3COM CORP
Form 10-Q
October 10, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 1, 2006
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	**01752**
Marlborough, Massachusetts	(Zip Code)

(Address of principal executive offices)

Registrant s telephone number, including area code: (**508) 323-1000**

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 þ No o

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

Large Accelerated Filer þ Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of September 29, 2006, 396,597,686 shares of the registrant s common stock were outstanding.

3COM CORPORATION
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 1, 2006
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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.

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This quarterly report on Form 10-Q contains forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, without limitation, predictions regarding the following aspects of our future: future growth; H-3C, our joint venture in China, including strategy, growth, purchase of additional equity interest in H-3C and the financing thereof, dependence, statutory tax rate, expected benefits, allocations of purchase price, consolidation, and resources needed to comply with Sarbanes-Oxley and manage operations; TippingPoint acquisition; investments in TippingPoint business; strategy for improving profitability of our SCN segment; environment for enterprise networking equipment; challenges relating to sales growth; leveraging and enhancing our relationship with H-3C; development and execution of our go-to-market strategy; strategic product and technology development plans; designing an appropriate business model, strategic plan and infrastructure to reach sustained profitability; dependence on China; ability to satisfy cash requirements for the next twelve months; effect and benefits of restructuring activities; strategic investments and capital call requirements; potential acquisitions and strategic relationships; outsourcing; competition and pricing pressures; estimated changes, future possible effects and effects of changes in key assumptions made in the application of SFAS No. 123R; expected

restructuring actions and expenses; expected decline in sales of connectivity products; and possible repurchase of shares; and you can identify these and other forward-looking statements by the use of words such as may, can, will, should, expects, plans, anticipates, believes, estimates, predicts, intends, continue, or the negative of 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 Part II Item 1A Risk Factors. 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 have no intent, and disclaim any obligation, to update any forward-looking statements.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
3COM CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

(In thousands, except per share data)	Three Months Ended August 31, 2006	2005
Sales	$ 300,144	$ 177,636
Cost of sales (including stock-based compensation expense of $319 and $9, respectively)	163,715	107,570
Gross profit	136,429	70,066
Operating expenses:		
Sales and marketing (including stock-based compensation expense of $1,237 and $67, respectively)	77,122	70,118
Research and development (including stock-based compensation expense of $1,168 and $30, respectively)	47,793	21,197
General and administrative (including stock-based compensation expense of $563 and $530, respectively)	20,276	18,213
Amortization and write-down of intangible assets	12,181	3,862
Restructuring (benefit) charges	(75)	3,361
Total operating expenses	157,297	116,751
Operating loss	(20,868)	(46,685)
Gain (loss) on investments, net	2,292	(414)
Interest income, net	10,090	5,835
Other income, net	4,718	154
Loss before income taxes, equity interest in loss of unconsolidated joint venture and minority interest	(3,768)	(41,110)
Income tax provision	(1,358)	(915)
Equity interest in loss of unconsolidated joint venture		(16)
Minority interest in income of consolidated joint venture	(8,942)	
Net loss	$ (14,068)	$ (42,041)
Basic and diluted net loss per share	$ (0.04)	$ (0.11)
Shares used in computing per share amounts:		
Basic and diluted	391,885	383,760

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

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3COM CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

(In thousands, except per share data)	August 31, 2006	May 31, 2006
ASSETS		
Current assets:		
Cash and equivalents	$ 525,177	$ 501,097
Short-term investments	390,482	363,250
Notes receivable	50,935	63,224
Accounts receivable, less allowance for doubtful accounts of $15,728 and $16,422, respectively	120,848	115,120
Inventories	171,366	148,819
Other current assets	56,970	57,835
Total current assets	1,315,778	1,249,345
Property and equipment, less accumulated depreciation and amortization of $240,631 and $232,944, respectively	80,309	89,109
Goodwill	354,259	354,259
Intangible assets, net	99,614	111,845
Deposits and other assets	28,929	56,803
Total assets	$ 1,878,889	$ 1,861,361
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 148,326	$ 153,245
Accrued liabilities and other	338,342	318,036
Total current liabilities	486,668	471,281
Deferred revenue and long-term obligations	13,299	13,788
Minority interest	182,872	173,930
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: 393,567 and 393,442, respectively	2,301,384	2,300,396
Treasury stock, at cost, of 552 and zero shares, respectively	(2,705)	
Unamortized stock-based compensation		(7,565)
Retained deficit	(1,101,391)	(1,087,512)
Accumulated other comprehensive loss	(1,238)	(2,957)
Total stockholders equity	1,196,050	1,202,362
Total liabilities and stockholders equity	$ 1,878,889	$ 1,861,361

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

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3COM CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(In thousands)	Three Months Ended August 31, 2006	2005
Cash flows from operating activities:		
Net loss	$ (14,068)	$ (42,041)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	20,095	13,129
Stock-based compensation charges	3,287	1,115
Gain on property and equipment disposals	(7,605)	(421)
(Gain) loss on investments, net	(2,422)	414
Minority interest in income of consolidated joint venture	8,942	
Equity interest in loss of unconsolidated joint venture		16
Deferred income taxes	(3,716)	(143)
Changes in assets and liabilities:		
Accounts receivable	(5,838)	(12,695)
Inventories	(21,662)	(7,497)
Other assets	14,314	(141)
Accounts payable	(6,623)	(7,546)
Other liabilities	18,582	82
Net cash provided by (used in) operating activities	3,286	(55,728)
Cash flows from investing activities:		
Purchases of investments	(190,310)	(211,421)
Proceeds from maturities and sales of investments	180,524	170,964
Purchases of property and equipment	(6,012)	(4,288)
Proceeds from sale of property and equipment	33,108	
Net cash provided by (used in) investing activities	17,310	(44,745)
Cash flows from financing activities:		
Issuances of common stock	2,934	655
Repurchases of common stock	(187)	(672)
Net cash provided by (used in) financing activities	2,747	(17)
Effect of exchange rate changes on cash and equivalents	737	454
Net change in cash and equivalents during period	24,080	(100,036)
Cash and equivalents, beginning of period	501,097	268,535
Cash and equivalents, end of period	$ 525,177	$ 168,499

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

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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 1, 2006 and June 2, 2006, our results of operations for the three months ended September 1, 2006 and September 2, 2005 and our cash flows for the three months ended September 1, 2006 and September 2, 2005.

