing operations to cash (used in) operating activities:		
Loss from discontinued operations		(1,856)
Depreciation and amortization	24,731	67,897
Write down of intangibles	1,161	1,905
(Gain) loss on property and equipment	(5,021)	29,848
(Gain) loss on investments, net	(82)	12,194
Equity interest in loss of unconsolidated joint venture	4,876	12,593
Deferred income taxes	(49)	(6)
Purchased in-process technology	1,675	
Stock-based compensation expense	865	1,251
Changes in current assets and liabilities:		
Accounts receivable	1,971	19,385
Inventories	(1,498)	(8,637)
Other assets	2,126	3,454
Accounts payable	(5,330)	(3,061)
Accrued liabilities and other	(18,703)	23,697
Income taxes	11,726	3,311
Net cash (used in) operating activities	(65,908)	(81,144)
Cash flows from investing activities:		
Investment in Huawei-3Com joint venture		(160,000)
Purchases of investments	(431,152)	(552,691)
Proceeds from maturities and sales of investments	413,173	562,550
Purchases of property and equipment	(7,464)	(8,232)
Purchase of technology assets	(1,675)	
Proceeds from sale of property and equipment	37,786	99,640
Net cash provided by (used in) investing activities	10,668	(58,733)
Cash flows from financing activities:		
Issuances of common stock	9,093	59,242
Repurchases of common stock	(73,365)	
Collection of note receivable issued for warrants		8,421
Repayments of long-term borrowings		(346)
Net cash provided by (used in) financing activities	(64,272)	67,317
Effect of exchange rate changes on cash and equivalents	2,357	658
Net decrease in cash and equivalents during period	(117,155)	(71,902)
Cash and equivalents, beginning of period	575,824	515,848

Cash and equivalents, end of period	$	458,669	$	443,946

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 (SEC). 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 November 26, 2004 and May 28, 2004, and our results of operations and cash flows for the three and six months ended November 26, 2004 and November 28, 2003. Certain amounts from the prior period have been reclassified to conform to the current period presentation.

We use a 52 or 53-week fiscal year ending on the Friday nearest to May 31. The results of operations for the three and six months ended November 26, 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 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.

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

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

Note 2. Discontinued Operations

On March 4, 2003, we entered into an agreement (Asset Purchase Agreement) to sell selected assets and liabilities of our CommWorks division to UTStarcom, Inc. in exchange for $100 million in cash, subject to certain closing adjustments. On May 23, 2003, we completed the sale pursuant to the terms of the Asset Purchase Agreement. As a result, we reported the CommWorks division as a discontinued operation beginning in the fourth quarter of fiscal 2003 and restated all prior periods presented on a comparative basis. The loss from discontinued operations for the three months and six months ended November 28, 2003 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 are issued at no cost to key employees and that generally vest over a one to four-year period. Such shares are subject to our right to reacquire those shares upon such person s termination of employment to the extent that such right has not lapsed. We also grant time accelerated restricted stock awards whereby shares with a specified time-based vesting period may be accelerated if specific performance milestones are achieved.

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

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

(in thousands, except per share amounts)	Three Months Ended November 26, 2004	Three Months Ended November 28, 2003	Six Months Ended November 26, 2004	Six Months Ended November 28, 2003
Net loss as reported	$ (48,811)	$ (138,981)	$ (84,356)	$ (244,975)
Add: Stock-based compensation included in reported net loss	213	953	865	1,251
Deduct: Total stock-based compensation determined under the fair value-based method, net of related tax effects	(3,223)	(5,412)	(7,735)	(10,689)
Pro forma net loss	$ (51,821)	$ (143,440)	$ (91,226)	$ (254,413)
Net loss per share-basic and diluted:				
As reported	$ (0.13)	$ (0.37)	$ (0.22)	$ (0.66)
Pro forma	(0.14)	(0.38)	(0.24)	(0.68)

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 and ESPP shares granted during the second quarter of fiscal 2005 and fiscal 2004 and the first six months of fiscal 2005 and 2004 have been estimated as of the date of grant using the Black-Scholes option pricing model. The assumptions used in preparing the estimates and the resulting fair values are shown below:

	Three Months Ended November 26, 2004	Three Months Ended November 28, 2003	Six Months Ended November 26, 2004	Six Months Ended November 28, 2003
Volatility-ESO	53.0%	66.0%	57.0%	67.0%
Volatility-ESPP	40.0%	45.0%	40.0%	45.0%
Risk-free interest rate-ESO	3.2%	2.7%	3.3%	2.6%
Risk-free interest rate-ESPP	2.2%	1.0%	2.2%	1.0%
Dividend yield-ESO and ESPP	0.0%	0.0%	0.0%	0.0%
Per-share fair value of options granted under ESO	$ 2.01	$ 3.21	$ 2.21	$ 2.75
Per-share fair value of purchase rights granted under ESPP	$ 1.13	$ 1.79	$ 1.13	$ 1.79

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

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 agreements to outsource certain information technology (IT) functions, reduced our workforce, and continued to consolidate and dispose of excess facilities.

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

Restructuring charges related to these various initiatives in the second quarters of fiscal 2005 and fiscal 2004 were $4.5 million and $58.9 million, respectively. Such charges were net of credits of $1.0 million and $0.6 million, respectively, related primarily to revisions of previous estimates of employee separation expenses, lease obligation costs, and values on held for sale properties. Restructuring charges related to these various initiatives in the first half of fiscal 2005 and fiscal 2004 were $7.3 million and $107.5 million, respectively. Such charges were net of credits of $5.9 million and $1.4 million, 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 within the next twelve months, and are included in the caption Accrued liabilities and other in the accompanying condensed consolidated balance sheets.

Fiscal 2005 Actions

The following table provides a summary of the components of restructuring charges recorded in the first and second quarters of fiscal 2005 with respect to the Fiscal 2005 Actions, together with changes in the accrued amounts and the ending balances as of November 26, 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
Provision	1,788	5	87	1,880
Payments and non-cash charges	(3,188)	(5)	(87)	(3,280)
Balance at November 26, 2004	$ 1,847	$	$	$ 1,847

Employee separation expenses include severance pay, outplacement services, and medical and other related benefits. The reduction in workforce affected employees mainly in the customer service, supply chain, sales and marketing, and general and administrative functions. The total reduction in workforce associated with actions initiated during the first half of fiscal 2005 includes approximately 90 employees. Separation payments associated with actions initiated during the first half of fiscal 2005 totaled $5.0 million through November 26, 2004.

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

Fiscal 2004 Actions

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2004 Actions, together with changes in the accrued amounts during the first and second quarters of fiscal 2005 and the ending balances of the associated accrued liabilities as of November 26, 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 changes	(2,596)	2,600	(192)	(188)
Balance at August 27, 2004	725	675		1,400
Provision		389	98	487
Payments and non-cash changes	(91)	78	(98)	(111)
Balance at November 26, 2004	$ 634	$ 1,142	$	$ 1,776

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce mainly affected employees involved with the Dublin, Ireland manufacturing operations, and also affected employees in sales and marketing, research and development, and general and administrative functions. Through November 26, 2004, total separation payments associated with the Fiscal 2004 Actions have been approximately $55.1 million.

Facilities-related charges in the first and second quarters 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.

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

Fiscal 2003 Actions

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2003 Actions, together with changes in the accrued amounts during the first and second quarters of fiscal 2005 and the ending balances as of November 26, 2004 (in thousands):

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

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

Fiscal 2001 and Fiscal 2002 Actions

The following table provides a summary of the components of accrued restructuring charges related to the Fiscal 2001 and Fiscal 2002 Actions, together with changes in the accrued amounts during the first and second quarters of fiscal 2005 and the ending balances as of November 26, 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
Provision	688		688
Payments and non-cash charges	(461)	(17)	(478)
Balance at November 26, 2004	$ 6,833	$ 34	$ 6,867

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

Note 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 a 49 percent ownership interest. We recorded our initial investment in H-3C at $160.1 million, reflecting the carrying value of the assets contributed. Huawei contributed its enterprise networking business assets including Local Area Network (LAN) switches and routers; engineering, sales, and marketing resources and personnel; and licenses to its related intellectual property in exchange for a 51 percent ownership interest. 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 second quarter of fiscal 2005, we recorded a loss of $2.3 million related to our share of H-3C s net loss, adjusted as described above, for the quarter ended September 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. During the first half of fiscal 2005, we recorded a loss of $4.9 million related to our share of H-3C s net loss. The carrying value of our investment in H-3C as of November 26, 2004 was $138.0 million.

