3COM CORP
Form 10-Q
October 11, 2001

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended August 31, 2001 **Commission File No. 0-12867**

OR

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

For the transition period from ______ to ______

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.)
5400 Bayfront Plaza **Santa Clara, California** (Address of principal executive offices)	**95052** (Zip Code)

Registrant's telephone number, including area code: **(408) 326-5000**

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 / /

As of October 1, 2001, 347,745,399 shares of the Registrant's Common Stock were outstanding.

This report contains a total of 36 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
(In thousands, except per share data)
(Unaudited)

	Three Months Ended	
	August 31, 2001	September 1, 2000
Sales	$ 389,589	$ 933,764
Cost of sales	326,821	593,036
Gross margin	62,768	340,728
Operating expenses:		
Sales and marketing	106,224	236,315
Research and development	85,881	145,828
General and administrative	40,999	57,543
Amortization and write down of intangibles	16,484	7,493

	Three Months Ended	
Purchased in-process technology		29,406
Merger-related credits, net		(212)
Restructuring charges	57,515	9,901
Total operating expenses	307,103	486,274
Operating loss	(244,335)	(145,546)
Gains (losses) on investments, net	(2,650)	16,736
Interest and other income, net	19,158	45,630
Loss from continuing operations before income taxes and equity interests	(227,827)	(83,180)
Income tax provision (benefit)	4,557	(20,795)
Equity interest in loss of unconsolidated investee		1,352
Loss from continuing operations	(232,384)	(63,737)
Income from discontinued operations		4,537
Net loss	$ (232,384)	$ (59,200)
Net income (loss) per share:		
Basic:		
Continuing operations	$ (0.67)	$ (0.18)
Discontinued operations		0.01
	$ (0.67)	$ (0.17)
Diluted:		
Continuing operations	$ (0.67)	$ (0.18)
Discontinued operations		0.01
	$ (0.67)	$ (0.17)
Shares used in computing per share amounts:		
Basic	344,313	353,777
Diluted	344,313	353,777

See notes to condensed consolidated financial statements.

3Com Corporation
Condensed Consolidated Balance Sheets
(In thousands, except par value)

	August 31, 2001	June 1, 2001
	(Unaudited)	
ASSETS		

	August 31, 2001	June 1, 2001
Current assets:		
Cash and equivalents	$ 815,146	$ 897,797
Short-term investments	630,480	742,414
Accounts receivable, net	194,294	286,813
Inventories, net	150,478	200,146
Investments and other	184,455	207,652
Total current assets	1,974,853	2,334,822
Property and equipment, net	542,469	609,679
Deferred income taxes	177,274	163,349
Goodwill, intangibles, deposits and other assets	322,819	344,952
Total assets	$ 3,017,415	$ 3,452,802
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 177,561	$ 279,181
Other accrued liabilities	463,676	576,851
Deferred income taxes	88,844	80,485
Current portion of long-term debt	328	328
Total current liabilities	730,409	936,845
Long-term debt	2,360	2,385
Other long-term obligations	8,237	8,151
Stockholders' equity:		
Preferred stock, $.01 par value, 10,000 shares authorized; none outstanding		
Common stock, $.01 par value, 990,000 shares authorized; shares issued: 365,665 and 365,711, respectively	2,127,839	2,127,803
Treasury stock, at cost, 19,456 and 21,412 shares, respectively	(354,300)	(373,661)
Notes receivable from sale of warrants	(21,052)	(21,052)
Unamortized stock-based compensation	(11,080)	(9,820)
Retained earnings	526,562	771,639
Accumulated other comprehensive income	8,440	10,512
Total stockholders' equity	2,276,409	2,505,421
Total liabilities and stockholders' equity	$ 3,017,415	$ 3,452,802

See notes to condensed consolidated financial statements.