We use a 52 or 53 week fiscal year ending on the Friday nearest to May 31. For convenience, the condensed consolidated financial statements have been shown as ending on the last day of the calendar month. Accordingly, the three months ended August 31, 2006 ended on September 1, 2006, the three months ended August 31, 2005 ended on September 2, 2005, and the year ended May 31, 2006 ended on June 2, 2006. The results of operations for the three months ended September 1, 2006 may not be indicative of the results to be expected for the fiscal year ending June 1, 2007 or any future periods. 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 year ended June 2, 2006.

Effective June 3, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). Because we used the modified prospective transition method in adopting SFAS No. 123R we have not restated results for prior periods to reflect stock compensation on the fair value method. Under this transition method, stock-based compensation expense for the first quarter of fiscal 2007 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of, May 31, 2006 based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). Stock-based compensation expense for all stock-based compensation awards granted after June 2, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. We recognize the compensation costs for awards granted after May 31, 2006 on a straight-line basis over the requisite service period of the award, which is generally equivalent to the vesting term. Prior to the adoption of SFAS No. 123R, we recognized stock-based compensation expense in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). See Note 2 to the Condensed Consolidated Financial Statements for a further discussion of stock-based compensation.

Recently issued accounting pronouncements

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute of tax positions taken or expected to be taken on a tax return. This Interpretation is effective for the first fiscal year beginning after December 15, 2006. We are currently evaluating the impact FIN 48 may have on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS No. 157 will have on our results of operations or financial condition.

NOTE 2. STOCK-BASED COMPENSATION

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, which requires all stock-based compensation to employees (as defined in SFAS No. 123R), including grants of employee stock options,

restricted

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stock awards, restricted stock units, and employee stock purchase plan shares to be recognized in the financial statements based on their fair values. We adopted SFAS No. 123R on June 3, 2006 using the modified prospective transition method and accordingly, prior period amounts have not been restated. In order to determine the fair value of stock options and employee stock purchase plan shares, we use the Black-Scholes option pricing model and apply the single-option valuation approach to the stock option valuation. In order to determine the fair value of restricted stock awards we use the closing market price of 3Com common stock on the date of grant. We recognize stock-based compensation expense on a straight-line basis over the requisite service period of the awards for options granted following the adoption of SFAS No. 123R. For unvested stock options outstanding as of May 31, 2006, we will continue to recognize stock-based compensation expense using the accelerated amortization method prescribed in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

Estimates of the fair value of equity awards in future periods will be affected by the market price of our common stock, as well as the actual results of certain assumptions used to value the equity awards. These assumptions include, but are not limited to, the expected volatility of the common stock, the expected term of options granted, and the risk free interest rate.

As noted above, the fair value of stock options and employee stock purchase plan shares is determined by using the Black-Scholes option pricing model and applying the single-option approach to the stock option valuation. The options generally have vesting on an annual basis over a vesting period of four years. We estimate the expected option term by analyzing the historical term period from grant to exercise and also consider the expected term for those options that are still outstanding. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period. For equity awards granted after May 31,2006, the volatility of the common stock is estimated using the historical volatility, as allowed in Staff Accounting Bulletin (SAB) No. 107. We believe that historical volatility represents the best information currently available for projecting future volatility. The risk-free interest rate used in the Black-Scholes option pricing model is determined by looking at historical U.S. Treasury zero-coupon bond issues with terms corresponding to the expected terms of the equity awards. In addition, an expected dividend yield of zero is used in the option valuation model because we do not expect to pay any cash dividends in the foreseeable future. In accordance with SFAS No. 123R, we are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. In order to determine an estimated pre-vesting option forfeiture rate, we used historical forfeiture data, which yields a forfeiture rate of 27%. We currently believe this historical forfeiture rate to be reflective of our anticipated rate on a go-forward basis. This estimated forfeiture rate has been applied to all unvested options and restricted stock outstanding as of May 31, 2006 and to all options and restricted stock granted since May 31, 2006. Therefore, stock-based compensation expense is recorded only for those options and restricted stock that are expected to vest. The following table summarizes the incremental effects of the share-based compensation expense resulting from the application of SFAS No. 123R to the options:

	Three Months Ended August 31,	
(In thousands, except per share data)	**2006**	**2005**
Cost of sales	$ 313	$
Sales and marketing	1,039	
Research and development	584	
General and administrative	684	
Sare-based compensation effect of SFAS No. 123R on net loss	$ 2,620	$
	$ (0.01)	$

Share-based compensation effect of SFAS No. 123R on basic and diluted net loss per share		
Share-based compensation effect of SFAS No. 123R on cash flow from operations	$ 2,620	$

As of August 31, 2006, total unrecognized stock-based compensation expense relating to unvested employee stock options, adjusted for estimated forfeitures, was $7.1 million. This amount is expected to be recognized over a weighted-average period of 1.4 years. If actual forfeitures differ from current estimates, total unrecognized stock-based compensation expense will be adjusted for future changes in estimated forfeitures.

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Prior to June 1, 2006, we accounted for stock options using the intrinsic value method, pursuant to the provisions of APB No. 25. Under this method, stock-based compensation expense was measured as the difference between the option s exercise price and the market price of the Company s common stock on the date of grant.

Pro forma information required under SFAS No. 123 for the year ago period, as if we had applied the fair value recognition provisions of SFAS No. 123 to awards granted under our equity incentive plans, was as follows:

(In thousands, except per share amounts)	Three Months Ended August 31, 2005
Net loss as reported	$ (42,041)
Add: Stock-based compensation included in reported net loss	1,115
Deduct: Total stock-based compensation determined under the fair value-based method, net of related tax effects	(3,644)
Adjusted net loss	$ (44,570)
Net loss per share-basic and diluted:	
As reported	$ (0.11)
Adjusted	$ (0.12)

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.