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

Balance Sheet:

	September 30, 2004	March 31, 2004
Current assets	$ 243,718	$ 242,904
Non-current assets	156,609	208,471
Current liabilities	91,203	86,825
Non-current liabilities	8,866	8,866

Statements of Operations:

	Three Months-Ended September 30, 2004	Six Months-Ended September 30, 2004
Sales	$ 65,880	$ 128,580
Gross margin	26,178	50,768
Loss from operations	5,393	11,127
Net loss	4,712	9,951

We and H-3C are parties to agreements providing for the sale of certain products between the two companies. During the second quarter of fiscal 2005, we made sales of products to H-3C of $3.5 million and made purchases of products from H-3C of $3.9 million. During the first half of fiscal 2005, we made sales of products to H-3C of $7.1 million and made purchases of products from H-3C of $7.1 million. As of November 26, 2004, our accounts receivable and accounts payable included $1.1 million and $0.7 million, respectively, related to transactions with H-3C. Also, as of November 26, 2004, we had deferred approximately $0.3 million related to sales of products to H-3C that had not yet been shipped to H-3C s end customers.

Note 6. **Comprehensive Loss**

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

	Three Months Ended		Six Months Ended	
	November 26, 2004	November 28, 2003	November 26, 2004	November 28, 2003
Net loss	$ (48,811)	$ (138,981)	$ (84,356)	$ (244,975)
Other comprehensive income (loss):				
Net unrealized (loss) on investments	(1,590)	(310)	(1,326)	(1,333)
Net unrealized (loss) on cash flow hedges	(1,247)		(959)	
Change in accumulated translation adjustments	2,518	641	2,358	658
Total comprehensive loss	$ (49,130)	$ (138,650)	$ (84,283)	$ (245,650)

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		Six Months Ended	
	November 26, 2004	November 28, 2003	November 26, 2004	November 28, 2003
Loss from continuing operations	$ (48,811)	$ (137,416)	$ (84,356)	$ (243,119)
Loss from discontinued operations		(1,565)		(1,856)
Net loss	$ (48,811)	$ (138,981)	$ (84,356)	$ (244,975)
Weighted average shares-basic	378,694	375,332	383,140	371,606
Effect of dilutive securities:				
Employee stock options				
Restricted stock				
Weighted average shares-diluted	378,694	375,332	383,140	371,606
Net loss per share-basic and diluted:				
Continuing operations	$ (0.13)	$ (0.37)	$ (0.22)	$ (0.65)
Discontinued operations				(0.01)
Net loss	$ (0.13)	$ (0.37)	$ (0.22)	$ (0.66)

Employee stock options and restricted stock totaling 1.3 million shares and 8.9 million shares for the three months ended November 26, 2004 and November 28, 2003, respectively, and 2.5 million shares and 2.8 million shares for the six months ended November 26, 2004 and November 28, 2003, respectively, were not included in the diluted weighted average shares calculation as the effects of these securities were anti-dilutive.

Note 8. **Inventories**

Inventories consist of (in thousands):

	November 26, 2004	May 28, 2004
Finished goods	$ 20,636	$ 25,869
Work-in-process	632	485
Raw materials	1,076	1,325
Total	$ 22,344	$ 27,679

Note 9. **Property and Equipment**

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

	November 26, 2004	May 28, 2004
Land	$ 6,999	$ 8,724
Building and improvements	38,325	38,325
Machinery and equipment	168,665	206,099
Software	105,119	105,943
Furniture and fixtures	24,347	26,880
Leasehold improvements	9,708	10,274
Construction in progress	1,621	1,664
Total, gross	354,784	397,909
Accumulated depreciation and amortization	(283,676)	(325,457)
Total, net	$ 71,108	$ 72,452

Property and equipment held for sale of $12.2 million as of November 26, 2004 included land, building and equipment in the U.K. Property and equipment held for sale of $42.1 million as of May 28, 2004 included land, buildings and equipment in Ireland and the U.K.

In November 2004, we completed the sale of our property in Dublin that was classified as held for sale. This property, consisting of approximately 468,000 square feet of office and manufacturing space, previously had been used in our administrative, research and development, and manufacturing activities.

Net proceeds from the sale resulted in a gain on the sale of $0.5 million that was recorded in restructuring charges in the second quarter of fiscal 2005.

