3COM CORP
Form 10-Q
October 07, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

[X]

For the quarterly period ended September 2, 2005

OR

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

[ ]

For the transition period from ________ to _________

Commission File No. 0-12867

3COM CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-2605794**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

350 Campus Drive	
Marlborough, Massachusetts	**01752**
(Address of principal executive offices)	(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 _X_ No __

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

Yes _X_ No __

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes __ No _X_

As of September 30, 2005, 386,966,167 shares of the registrant s common stock were outstanding (excluding 6,381,458 shares held in treasury).

3COM CORPORATION

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 2, 2005

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We use a 52 or 53 week fiscal year ending on the Friday nearest to May 31, with each fiscal quarter ending on the Friday generally nearest August 31, November 30 and February 28. For presentation purposes, the periods are shown as ending on August 31, November 30, February 28 and May 31, as applicable.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

3COM CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended	
(In thousands, except per share data)	**August 31, 2005**	**2004**
Sales	$ 177,636	$ 162,349
Cost of sales	107,570	100,254
Gross profit	70,066	62,095
Operating expenses:		
Sales and marketing	70,118	55,099
Research and development	21,197	22,435
General and administrative	18,213	15,672
Amortization of intangible assets	3,862	1,014
Restructuring charges	3,361	2,784
Total operating expenses	116,751	97,004
Operating loss	(46,685)	(34,909)
(Loss) gain on investments, net	(414)	433
Interest and other income, net	5,989	1,033
Loss before income taxes and equity interest in loss of unconsolidated joint venture	(41,110)	(33,443)
Income tax (provision) benefit	(915)	465
Equity interest in loss of unconsolidated joint venture	(16)	(2,567)
Net loss	$ (42,041)	$ (35,545)
Basic and diluted net loss per share	$ (0.11)	$ (0.09)
Shares used in computing per share amounts:		
Basic and diluted	383,760	387,585

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

3COM CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except per share data)	**August 31, 2005**	**May 31, 2005**
ASSETS		
Current assets:		
Cash and equivalents	$ 168,499	$ 268,535
Short-term investments	613,242	575,569
Accounts receivable, less allowance for doubtful accounts ($15,447 and $15,090, respectively)	74,359	61,664
Inventories	34,673	29,311
Other current assets	44,518	42,430
Total current assets	935,291	977,509
Investment in Huawei-3Com joint venture	135,953	135,969
Property and equipment, less accumulated depreciation and amortization ($238,031 and $238,945, respectively)	69,711	69,535
Goodwill	309,121	310,367
Intangible assets, net	62,020	65,882
Deposits and other assets	33,246	33,705
Total assets	$ 1,545,342	$ 1,592,967
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 92,086	$ 99,632
Accrued liabilities and other	210,866	209,928
Total current liabilities	302,952	309,560
Deferred revenue and long-term obligations	7,552	8,484
Stockholders equity:		
Preferred stock, $0.01 par value, 10,000 shares authorized; none outstanding	-	-
Common stock, $0.01 par value, 990,000 shares authorized; shares issued: 393,353 and 393,377, respectively	2,299,488	2,302,190
Treasury stock, at cost, 6,532 and 8,135 shares, respectively	(31,962)	(39,821)
Unamortized stock-based compensation	(14,817)	(14,011)
Retained deficit	(1,013,242)	(967,952)
Accumulated other comprehensive loss	(4,629)	(5,483)
Total stockholders equity	1,234,838	1,274,923
Total liabilities and stockholders equity	$ 1,545,342	$ 1,592,967