Share-based compensation recognized in the three months ended August 31, 2006 as a result of the adoption of SFAS No. 123R as well as pro forma disclosures according to the original provisions of SFAS No. 123 for periods prior to the adoption of SFAS No. 123R use the Black-Scholes option pricing model for estimating the fair value of options granted under the company s equity incentive plans. There were no employee stock purchase plan shares issued during the three months ended August 31, 2006 and 2005. Employee stock purchase shares normally occur only in the quarters ended November 30 and May 31. 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. Option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. The underlying assumptions used in the Black-Scholes model and the resulting estimates of fair value per share were as follows for options granted during the three months ended August 31, 2006 and 2005:

	Three Months Ended August 31,	
	2006	2005 [1]
Employee stock options:		
Volatility	42.8%	46.0%
Risk-free interest rate	5.0%	3.9%
Dividend yield	0.0%	0.0%
Expected life (years)	4.0	4.0
Fair value per share	$ 1.84	$ 1.42

1 Assumptions used in the calculation of

fair value according to the provisions of SFAS No. 123.

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As of August 31, 2006, our outstanding stock options as a percentage of outstanding shares were approximately 12 percent. Stock option detail as of August 31, 2006, were as follows (shares in thousands):

	Number of shares	Weighted average exercise price
Outstanding June 1, 2006	61,421	$ 5.71
Granted	493	4.62
Exercised	(840)	3.49
Cancelled	(15,702)	5.32
Outstanding August 31, 2006	45,372	$ 5.87
Exercisable	31,549	$ 6.81
Weighted average grant-date fair value of options granted		$ 1.84

During the quarter ended August 31, 2006 approximately 0.8 million options were exercised at an aggregate intrinsic value of $1.3 million. The intrinsic value is calculated as the difference between the market value as of September 1, 2006 and the exercise price of the shares. The market value as of September 1, 2006 was $4.43 as reported by the NASDAQ Global Select Market. The aggregate intrinsic value of options outstanding and options exercisable as of August 31, 2006 was $21.4 million and $8.4 million, respectively.

The number of options cancelled during the three months ended August 31, 2006 includes 12.0 million related to the former Chief Executive Officer. On September 5, 2006 we granted 12.0 million options to the new Chief Executive Officer and 9.7 million shares to other employees. Also granted on September 5, 2006 were 2.3 million restricted stock awards and 3.5 million restricted stock units to various employees.

Options outstanding that are vested and expected to vest as of August 31, 2006 are as follows:

	Number of shares	Weighted average Grant-Date Fair Value	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Vested and expected to vest at August 31, 2006	40,756,529	$ 6.09	0.3	$ 17,980

Restricted stock awards activity during the three months ended August 31, 2006 and restricted stock awards detail as of August 31, 2006, were as follows (shares in thousands):

	Number of Shares (unvested)	Weighted average Grant-Date Fair Value
Outstanding June 1, 2006	2,117	$ 4.07
Granted	40	4.71
Vested	(131)	3.96
Forfeited	(717)	4.33
Outstanding August 31, 2006	1,309	$ 3.97

During the quarter ended August 31, 2006 approximately 0.1 million restricted shares with an aggregate fair value of $0.6 million became rested.

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NOTE 3. ACQUISITIONS

On November 17, 2003, we formed the Huawei-3Com joint venture, or H-3C, with a subsidiary of Huawei Technologies, Ltd., or Huawei. H-3C is domiciled in Hong Kong, and has its principal operating center in Hangzhou, China.

At the time of formation, we contributed cash of $160.0 million, 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 our carrying value for the cash and assets contributed. Huawei contributed its enterprise networking business assets including Local Area Network, or 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 had the one-time option to purchase an additional two percent ownership interest from Huawei. On October 28, 2005, we exercised this right and entered into an agreement to purchase an additional two percent ownership interest in H-3C from Huawei for an aggregate purchase price of $28.0 million. We were granted regulatory approval by the Chinese government and subsequently completed this transaction on January 27, 2006 (date of acquisition). Consequently, we now own a majority interest in the joint venture and have determined that the criteria of Emerging Issues Task Force No. 96-16, Investor s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights have been met and, therefore, consolidated H-3C s financial statements beginning February 1, 2006, a date used under the principle of a convenience close. As H-3C reports on a calendar year basis, we consolidate H-3C based on H-3C s most recent financial statements, two months in arrears. Our Consolidated Statement of Operations for the quarter ended August 31, 2006 contains all three months of results from H-3C s quarter ended June 30, 2006. As we only own 51% of H-3C our Consolidated Balance Sheet reflects a minority interest liability related to Huawei s 49% ownership in H-3C and our Consolidated Statement of Operations contains an allocation to minority interest of amounts representing Huawei s 49% share of H-3C s net income. Under the terms of our existing shareholders agreement, and as previously disclosed, we and Huawei each have the right, commencing on or after November 15, 2006, to initiate a bid process to purchase the equity interest in H-3C held by the other.

Prior to February 1, 2006, we accounted for our investment in H-3C using the equity method. Under this method, we recorded our proportionate share of H-3C s net income or loss based on the most recently available quarterly financial statements. The following pro forma financial information presents the consolidated results of operations of 3Com and H-3C as if the 2% acquisition had occurred as of the beginning of the period presented below. Preliminary adjustments, which reflect the amortization of purchased intangible assets and charges for in-process research and development have been made to the consolidated results of operations. We also eliminated the inter-company activity between the parties in the consolidated results. The unaudited pro forma financial information is not intended, and should not be taken, as representative of our future consolidated results of operations or the results that would have occurred if the acquisition occurred on March 1, 2005.