3Com Corporation
Condensed Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Three Months Ended	
	August 31, 2001	September 1, 2000
Cash flows from operating activities:		
Loss from continuing operations	$ (232,384)	$ (63,737)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:		
Depreciation and amortization	79,926	67,589
Write down of intangibles	3,473	5,815
Loss on disposal of fixed assets	10,657	14,871
(Gain) loss on investments, net	2,650	(16,736)
Deferred income taxes	(4,369)	(2,871)
Merger-related credits, net		(212)
Purchased in-process technology		29,406
Stock-based compensation	2,139	
Equity in loss of unconsolidated investee		1,352
Changes in current assets and liabilities, net of effects of acquisitions:		
Accounts receivable	92,519	(111,673)
Inventories	49,668	15,182
Investments and other assets	26,459	(20,073)
Accounts payable	(101,620)	37,218
Accrued liabilities and other	(113,173)	(34,055)
Income taxes payable	(5,518)	(77,542)
Net cash used in operating activities	(189,573)	(155,466)
Cash flows from investing activities:		
Purchase of investments	(76,869)	(598,118)
Proceeds from maturities and sales of investments	189,440	179,034
Purchase of property and equipment	(10,670)	(61,356)
Proceeds from sale of property and equipment	3,198	
Businesses acquired in purchase transactions, net of cash received		(51,741)
Other, net		2,348
Net cash provided by (used in) investing activities	105,099	(529,833)
Cash flows from financing activities:		
Issuance of common stock	1,620	194,400
Repurchase of common stock		(250,176)
Repayments of long-term borrowings	(24)	(24,204)
Other, net	227	(343)
Net cash provided by (used in) financing activities	1,823	(80,323)
Net cash provided by discontinued operations		30,291
Decrease in cash and equivalents	(82,651)	(735,331)
Cash and equivalents, beginning of period	897,797	1,700,420
Cash and equivalents, end of period	$ 815,146	$ 965,089

See notes to condensed consolidated financial statements.

3Com Corporation

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1.
Basis of Presentation

The unaudited condensed consolidated financial statements have been prepared by 3Com Corporation ("3Com"), 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 (consisting solely of normal recurring adjustments) necessary for a fair presentation of 3Com's financial position as of August 31, 2001, results of operations for the three months ended August 31, 2001 and September 1, 2000, and cash flows for the three months ended August 31, 2001 and September 1, 2000. Certain amounts from the prior period have been reclassified to conform to the current period presentation. Such reclassifications had no effect on net income as previously reported.

3Com uses 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 31, 2001 may not be indicative of the results to be expected for the fiscal year ending May 31, 2002. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in 3Com's Annual Report on Form 10-K for the fiscal year ended June 1, 2001.

Revenue Recognition

3Com generally recognizes a sale when the product has been delivered and risk of loss has passed to the customer, collection of the resulting receivable is probable, persuasive evidence of an arrangement exists, and the fee is fixed or determinable. 3Com accrues related product return reserves, warranty, other post-contract support obligations, and royalty expenses at the time of sale. A limited warranty is provided on 3Com products for periods ranging from 90 days to the lifetime of the product, depending upon the product. Service and maintenance sales are recognized over the contract term. 3Com provides limited product return and price protection rights to certain distributors and resellers. Product return rights are generally limited to a percentage of sales over a one to three month period.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations" which addresses the financial accounting and reporting for business combinations and supersedes Accounting Principals Board (APB) Opinion No. 16, "Business Combinations," and SFAS No. 38, "Accounting for Preacquisition Contingencies of Purchased Enterprises." SFAS No. 141 requires that all business combinations be accounted for by a single method, the purchase method, modifies the criteria for recognizing intangible assets, and expands disclosure requirements. The provisions of SFAS No. 141 apply to all business combinations initiated after June 30, 2001. 3Com does not expect the adoption of SFAS No. 141 to have a material effect on the results of operations or statements of financial position of the Company.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets" which addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." SFAS No. 142 addresses how intangible assets that are acquired individually or with a group of other assets should be accounted for in financial statements upon their acquisition and after they have been initially recognized in the financial statements. SFAS No. 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but rather tested at least annually for impairment, and intangible assets that have finite useful lives be amortized over their useful lives. SFAS No. 142 provides specific guidance for testing goodwill and

intangible assets that will not be amortized for impairment. In addition, SFAS No. 142 expands the disclosure requirements about goodwill and other intangible assets in the years subsequent to their acquisition. SFAS No. 142 is effective for 3Com's fiscal year 2003. Impairment losses for goodwill and indefinite-life intangible assets that arise due to the initial application of SFAS No. 142 are to be reported as a change in accounting principle. However, goodwill and intangible assets acquired after June 30, 2001 will be subject immediately to provisions of SFAS 142. 3Com is in the process of determining the impact that adoption will have on the consolidated financial statements.