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

3COM CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	**Three Months Ended August 31, 2005**	**2004**
Cash flows from operating activities:		
Net loss	$ (42,041)	$ (35,545)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	13,129	12,388
Gain on property and equipment	(421)	(2,680)
Purchased in-process research and development	-	1,675
Loss (gain) on investments, net	414	(433)
Equity interest in loss of unconsolidated joint venture	16	2,567
Deferred income taxes	(143)	47
Stock-based compensation expense	1,115	652
Changes in assets and liabilities:		
Accounts receivable	(12,695)	2,949
Inventories	(7,497)	2,053
Other assets	(141)	(1,523)
Accounts payable	(7,546)	(12,446)
Accrued liabilities and other	82	(11,792)
Net cash used in operating activities	(55,728)	(42,088)
Cash flows from investing activities:		
Purchases of investments	(211,421)	(231,987)
Proceeds from maturities and sales of investments	170,964	211,717
Purchases of property and equipment	(4,288)	(3,450)
Proceeds from sale of property and equipment	-	203
Purchase of technology assets	-	(1,675)
Net cash used in investing activities	(44,745)	(25,192)
Cash flows from financing activities:		
Issuances of common stock	655	4,758
Repurchases of common stock	(672)	(73,365)
Net cash used in financing activities	(17)	(68,607)
Effect of exchange rate changes on cash and equivalents	454	(161)
Net change in cash and equivalents during period	(100,036)	(136,048)
Cash and equivalents, beginning of period	268,535	476,274
Cash and equivalents, end of period	$ 168,499	$ 340,226

The accompanying notes are an integral part of these 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 September 2, 2005 and June 3, 2005, and our results of operations and cash flows for the three months ended September 2, 2005 and August 27, 2004.

We use a 52 or 53 week fiscal year ending on the Friday nearest to May 31. The first quarter of fiscal 2006 ended on September 2, 2005, while the first quarter of fiscal 2005 ended on August 27, 2004, and the fiscal year 2005 ended on June 3, 2005. For convenience, the consolidated financial statements have been shown as ending on the last day of the calendar month. The results of operations for the three months ended September 2, 2005 may not be indicative of the results to be expected for the fiscal year ending June 2, 2006. 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 June 3, 2005.

Certain amounts from prior periods have been restated to conform to the current period presentation. For the Condensed Consolidated Statements of Cash Flows for the three months ended August 31, 2004, we concluded that it was appropriate to classify auction rate securities, which are securities with longer stated maturities, but have interest rates that reset similar to short-term securities, as short-term investments. Previously, such investments had been classified as cash and equivalents. These restatements were not material to the financial statements and had no impact on working capital, results of operations or cash flows from operating activities.

Recently issued accounting pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment, which requires companies to measure and recognize compensation expense for stock-based payments at fair value. SFAS No. 123R was initially effective as of the first interim or annual reporting period that begins after June 15, 2005. In April 2005, the SEC issued a rule amending the compliance date which allows companies to implement SFAS No. 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. As a result, we will implement SFAS No. 123R in the reporting period starting June 1, 2006. We are currently evaluating the impact of SFAS No. 123R on our financial position and results of operations. See Note 2 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 SFAS No. 123 to stock-based employee compensation.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations - An Interpretation of SFAS No. 143. This interpretation provides additional guidance as to when companies should record the fair value of a liability for a conditional asset retirement obligation when there is uncertainty about the timing and (or) method of settlement of the obligation. The adoption of FASB Interpretation No. 47 will not have a material impact on our financial statements.

In June 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, SFAS No. 154 does not change the transition provisions of any existing accounting pronouncements.

NOTE 2. 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.

We have restricted stock plans under which key employees may be granted shares of common stock that are issued at no cost to the employee and generally vest over a one to four-year period. We have the right to reacquire these shares from an employee if such person s employment is terminated prior to vesting. We also grant time accelerated restricted stock awards whereby the vesting of shares with a specified time-based vesting may be accelerated if specific performance milestones are achieved.

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

As permitted under SFAS No. 123, Accounting for Stock-Based Compensation, we follow Accounting Principles Board (APB) Opinion 25 and related Interpretations in accounting for stock-based awards to employees. Under APB Opinion 25, compensation expense associated with employee stock awards is measured as the difference, if any, between the price to be paid by an employee and the fair value of the underlying common stock on the grant date, which usually is the measurement date for accounting purposes. Generally, we recognize no compensation expense with respect to stock-based option awards and stock issued under the employee stock purchase plan. 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.

As discussed in Note 1, we will be required to apply SFAS No. 123(R) in the reporting period starting June 1, 2006. SFAS No. 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements using a fair value model.

The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based compensation.