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

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

Note 10. Intangible Assets, Net

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

	November 26, 2004	May 28, 2004
Total, gross	$ 35,995	$ 37,156
Accumulated amortization	(34,175)	(32,147)
Total, net	$ 1,820	$ 5,009

In the second quarter of 2005, we recorded an impairment of intangible assets, consisting mainly of developed technology associated with our acquisition of NBX Corporation in fiscal 1999. We determined the amount of the impairment by comparing the carrying value of the intangible asset with the fair value, which was estimated as the present value of expected future net cash flows at a discount rate of ten percent per year. The impairment resulted primarily from reduced revenue projections, as well as a lower percentage of projected revenue coming from the existing technology. As a result of the impairment analysis, we recorded a write down of $1.2 million, which is included in the caption Amortization and write down of intangibles in the condensed consolidated statements of operations for the six months ended November 26, 2004.

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 revenue and gross margin projections as compared to the initial projections at the time of the acquisition, due to the earlier-than-expected end of life 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 for the six months ended November 28, 2003.

Based on the carrying value of our intangible assets as of November 26, 2004, amortization expense is expected to be $0.8 million for the second half of fiscal 2005 and $1.0 million for fiscal 2006.

Note 11. Accrued Liabilities and Other

Accrued liabilities and other consist of (in thousands):

		November 26, 2004		May 28, 2004
Accrued payroll and related expenses	$	32,870	$	37,995
Accrued product warranty		40,865		43,825
Accrued rebates		25,954		29,536
Income and other taxes payable		48,349		34,184
Deferred revenue		23,675		25,942
Other		51,037		54,679
Total	$	222,750	$	226,161

Note 12. Accrued Warranty and Other Guarantees

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

The following table summarizes the activity in the allowance for estimated warranty costs for the six months ended November 26, 2004 and November 28, 2003 (in thousands):

		First six months of fiscal 2005		First six months of fiscal 2004
Accrued warranty, beginning of period	$	43,825	$	44,775
Cost of warranty claims processed during the period		(16,751)		(17,494)
Provision for warranties related to products sold during the period		13,791		17,481
Adjustments to preexisting warranties				(23)
Accrued warranty, end of period	$	40,865	$	44,739

In prior years, we entered into several agreements whereby we sold products to resellers who, in turn, sold the products to others, and we guaranteed the payments of the end users. If all end users under these agreements were to default on their remaining obligations outstanding as of November 26, 2004, we would be required to pay approximately $1.5 million. However, since deferred revenue and other associated accruals related to such sales approximate the guaranteed amounts, any payments resulting from end user defaults would not have a material impact on our results of operations.

In connection with the development of our facility in Rolling Meadows, 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 28, 2004. In connection with the completion of the sale of the Rolling Meadows facility in the first quarter of fiscal 2004 as discussed in Note 4, we repaid the $2.5 million municipal bond.

Note 13. Stockholders Equity

In the first quarter of fiscal 2005, we repurchased approximately 15.0 million shares of our common stock at a total cost of $73.4 million. These repurchases were made pursuant to the stock repurchase program that was approved by our Board of Directors in March 2003, and that authorizes expenditures of up to $100.0 million during a two-year period through March 2005. We did not repurchase any shares during the second quarter of fiscal 2005. At November 26, 2004, approximately $26.6 million of the authorization remains available for future repurchases.

Note 14. **Business Segment Information**

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

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

	Three Months Ended		Six Months Ended	
	November 26, 2004	November 28, 2003	November 26, 2004	November 28, 2003
Americas	$ 59,030	$ 60,924	$ 132,854	$ 129,527
Europe, Middle East, & Africa	72,945	87,979	140,327	151,798
Asia Pacific Rim	19,093	32,988	40,236	62,445
	$ 151,068	$ 181,891	$ 313,417	$ 343,770

Note 15. **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, 3Com 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 certain of its United States Patents (the 3Com Patents). On March 5, 2003, PCTEL filed suit against 3Com in the United States District Court for the Northern District of California, Civil Action Number C 03 0982, alleging infringement of a United States Patent held by PCTEL, seeking damages and injunctive relief, and further seeking a declaration that PCTEL does not infringe the 3Com Patents and that such patents are void and invalid. The action which 3Com 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 3Com in the District Court for the Northern District of California. In November 2004, we entered into a settlement agreement with PCTEL pursuant to which both 3Com and PCTEL agreed to dismiss their respective lawsuits in exchange for a cross license of certain technology. In addition, we have agreed to certain business arrangements with PCTEL regarding wireless software and antennas.