2. Derivative Financial Instruments

Effective June 2, 2001, 3Com adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS 133 requires that all derivative financial instruments be recognized as either assets or liabilities on the balance sheet and carried at fair value. Changes in the fair value of derivative instruments are recognized periodically in earnings or stockholders' equity, depending on the intended use of the instrument. Valuation changes for derivatives designated as fair value hedges are recognized in earnings in the period of change, along with the change in value of the underlying hedged item. Gains or losses on derivatives designated as cash flow hedges are initially reported as a component of other comprehensive income and later reclassified into earnings in the period affected by the underlying hedged exposure. Changes in value of derivatives that are not designated as hedging instruments and the amount of any hedging instruments deemed to be ineffective are recorded in earnings in the period of change.

3Com enters into certain foreign exchange contracts, primarily forwards and purchased options, to hedge certain balance sheet exposures and intercompany balances against future movements in foreign exchange rates. Such contracts are considered to be effective economic hedges of the underlying assets and liabilities but are not designated as hedges under SFAS 133 and resultant changes in value are recorded currently in earnings. 3Com does not use derivative financial instruments for speculative or trading purposes.

3Com may also, from time to time, invest in warrants to purchase securities of other companies as strategic investments. These warrants are recognized as assets on the balance sheet and carried at fair value. Changes in the fair value are recognized periodically in earnings.

The adoption of SFAS No. 133 resulted in a cumulative pre-tax gain related to the value of warrants held as strategic investments. During the three months ended August 31, 2001, a reduction in earnings was recorded related to the value of warrants held as strategic investments. The cumulative pre-tax gain and the reduction in earnings for the three months ended August 31, 2001 were recorded in other income and were not material to 3Com's results of operations, financial position or cash flows.

3. Restructuring Charges

Beginning the fourth quarter of fiscal 2000, 3Com undertook several initiatives aimed at both changing business strategy as well as improving operational efficiencies. 3Com recorded restructuring charges of $57.5 million and $9.9 million in the three months ended August 31, 2001 and September 1, 2000, respectively.

Exit of the Analog-Only Modem and High-End LAN and WAN Chassis Product Lines

3Com realigned its strategy in the fourth quarter of fiscal 2000 to focus on high-growth markets, technologies, and products. Operations were restructured, and in support of this new strategy 3Com exited its analog-only modem and high-end Local Area Network (LAN) and Wide Area Network (WAN) chassis product lines and completed the separation of Palm. As of June 1, 2001, 3Com had $0.4 million accrued for severance and outplacement relating to these activities. During the first quarter of fiscal 2002 3Com paid $0.2 million of this liability and recorded a net restructuring benefit of approximately $0.2 million relating to revisions of previous estimates of restructuring costs.

Actions Related to Reduction in Force and Cost Reduction Efforts

In fiscal 2001, 3Com announced the restructuring of its Commercial and Consumer Networks Business and CommWorks Corporation to enhance the focus and cost effectiveness of these businesses in serving their respective markets. Three independent businesses Business Connectivity Company (BCC), Business Networks Company (BNC), and CommWorks Corporation (CommWorks) were formed through this restructuring effort, with each business utilizing central shared corporate services. 3Com implemented a reduction in workforce and cost reduction actions aimed at expense and asset reduction, and exited its consumer Internet Appliance product line as part of this restructuring effort.

In the first quarter of fiscal 2002, 3Com announced its exit from its consumer cable and digital subscriber line (DSL) modem businesses, as well as its intent to outsource the manufacturing of high volume server, desktop and mobile connectivity products in a contract manufacturing arrangement. Concurrent with such outsourcing, 3Com is consolidating its real estate portfolio and certain facilities are expected to be sold. Components of accrued restructuring charges and changes in accrued amounts related to the announcements of fiscal 2001 the first quarter of fiscal 2002 as of August 31, 2001 were as follows (in thousands):

	Severance and Outplacement	Long-term Asset Write-downs	Facilities-related Charges	Other Restructuring Costs	Total
Balance at June 1, 2001	$ 39,902	$	$	$ 1,782	$ 41,684
Provision	20,694	6,860	26,772	3,335	57,661
Deductions	(37,293)	(6,860)	(22,405)	(1,322)	(67,880)
Balance at August 31, 2001	$ 23,303	$	$ 4,367	$ 3,795	$ 31,465

The total reduction in workforce is planned to be approximately 4,500 positions including full time regular employees and alternative workforce. Employee separation expenses are comprised of severance pay, outplacement services, medical and other related benefits. Affected employee groups include corporate services, manufacturing and logistics, product organizations, sales, customer support and administrative positions. Since the inception of the restructuring through August 31, 2001 approximately 3,800 positions have been separated or were currently in the separation process, resulting in $66.3 million of separation payments. Remaining cash expenditures associated with employee separations are estimated to be approximately $23.3 million.