	Three Months Ended	
	August 31,	
(In thousands, except per share amounts)	**2005**	**2004**

Net loss as reported	$ (42,041)	$ (35,545)
Add: Stock-based compensation included in reported net loss	1,115	652
Deduct: Total stock-based compensation determined under the fair value-based method, net of related tax effects	(3,644)	(4,512)
Adjusted net loss	$ (44,570)	$ (39,405)
Net loss per share-basic and diluted:		
As reported	$ (0.11)	$ (0.09)
Adjusted	$ (0.12)	$ (0.10)

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

The fair values of employee stock options granted during the first quarter of fiscal 2006 and fiscal 2005 have been estimated as of the date of grant using the Black-Scholes option pricing model. 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. The assumptions used in preparing the estimates and the resulting fair values are shown below:

	Three Months Ended	
	August 31, 2005	**2004**
Volatility	46%	57%
Risk-free interest rate	3.9%	3.3%
Dividend yield	0.0%	0.0%
Estimated average life (years after vesting)	1.5	1.5
Fair value per share	$ 1.42	$ 2.24

During the first quarters of fiscal 2006 and fiscal 2005, there were no shares issued under the employee stock purchase plan.

NOTE 3. STOCK OPTION PLANS

As of August 31, 2005, our outstanding stock options as a percentage of outstanding shares were 16 percent. Stock option activity during the first quarter of fiscal 2006 and stock option detail as of August 31, 2005, were as follows (shares in thousands):

	Number of shares	**Weighted Average Exercise Price**
Outstanding June 1, 2005	63,359	$ 5.83
Granted	5,241	3.55
Exercised	(454)	1.08
Cancelled	(5,691)	6.28
Outstanding August 31, 2005	62,455	$ 5.64

The following table summarizes information concerning outstanding and exercisable options as of August 31, 2005 (shares in thousands):

	Outstanding Options		Exercisable Options	
Range of exercise price	**Number of shares**	**Weighted average exercise price**	**Number of shares**	**Weighted average exercise price**
$ 0.00 4.00	18,205	$ 2.43	2,195	$ 1.40
4.01 5.00	12,839	4.61	7,988	4.62
5.01 6.00	14,702	5.58	12,952	5.62
6.01 7.00	3,287	6.23	2,652	6.22
7.01 8.00	2,006	7.61	1,559	7.60
$ 8.01 22.00	11,416	11.50	11,333	11.52
	62,455	$ 5.64	38,679	$ 7.02

NOTE 4. ACQUISITION

On January 31, 2005, we completed our acquisition of 100 percent of the outstanding common shares of TippingPoint Technologies, Inc. (TippingPoint) for consideration of $430.0 million, subject to adjustment. This amount excludes the cost of integration, as well as other indirect costs related to the transaction. TippingPoint is a provider of networked-based intrusion prevention systems. The acquisition enabled us to expand our portfolio of secure, converged voice and data networking solutions.

The TippingPoint acquisition was accounted for as a purchase, and accordingly, the assets purchased and liabilities assumed are included in the consolidated balance sheet as of May 31, 2005 and August 31, 2005. The operating results of TippingPoint are included in the consolidated financial statements since the date of acquisition.

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

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

In accordance with SFAS No. 141, Business Combinations, the purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed, including in-process research and development, based on their estimated fair values, and deferred stock compensation was recorded based on intrinsic value in accordance with FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB Opinion No. 25. The excess purchase price over those values is recorded as goodwill. The fair values assigned to tangible and intangible assets acquired and liabilities assumed are based on management s estimates and assumptions, and other information compiled by management, including valuations that utilize established valuation techniques appropriate for the high technology industry. Goodwill recorded as a result of this acquisition is not deductible for tax purposes. In accordance with SFAS No. 142 Goodwill and Other Intangible Assets, goodwill is not amortized but will be reviewed at least annually for impairment. Purchased intangibles with finite lives will be amortized on a straight-line basis over their respective estimated useful lives. The total preliminary purchase price has been allocated as follows (in millions):

Net tangible assets assumed	$ 37.4
Amortizable intangible assets:	
Existing technology	39.1
Maintenance agreements	