(in millions, except per share amounts)

	Three Months Ended August 31, 2005
Net sales	$ 259.6
Net loss	(42.6)
Basic and diluted net loss per share	$ (0.11)

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 businesses in serving their respective markets. These restructuring efforts continued through fiscal 2006. As of August 31, 2006, accrued liabilities related to actions initiated in fiscal 2001, 2002, 2003, 2004, 2005, and 2006 (the

Fiscal 2001 Actions , Fiscal 2002 Actions , Fiscal 2003 Actions , Fiscal 2004 Actions , Fiscal 2005 Actions , and 2006 Actions) mainly consist of lease obligations associated with vacated facilities and employee separation costs. During the first quarter of fiscal 2007 (the Fiscal 2007 Actions), we took the following additional measures to reduce

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costs:

- further reductions in workforce; and

- continued efforts to consolidate and dispose of excess facilities.

Restructuring charges related to these various initiatives resulted in a net benefit of $0.1 million in the first quarter of fiscal 2007 and a charge of $3.4 million in the first quarter of fiscal 2006. The net restructuring benefit in the first quarter of fiscal 2007 resulted from severance, outplacement and other costs of $7.9 million, slightly more than offset by a gain on the sale of our Santa Clara facility of $8.0 million. Restructuring charges in the first quarter of fiscal 2006 included $2.0 million for severance and outplacement costs and $1.4 million for facilities-related charges and long-term asset write-downs.

Accrued liabilities associated with restructuring charges are included in the caption Accrued liabilities and other in the accompanying consolidated balance sheets. These liabilities are classified as current because we expect to satisfy such liabilities in cash within the next 12 months.

Fiscal 2007 Actions

Activity and liability balances related to the fiscal 2007 restructuring actions are as follows (in thousands):

	Employee Separation Expense	Facilities-related Sales	Other Restructuring Costs	Total
Balance as of June 1, 2006	$	$	$	$
Provisions (benefits)	7,619	(7,965)	85	(261)
Payments and non-cash charges	(2,933)	7,965	(85)	4,947
Balance as of August 31, 2006	$ 4,686	$	$	$ 4,686

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce affected employees involved in research and development, sales and marketing, customer support, and general and administrative functions. Through August 31, 2006, the total reduction in workforce associated with actions initiated during fiscal 2007 included approximately 115 employees who had been separated or were currently in the separation process and approximately 30 additional employees who had been notified but had not yet worked their last day.

In the first quarter we recorded a benefit for the sale of our owned Santa Clara facility in the amount of $8.0 million. Other restructuring charges were for payments to suppliers in support of the restructuring efforts.

Fiscal 2006 Actions

Activity and liability balances related to the fiscal 2006 restructuring actions are as follows (in thousands):

	Employee Separation Expense	Facilities-related Charges	Total
Balance as of June 1, 2006	$ 4,877	$ 891	$ 5,768
Provisions (benefits)	(10)	(13)	(23)
Payments and non-cash charges	(2,902)	(60)	(2,962)
Balance as of August 31, 2006	$ 1,965	$ 818	$ 2,783

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce affected employees involved in research and development, sales and marketing, customer support, and general and administrative functions. Through August 31, 2006 separation payments associated with actions initiated in fiscal 2006 were approximately $7.6 million.

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The benefit recorded in our first quarter results was primarily for employees retained and revised lease obligation terms.

We expect to complete any remaining activities related to actions initiated in fiscal 2006 during fiscal 2007.

Fiscal 2005 Actions

Activity and liability balances related to the fiscal 2005 restructuring actions are as follows (in thousands):

	Employee Separation Expense	Long-term Asset Write-downs	Facilities-related Charges	Other Restructuring Costs	Total
Balance as of June 1, 2006	$ 1,843	$ 255	$	$ 13	$ 2,111
Provisions (benefits)	(11)		14		3
Payments and non-cash charges	(145)		(14)		(159)
Balance as of August 31, 2006	$ 1,687	$ 255	$	$ 13	$ 1,955

The separation benefit recorded in our first quarter results was primarily for employees retained.

We expect to complete any remaining activities related to actions initiated in fiscal 2006 during fiscal 2007.

Fiscal 2001, 2002, 2003 and 2004 Actions

Activity and liability balances related to the fiscal 2001, 2002, 2003 and 2004 restructuring actions are as follows (in thousands):

	Facilities-related Charges	Other Restructuring Costs	Total
Balance as of June 1, 2006	$ 5,641	$ 5	$ 5,646
Provisions	205		205
Payments and non-cash charges	(921)		(921)
Balance as of August 31, 2006	$ 4,925	$ 5	$ 4,930

Facilities related charges in the quarter were related to a provision of $0.4 million for fiscal 2003 actions for revised lease obligation terms offset by benefits for the 2001, 2002 and 2004 plans of $0.2 million for extended lease terms.

NOTE 5. INVESTMENT IN UNCONSOLIDATED JOINT VENTURE

As described in Note 3 we formed H-3C with a subsidiary of Huawei.

Prior to the acquisition we accounted for our investment by the equity method. Under this method, we recorded our proportionate share of H-3C s net income or loss based on the most recently available quarterly financial statements. Since H-3C follows a calendar year basis of reporting, we reported our equity in H-3C s net loss for H-3C s fiscal period from April 1, 2005 through June 30, 2005, in our results of operations for the first quarter of fiscal 2006. This represents reporting two months in arrears.

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The following summarized information is from the statement of operations for H-3C for the three month period ended June 30, 2005. The unaudited financial information is not intended, and should not be taken, as representative of future results of our H-3C segment.
(in thousands):

	Three months ended June 30, 2005
Statement of Operations:	
Sales	$95,772
Gross profit	40,450
Net loss	(33)

In determining our share of the net loss of H-3C certain adjustments were made to H-3C s reported results. These adjustments were made primarily to recognize the value and the 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.
3Com and H-3C are parties to agreements for the sale of certain products between each other. During the first quarter of fiscal 2006, we made sales of products to H-3C of $3.2 million and made purchases of products from H-3C of $16.9 million. Upon consolidation, these sales and purchases are eliminated in our consolidated results.

NOTE 6. COMPREHENSIVE LOSS

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

	Three Months Ended August 31,	
	2006	2005
Net loss	$ (14,068)	$ (42,041)
Other comprehensive income:		
Net unrealized gain on investments	1,039	419
Change in accumulated translation adjustments	682	436
Total comprehensive loss	$ (12,347)	$ (41,186)

NOTE 7. NET LOSS PER SHARE

Employee stock options totaling 45.4 million shares for the three months ended August 31, 2006 and 62.5 million shares for the three months ended August 31, 2005 were not included in the computation of diluted earnings per share as the net loss for these periods would have made their effect antidilutive.