Long term asset write-downs include items identified as no longer needed to support ongoing operations for 3Com. During the first quarter of fiscal 2002, 3Com recorded a charge of $6.9 million, primarily for manufacturing equipment as a result of the consolidation of our manufacturing operations.

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Facilities-related charges include accelerated depreciation of buildings and lease terminations. In the first quarter of fiscal 2002, 3Com recorded $26.8 million in facilities-related charges, including a $19.2 million accelerated depreciation charge for its Mt. Prospect manufacturing facility that it intends to sell. Remaining cash expenditures associated with facilities as of August 31, 2001 are estimated to be approximately $4.4 million. As the consolidation of its manufacturing operations continues, 3Com expects to incur additional expenses related to facilities in fiscal 2002.

Other restructuring costs include payments to suppliers as well as for professional services. Remaining cash expenditures associated with other restructuring costs are estimated to be approximately $3.8 million.

4. Comprehensive Income (Loss)

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

	Three Months Ended	
	August 31, 2001	September 1, 2000
Net loss	$ (232,384)	$ (59,200)
Other comprehensive income:		
Change in unrealized gain on available-for-sale securities	(2,216)	60,176
Change in accumulated translation adjustments	144	(343)
Total comprehensive income (loss)	$ (234,456)	$ 633

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5. Net Income (Loss) Per Share

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

	Three Months Ended	
	August 31, 2001	September 1, 2000
Loss from continuing operations	$ (232,384)	$ (63,737)
Income from discontinued operations		4,537
	$ (232,384)	$ (59,200)
Weighted average shares Basic	344,313	353,777
Effect of dilutive securities:		
Employee stock options		
Restricted stock		
Weighted average shares Diluted	344,313	353,777
Net income (loss) per share Basic:		
Continuing operations	$ (0.67)	$ (0.18)
Discontinued operations		0.01
	$ (0.67)	$ (0.17)
Net income (loss) per share Diluted:		
Continuing operations	$ (0.67)	$ (0.18)
Discontinued operations		0.01
	$ (0.67)	$ (0.17)

Employee stock options and restricted stock totaling 5.9 million and 74.3 million shares were not included in the diluted weighted average shares calculation for the three months ended August 31, 2001 and September 1, 2000, respectively, as the effects of these securities were antidilutive.

6. Inventories

Inventories, net, consist of (in thousands):

	August 31, 2001	June 1, 2001
Finished goods	$ 39,602	$ 46,091
Work-in-process	54,560	64,319
Raw materials	56,316	89,736
Total inventory	$ 150,478	$ 200,146

7. Business Segment Information

As discussed in Note 3, 3Com reorganized its business around three ongoing businesses BNC, BCC, and CommWorks which were effective for the first quarter of fiscal 2002. Historical segment information has been restated to conform to the current organization structure. The following tables display information on 3Com's reportable segments (in thousands):

	Three Months Ended	
	August 31, 2001	September 1, 2000
Sales:		
Business Networks Company	$ 195,210	$ 300,088
Business Connectivity Company	125,459	279,812
CommWorks	59,355	167,243
Exited Product Lines	9,565	186,621
	$ 389,589	$ 933,764
Contribution margin:		
Business Networks Company	$ (26,360)	$ 4,805
Business Connectivity Company	(30,517)	74,097
CommWorks	(29,260)	31,134
Exited Product Lines	(22,131)	(60,122)
	$ (108,268)	$ 49,914

A reconciliation of the totals reported for the operating segments to the applicable line items in the consolidated financial statements is set forth below (in thousands):

	Three Months Ended	
	August 31, 2001	September 1, 2000
Total contribution margin from operating segments	$ (108,268)	$ 49,914
Unallocated operating expenses (1)	78,552	156,365
Purchased in-process technology		29,406
Merger-related credits, net		(212)