On April 28, 1997, Xerox Corporation (Xerox) filed suit against U.S. Robotics Corporation and U.S. Robotics Access Corporation in the United States District Court for the Western District of New York. 3Com completed its acquisition of these defendant companies on June 12, 1997. The case is now captioned *Xerox Corporation v. 3Com Corporation, U.S. Robotics Corporation, U.S. Robotics Access Corporation, Palm Computing, Inc., and Palm, Inc.* (Civil Action Number 97-CV-6182T). Xerox alleged willful infringement of one of its United States patents. Xerox sought to recover damages and to permanently enjoin the defendants from infringing the patent in the future. In 2000, the District Court dismissed the case, ruling that there was no infringement. On appeal, the Court of Appeals for the Federal Circuit affirmed-in-part, reversed-in-part and remanded the case to the District Court for further action. On December 20, 2001, the District Court granted Xerox s motion for summary judgment 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 defendants, holding that Xerox s patent was invalid, and dismissed the remaining claims. Xerox has appealed the decision.

Note 16. Subsequent Event

On December 13, 2004, we entered into a definitive agreement to acquire TippingPoint Technologies, Inc., (TippingPoint) a leading provider of networked-based intrusion prevention systems (IPS). The purchase price is $47.00 in cash per outstanding TippingPoint share. The total purchase price is currently estimated to be approximately $430 million including acquisition costs and assumed stock options.

The transaction has been approved by both companies boards of directors and is subject to the approval of TippingPoint s stockholders, regulatory approvals and other customary closing conditions. Stockholders beneficially owning a majority of TippingPoint s shares have executed voting agreements pursuant to which they have agreed to vote in favor of the transaction. We expect that the acquisition will be completed during the second half of fiscal 2005.

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:

Results of operations, including reduced expenses;

Our prospects and opportunities for future growth and profitability;

Improvements in net cash flows from operations and our ability to satisfy anticipated cash requirements for the next twelve months;

Expected benefits of the pending acquisition of TippingPoint and the anticipated timing for the completion of the TippingPoint acquisition;

Expected benefits of the Huawei-3Com joint venture;

Selective hiring;

Relationships with key distributors and strategic partners, including the continued significance of certain distributors and increased reliance on strategic relationships;

Expansion of our product portfolio and solutions and the results thereof, our sourcing of products from original equipment manufacturers and the Huawei-3Com joint venture, and our product mix, including the declining sales of our desktop, mobile and server connectivity products;

Activities of 3Com Ventures, including estimated capital call payments over the next 12 months to certain venture capital funds;

Expanded outsourcing activities, including with respect to customer service operations;

Expected restructuring charges and the effects of our recent and expected restructuring activities;

Our ability to compete with Huawei in the enterprise networking market;

Prospects regarding certain litigation matters;

Cash obligations related to leases, royalty and patent licensing arrangements, IT outsourcing agreements and customer service agreements;

Channel inventory levels; and

Sales growth, increases in our direct field sales organization and enhancement of our service and support capabilities.

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

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

BASIS OF PRESENTATION

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

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

BUSINESS OVERVIEW

We provide innovative, practical and high-value data and voice networking products, services and solutions for business enterprises of all sizes and public sector organizations. We are a company with a global presence, strong brand identity, large intellectual property portfolio and strong balance sheet. We believe that our relationships with strategic partners, broad product portfolio and significant distribution channels provide us with a strong foundation for future growth.

We generally sell our products through a two-tier distribution channel comprised of distributors and resellers. Distributors are the first tier of the channel providing global distribution, logistics, market development and other services. Distributors generally sell to the second tier of the channel, comprising value added resellers (VARs) and other channel partners. 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.

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

	Three Months Ended		**Six Months Ended**	
	November 26, 2004	**November 28, 2003**	**November 26, 2004**	**November 28, 2003**
Ingram Micro, Inc.	21%	18%	22%	20%
Tech Data Corporation	16	11	15	12
Total	37%	29%	37%	32%

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;

significant changes to our executive leadership;

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 some 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 us 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. 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. 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 a 49 percent ownership interest of the joint venture. In the first quarter of fiscal 2005, we expanded the joint venture s market to include Hong Kong in addition to China and Japan. We expect this venture to provide three key benefits to us an expanded product line, access to low cost and highly effective engineering talent, and a significant presence in the China, Japan and Hong Kong markets.