NOTE 8. INVENTORIES

The components of inventories are as follows (in thousands):

	August 31, 2006	May 31, 2006
Finished goods	$ 98,472	$ 69,386
Work-in-process	15,851	12,777
Raw materials	57,043	66,656
Total	$ 171,366	$ 148,819

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NOTE 9. INTANGIBLE ASSETS, NET

The following table details our purchased intangible assets (in thousands):

	August 31, 2006			May 31, 2006		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Existing technology	$ 203,946	$ (124,344)	$ 79,602	$ 203,946	$ (114,235)	$ 89,711
Maintenance contracts	19,000	(5,014)	13,986	19,000	(4,222)	14,778
Other	15,301	(9,275)	6,026	15,301	(7,945)	7,356
Total	$ 238,247	$ (138,633)	$ 99,614	$ 238,247	$ (126,402)	$ 111,845

NOTE 10. ACCRUED WARRANTY

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 three months ended August 31, 2006 and 2005 (in thousands):

	Three Months Ended August 31,	
	2006	2005
Accrued warranty, beginning of period	$ 41,791	$ 41,782
Cost of warranty claims processed during the period	(11,592)	(7,919)
Provision for warranties related to products sold during the period	11,589	6,865
Accrued warranty, end of period	$ 41,788	$ 40,728

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. However, since deferred revenue and other associated accruals related to such sales approximate the guaranteed amounts, any payments resulting from end user defaults are not expected to have a material impact on our results of operations.

NOTE 11. SEGMENT INFORMATION

Based on the information provided to our chief operating decision-maker (CODM) for purposes of making decisions about allocating resources and assessing performance, prior to February 1, 2006, we reported one operating segment, 3Com.

As a result of the acquisition of H-3C, we have two segments that provide information to the CODM: the Secure Converged Networking, or SCN, business and the acquired H-3C business. Each of these segments has designated management teams with direct responsibility over the operations of the respective segments. Accordingly, our CODM now focuses primarily on information and analysis for purposes of making decisions about allocating resources and assessing performance. As a result, we currently report two operating segments, SCN and H-3C.

Management evaluates segment performance based on segment net revenue, operating income (loss), net income (loss), and net assets.

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Summarized financial information of our continuing operations by segment for the three months ended August 31, 2006 is as follows. Note that the three months ended August 31, 2005 is not presented as prior to February 1, 2006 we did not consolidate the H-3C segment.
(in thousands)

	Three Months Ended August 31, 2006			
	SCN	H-3C	Eliminations[1]	Total
Revenue	$ 155,823	$169,968	$(25,647)	$ 300,144
Gross profit	56,345	80,084		136,429
Sales and marketing, research and development, and general and administrative	85,403	59,788		145,191
Restructuring, amortization, and in-process research and development	3,516	8,590		12,106
Operating income (loss)	(32,574)	11,706		(20,868)
Net income (loss)	$ (23,375)	$ 18,249	$ (8,942)	$ (14,068)
Assets	$1,453,244	$453,885	$(28,240)	$1,878,889

1 Represents eliminations for inter-company sales as well as the recording of minority interest related to Huawei s 49 percent ownership in the joint-venture.

Certain product groups accounted for a significant portion of our sales. Sales from these product groups as a percentage of total sales for the respective periods are as follows (in thousands except percentages):

	Three Months Ended August 31,			
	2006		2005	
Networking	$ 244,033	81.3%	$ 127,054	71.5%
Security	25,462	8.5	16,876	9.5
Voice	15,949	5.3	15,408	8.7
Services	8,351	2.8	7,835	4.4
Connectivity Products	6,349	2.1	10,463	5.9
Total	$ 300,144		$ 177,636	

During the quarter Huawei Technologies together with its affiliates became a customer which represents at least 10% of total consolidated sales. The customer is part of the H-3C segment.

NOTE 12. GEOGRAPHIC INFORMATION

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

	Three Months Ended August 31,	
	2006	2005
North America	$ 58,423	$ 68,624
Latin and South America	15,319	14,117
Europe, Middle East, and Africa	69,534	74,908
Asia Pacific	156,868	19,987
Total	$ 300,144	$ 177,636

Sales information by geography to the extent available is reported based on the customer s designated delivery point, except in the case of H-3C s Original Equipment Manufacturer, or OEM, sales which are based on the hub locations of H-3C s OEM partners.

NOTE 13. LITIGATION

We are a party to lawsuits in the normal course of our business. Litigation can be expensive and disruptive to normal

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business operations. Moreover, the results of complex legal proceedings are difficult to predict. We believe that we have meritorious defenses in the matter set forth below in which we are named as a defendant. An unfavorable resolution of the lawsuit described below 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 as a result of this litigation and, accordingly, we have not recorded any associated liability in our consolidated balance sheets.

On December 5, 2001, TippingPoint and two of its current and former officers and directors, as well as the managing underwriters in TippingPoint s initial public offering, were named as defendants in a purported class action lawsuit filed in the United States District Court for the Southern District of New York. The lawsuit, which is part of a consolidated action that includes over 300 similar actions, is captioned In re Initial Public Offering Securities Litigation, Brian Levey vs. TippingPoint Technologies, Inc., et al. (Civil Action Number 01-CV-10976). The principal allegation in the lawsuit is that the defendants participated in a scheme to manipulate the initial public offering and subsequent market price of TippingPoint s stock (and the stock of other public companies) by knowingly assisting the underwriters requirement that certain of their customers had to purchase stock in a specific initial public offering as a condition to being allocated shares in the initial public offerings of other companies. In relation to TippingPoint, the purported plaintiff class for the lawsuit is comprised of all persons who purchased TippingPoint stock from March 17, 2000 through December 6, 2000. The suit seeks rescission of the purchase prices paid by purchasers of shares of TippingPoint common stock. On September 10, 2002, TippingPoint s counsel and counsel for the plaintiffs entered into an agreement pursuant to which the plaintiffs dismissed, without prejudice, TippingPoint s former and current officers and directors from the lawsuit. In May 2003, a memorandum of understanding was executed by counsel for the plaintiffs, the issuer-defendants and their insurers setting forth the terms of a settlement that would result in the termination of all claims brought by the plaintiffs against the issuer-defendants and the individual defendants named in the lawsuit. In August 2003, TippingPoint s Board of Directors approved the settlement terms described in the memorandum of understanding. In May 2004, TippingPoint signed a settlement agreement on behalf of itself and its current and former directors and officers with the plaintiffs. This settlement agreement formalizes the previously approved terms of the memorandum of understanding and, subject to certain conditions, provides for the complete dismissal, with prejudice, of all claims against TippingPoint and its current and former directors and officers. Any direct financial impact of the settlement is expected to be borne by TippingPoint s insurers. On August 31, 2005, the District Court issued its preliminary approval of the settlement terms. The settlement remains subject to numerous conditions, including final approval by the District Court. There can be no assurance that such conditions will be met. If the District Court rejects the settlement agreement, in whole or in part, or the settlement does not occur for any other reason and the litigation against TippingPoint continues, we intend to defend this action vigorously, and to the extent necessary, to seek indemnification and/or contribution from the underwriters in TippingPoint s initial public offering pursuant to its underwriting agreement with the underwriters. However, there can be no assurance that indemnification or contribution will be available to TippingPoint or enforceable against the underwriters.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

INTRODUCTION

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

BUSINESS OVERVIEW

We provide secure, converged networking solutions on a global scale to businesses of all sizes. Our products and solutions enable customers to manage business-critical voice and data in a secure and efficient network environment. We deliver networking products and services for enterprises that view their networks as mission critical and value superior performance. Our products form integrated solutions and function in multi-vendor environments. Our products are sold on a worldwide basis through a combination of value added partners and direct sales representatives. Our long-term technology-based strategy centers on enterprises and public sector organizations migrating to secure Internet Protocol (IP) based infrastructures that deliver converged voice and data applications. Our products and services can generally be classified in the following categories:

Networking;

Security;

Voice;

Services; and

Connectivity Products.

We have undergone significant changes in recent years, including:

significant headcount reductions and consolidation of facilities;

restructuring activities which included outsourcing of information technology, all manufacturing activity in our SCN segment, and other functions, and selling excess facilities;

significant changes to our executive leadership;

forming the Huawei-3Com joint venture (H-3C);

acquisition of majority ownership of H-3C;

acquiring TippingPoint Technologies, Inc.; and

realigning our sales and marketing channels and expenditures.

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

Significant Events

On November 17, 2003, we formed our joint venture, Huawei-3Com (H-3C), which is domiciled in Hong Kong and has its principal operating center in Hangzhou, China. We contributed $160.0 million in cash, assets related to our operations in China and Japan, and licenses to intellectual property related to those operations 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. In the third quarter of fiscal 2006, we further expanded H-3C s available markets to include several additional countries. We expect this venture to continue to provide three key benefits to us an expanded product line, access to lower cost and highly effective engineering talent, and a significant presence in the China, Japan, Hong Kong, and other developing markets.

During fiscal 2006, we exercised our right to purchase an additional two percent ownership interest in H-3C and entered into an agreement with Huawei for an aggregate purchase price of $28.0 million in cash. We were granted regulatory approval by the Chinese government and subsequently completed this transaction on January 27, 2006 (date of acquisition). Consequently, we now own a majority interest in the joint venture and have determined that the criteria of Emerging Issues Task Force No. 96-16, Investor s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but

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the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights have been met. Accordingly, we consolidated H-3C s financial statements from the date of acquisition. Both partners have the right to initiate a bid process to purchase all of the other partner s ownership interest at any time after the third anniversary of H-3C s formation.

We have introduced multiple new products targeted at the medium to large enterprise market, including modular switches and routers, as well as VoIP, security and wireless solutions. We also continue to develop solutions for the small to medium enterprise market, including a unified switch offering, VoIP, smart switches, and Power over Ethernet technology.

During the three months ended August 31, 2006 we continued to experience strong results in our H-3C segment and we reduced operating expenses in our SCN business segment, offset in-part by continued investment in the TippingPoint security business.

On October 5, 2006 we announced the election of Dominique Trempont to our board of directors and, effective October 9, 2006, to the Board s Audit and Finance Committee. We also announced that Julie St. John resigned from our Board and its Audit and Finance Committee effective September 29, 2006. Following Ms. St. John s departure, we were, for a brief period, not compliant with NASDAQ s governance requirement to maintain three audit committee members. We regained compliance on October 9, 2006 when Mr. Tempont officially joined such committee.

Summary of Three Months Ended August 31, 2006 Financial Performance

Our sales in the three months ended August 31, 2006 were $300.1 million, compared to sales of $177.6 million in the three months ended August 31, 2005, an increase of $122.5 million, or 69.0 percent.

Our gross margin improved to 45.5 percent in the three months ended August 31, 2006 from 39.4 percent in the three months ended August 31, 2005.

Our operating expenses in the three months ended August 31, 2006 were $157.3 million, compared to $116.8 million in the three months ended August 31, 2005, a net increase of $40.5 million, or 34.7 percent.

Our net loss in the three months ended August 31, 2006 was $14.1 million, compared to a net loss of $42.0 million in the three months ended August 31, 2005. In the three months ended August 31, 2006 net loss in our SCN segment was $23.4 million which was partially offset by net income of $18.2 million in our H-3C segment before reflecting the minority interest to Huawei of $8.9 million.

Our balance sheet remained strong with cash and equivalents and short-term investment balances of $915.7 million as of August 31, 2006, compared to cash and equivalents and short-term investment balances of $864.3 million at the end of fiscal 2006.