During the first half of fiscal 2005, we undertook several additional actions that we believe will enhance our competitiveness, execution and profitability over the longer term. These actions included the following:

We introduced multiple new products that are targeted at markets we expect will grow in the future and that are designed to meet the needs of enterprises of all sizes. These products include modular routers and switches sourced from H-3C, including the new 8800 modular switching family providing 10 Gigabit capability, as well as voice, security and wireless solutions.

We increased our focus on our customer facing capabilities in the areas of sales, marketing and service. We are adding sales and technical support people across our geographies and are increasing our marketing investments as well. In the second quarter of the fiscal year, we entered an agreement with Siemens Business Services to provide service offerings on a global basis for enterprise customers. With this new agreement, we can offer a range of support choices for our customers including two and four hour same business day hardware replacement with on site assistance, as well as expand our foreign language capability and hours of coverage for technical support.

To further lower our costs and expenses, we reduced our total workforce by approximately six 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.

On December 13, 2004, we entered into a definitive agreement to acquire TippingPoint Technologies, Inc., a leading provider in network-based intrusion prevention systems (IPS). If the acquisition is completed, we expect TippingPoint will bring a number of benefits to us. We believe IPS is one of the fastest growing segments of the security market. Also, we plan to cross sell into TippingPoint s customer base; many of their customers are target customers for our growing enterprise product line. We believe TippingPoint s technologies are uniquely qualified to sell into a converged voice and data environment, allowing us to design reliable VOIP and security solution for enterprise customers. We believe that there are few, if any, other vendors that could make this claim.

Summary of Financial Performance for the Second Quarter of Fiscal 2005

Our sales for the second quarter of fiscal 2005 were $151.1 million, a decrease of $30.8 million, or 17 percent compared to sales for the second quarter of fiscal 2004 of $181.9 million.

Our gross margin increased to 34.9% for the second quarter of fiscal 2005 from 31.3% for the second quarter of fiscal 2004.

Our operating expenses for the second quarter of fiscal 2005 were $102.6 million, compared to $171.8 million for the second quarter of fiscal 2004, a net decrease of $69.2 million or 40.3 percent. Operating expenses for the second quarter of fiscal 2005 and fiscal 2004 included restructuring charges of $4.5 million and $58.9 million, respectively.

Our net loss for the second quarter of fiscal 2005 was $48.8 million compared to a net loss for the second quarter of fiscal 2004 of $139.0 million, an improvement of $90.2 million.

Our balance sheet remains strong with cash and equivalents and short-term investment balances at the end of the second quarter of fiscal 2005 of $1,273.9 million, compared to cash and equivalents and short-term investment balances of $1,263.6 million at the end of the first quarter of fiscal 2005.

Business Environment and Future Trends

Networking industry analysts and participants differ widely in their assessments concerning the prospects for near-term industry growth. 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 in the short term with respect to our goals for sales growth, gross margin expansion and profitability. Such factors and trends include:

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

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

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

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

Based on our current projections for the third quarter of fiscal 2005 sales approximately flat sequentially and gross margins to be approximately 35 percent we expect that we will incur a net loss and negative cash flow from operations for the quarter. 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. Our future success is highly dependent on increased sales of our enterprise networking products, and our largest growth opportunities continue to be linked to the expansion of our product lines targeting mid- to large-sized enterprise customers. As our portfolio of products and solutions has filled in, our focus increasingly turns to our customer facing capabilities sales, marketing and service.

We are committed to our strategy of being a leading provider of secure, converged network solutions for small, medium and large enterprises. We believe that, through our expanding portfolio of products and solutions, we can offer enterprise 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, 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 solutions are built on an open architecture to protect network investments that support evolutionary migrations, heterogeneous networks, and ease of integration for new applications.

We believe that our recent initiatives and our business strategy are consistent with our goals of growth and profitability over the longer term. However, in light of our results of operations and cash flows for the first half of fiscal 2005, we may need to restructure our business or realign our resources further to promote growth in sales 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 involves consideration of 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 typically do not 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 November 26, 2004, our net accounts receivable balance was $64.4 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 November 26, 2004, our net inventory balance was $22.3 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 November 26, 2004, we had $1.8 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 November 26, 2004, we had $154.1 million of equity securities and other investments, including $138.0 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 acti