Business Environment and Future Trends

Networking industry analysts and participants differ widely in their assessments concerning the prospects for near-term industry growth. Industry factors and trends also present significant challenges in the medium term with respect to our goals for sales growth, gross margin improvement and profitability. Such factors and trends include:

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 competitive products and makes it increasingly difficult for us to differentiate our products.

Our key focus in fiscal 2007 is to manage our H-3C operating segment for expected growth and to manage our SCN operating segment towards our goal of a return to profitability while maintaining strong investment levels in our TippingPoint security products and sales teams. In fiscal 2007, we plan to continue investment in the H-3C segment that provided strong growth in fiscal 2006. This involves continued investment in research and development,

increased distribution both inside and outside of China, and growing the infrastructure. We continue to face significant challenges in the SCN segment with respect to sales growth, gross margin and profitability. Future sales growth for the SCN segment depends to a substantial degree on increased sales of our networking products, and we believe our best growth opportunity requires us to expand our product lines targeting selected enterprise customers. In order to achieve our sales goals in the

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SCN segment for fiscal 2007, it is imperative that we continue to enhance the features and capabilities of these products in a timely manner in order to expand our addressable market opportunities, distribution channels and market competitiveness. Also, we expect a very competitive, difficult pricing environment for the foreseeable future; this will likely exert downward pressure on our SCN sales, gross margin and profitability.

Another key priority will be to determine future H-3C ownership pursuant to a negotiated purchase or the bid process. On August 8, 2006, we announced that we will begin negotiations with Huawei for the purchase by us of an additional equity interest in H-3C. We currently own 51% of H-3C and Huawei owns 49%. Under the terms of our existing shareholders agreement, and as previously disclosed, we each have the right, commencing on and after November 15, 2006, to initiate a bid process to purchase the equity interest in H-3C held by the other. The negotiations are intended to result in an agreement outside of the bid process. We cannot provide assurance that we will be able to negotiate acceptable terms with Huawei or that the transaction will be consummated at all. We may need to raise equity or debt capital in order to finance any such transaction, and such financing may not be available on terms acceptable to us. We may also use existing cash to finance a portion of the consideration for any such transaction, which, if used, would reduce available cash on hand.

Our action plan for fiscal 2007 are based on certain assumptions concerning the overall economic outlook for the markets in which we operate, the expected demand for our products, our ability to compete effectively and gain market share, and the cost and expense structure of our business. These assumptions could prove to be inaccurate. If current economic conditions deteriorate, or if our planned actions are not successful in achieving our goals, there could be additional adverse impacts on our financial position, sales, profitability or cash flows. In that case, we might need to modify our strategic focus and restructure our business again to realign our resources and achieve additional cost and expense savings.

We are committed to our objective of being a leading provider of secure, converged networking solutions for small, medium and large enterprises. We believe that our recent initiatives and our business strategy are consistent with our goals of growth and profitability over the longer term.

CRITICAL ACCOUNTING POLICIES

Our critical accounting policies are described in Note 2 to our Consolidated Financial Statements contained in our Annual Report on Form 10-K for the fiscal year ended May 31, 2006. These policies continue to be those that we feel are most important to a reader s ability to understand our financial results. In addition, effective June 1, 2006, we adopted SFAS No. 123R, which we have identified as an additional critical accounting policy, and have provided a description of that policy below.

Stock-based Compensation. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, which requires all stock-based compensation to employees (as defined in SFAS No. 123R), including grants of employee stock options, restricted stock awards, and restricted stock units, to be recognized in the financial statements based on their fair values.

Estimates of the fair value of equity awards in future periods will be affected by the market price of our common stock, as well as the actual results of certain assumptions used to value the equity awards. These assumptions include, but are not limited to, the expected volatility of the common stock, the expected term of options granted, and the risk free interest rate.

The fair value of stock options and employee stock purchase plan shares is determined by using the Black-Scholes option pricing model and applying the single-option approach to the stock option valuation. The options generally have vesting on an annual basis over a vesting period of four years. We estimate the expected option term by analyzing the historical term period from grant to exercise and also considers the expected term for those options that are outstanding. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period. For equity awards granted after June 1, 2006, the volatility of the common stock is estimated using the historical volatility, as allowed in Staff Accounting Bulletin (SAB) No. 107.

The risk-free interest rate used in the Black-Scholes option pricing model is determined by looking at historical U.S. Treasury zero-coupon bond issues with terms corresponding to the expected terms of the equity awards. In addition, an expected dividend yield of zero is used in the option valuation model, because we do not expect to pay any cash dividends in the foreseeable future. Lastly, in accordance with SFAS No. 123R, we are required to estimate forfeitures

at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. In order to determine an estimated pre-vesting option forfeiture rate, we used historical forfeiture data, which yields a forfeiture rate of 27%. We

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believe this historical forfeiture rate to be reflective of our anticipated rate on a go-forward basis. This estimated forfeiture rate has been applied to all unvested options and restricted stock outstanding as of June 1, 2006 and to all options and restricted stock granted since June 1, 2006. Therefore, stock-based compensation expense is recorded only for those options and restricted stock that are expected to vest.

RESULTS OF OPERATIONS

THREE MONTHS ENDED AUGUST 31, 2006 AND 2005

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

	Three Months Ended August 31,	
	2006	**2005**
Sales	100.0%	100.0%
Cost of sales	54.5	60.6
Gross profit margin	45.5	39.4
Operating expenses:		
Sales and marketing	25.7	39.5
Research and development	15.9	11.9
General and administrative	6.8	10.3
Amortization and write-down of intangible assets	4.1	2.2
Restructuring charges	0.0	1.9
Total operating expenses	52.4	65.7
Operating loss	(7.0)	(26.3)
Gain (loss) on investments, net	0.8	(0.2)
Interest income, net	3.3	3.3
Other income, net	1.6	0.1
Loss before income taxes and equity interest	(1.3)	(23.1)
Income tax provision	(0.4)	(0.5)
Equity interest in loss of unconsolidated joint venture		(0.0)
Minority interest in income of consolidated joint venture	(3.0)	
Net loss	(4.7)%	(23.7)%

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Sales

Sales increased $122.5 million, or 69.0%, in the three months ended August 31, 2006 compared to the same period in the previous fiscal year. This growth is primarily attributable to the inclusion of H-3C sales in the current period. The increase was partially offset by decreases in networking revenues in our SCN segment, largely resulting from the business challenges described earlier.

Sales by major product categories are as follows (dollars in millions):

	Three Months Ended August 31,			
	2006		2005	
Networking	$ 244.0	81%	$ 127.1	72%
Security	25.5	9%	16.9	9%
Voice	15.9	5%	15.4	9%
Services	8.4	3%	7.8	4%
Connectivity Products	6.3	2%	10.4	6%
Total	$ 300.1	100%	$ 177.6	100%

Networking revenue includes sales of our Layer 2 and Layer 3 stackable 10/100/1000 managed switching lines, our modular switching lines and routers, wireless switching offerings and our OfficeConnect and baseline-branded small to medium-sized enterprise market products. Sales of our networking products increased $116.9 million or 92% in the three months ended August 31, 2006 compared to the same period in the previous fiscal year. The increase in the three months ended August 31, 2006 is primarily attributable to the inclusion of H-3C s sales in the current period partially off-set by lower revenue in the SCN segment.

Security revenue includes our TippingPoint products and services, as well as other security products, such as VPN offerings. Sales of our security products increased $8.6 million or 51% in the three months ended August 31, 2006 compared to the same period in the previous fiscal year. The increase is primarily driven by increased sales of our SCN security products and the inclusion of H-3C s security offerings.

Voice revenue includes our VCX and NBX® VoIP product lines, as well as voice gateway offerings. Sales of our Voice products increased $0.5 million or 3% in the three months ended August 31, 2006 compared to the same period in the previous fiscal year. This increase is primarily attributable to the inclusion of H-3C s sales in the current period largely offset by lower SCN voice solution sales in the rest of the world.

Services revenue includes professional services and maintenance contracts, excluding TippingPoint maintenance which is included in security. Services revenue increased $0.6 million or 8% in the three months ended August 31, 2006, when compared to the same period in the previous fiscal year. The increase in the service revenue is primarily attributable to the inclusion of H-3C s results in the current period.

Connectivity Products revenue includes our legacy network interface card, personal computer card, and mini-peripheral component interconnect form factors. Sales of our connectivity products decreased $4.1 million or 39% in the three months ended August 31, 2006 compared to the same period in the previous fiscal year. In the fourth quarter of fiscal 2006 we made a decision to end-of-life many connectivity products as we determined that the cost to ensure European Union Restriction of Hazardous Substance (RoHS) compliance was not commensurate to our future projected revenue streams. We expect sales from connectivity products to decline again in the remainder of fiscal 2007 due to reduced demand for our products, our end of life decision and continued pricing pressures.

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Gross Margin

Gross margin improved 6.1 points to 45.5% in the three months ended August 31, 2006 from 39.4% in the same period in the previous fiscal year. Significant components of the improvement in gross profit margins were as follows:

1) Consolidation of H-3C	9.3
2) SCN cost improvements	5.0
3) SCN product mix and selling price reductions	(6.5)
4) SCN volume impact	(1.7)
Total	6.1%

1) The increase is due to the consolidation of H-3C results in the current period. H-3C products generally have higher gross margins.

2) The increase in the SCN margin was the result of lower product and service material and delivery costs.

3) The decrease in the SCN margin was the result of lower average selling prices and an unfavorable shift in product mix.

4) The decrease in the SCN margin was the result of lower revenue on the portion of our costs that are fixed in nature.

Operating Expenses

(Dollars in millions)	Three Months Ended August 31,		Change	
	2006	2005	$	%
Sales and marketing	$ 77.1	$ 70.1	$ 7.0	10%
Research and development	47.8	21.2	26.6	125%
General and administrative	20.3	18.2	2.1	12%
Amortization of intangible assets	12.2	3.9	8.3	213%
Restructuring	(0.1)	3.4	(3.5)	*
Total	$ 157.3	$ 116.8	$ 40.5	35%

* percentage calculation not meaningful

Sales and Marketing. The most significant factors in the increase in the three months ended August 31, 2006 compared to the same period in fiscal 2006 were the inclusion of H-3C s expenses in the current fiscal period partially offset by a reduction in the SCN sales and marketing expenses. The reduction of the SCN sales and marketing expenses were primarily related to the reduction of marketing expenses, and a reduction in employee related expenses in the three months ended August 31, 2006.

Research and Development. The most significant factors contributing to the increase in the three months ended August 31, 2006 compared to the same period in fiscal 2006 were the inclusion of H-3C s expenses in the current fiscal period and a slight increase in SCN research and development expenses. The slight increase in the SCN research and development costs were increased investment in the TippingPoint research and development team and the increase in performance related compensation expenses partially offset by reduced non recurring engineering projects and

employee related expenses in the non-TippingPoint related SCN segment.

General and Administrative. The most significant factors in the increase in the three months ended August 31, 2006 compared to the same period in fiscal 2006 were the inclusion of H-3C s expenses in the current fiscal period partially offset by a reduction in the SCN general and administrative expenses. The reduction of the SCN general and administrative expenses were primarily related to the reduced workforce-related expenses due to our restructuring initiatives and reduced IT and facilities-related expenses in three months ended August 31, 2006. Because we granted options and restricted stock to our new CEO and other employees on September 5, 2006 (i.e., after our August 31, 2006 quarter end) we currently expect that stock-based compensation expense allocable to general and administrative expenses will increase on a sequential basis.

Amortization of Intangible Assets. Amortization of intangible assets increased in the three months ended August 31, 2006 when compared to the previous fiscal year due to the consolidation of H-3C s results beginning in the fourth quarter in fiscal year 2006. These assets are being amortized on a straight-line basis over their estimated useful lives of between two and six

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years.

Restructuring Charges

Restructuring charges in the three months ended August 31, 2006 included $7.6 million for severance and outplacement costs and $0.3 million for facilities-related charges and long-term asset write-downs more than offset by an $8.0 gain on the sale of our Santa Clara facility.

Restructuring charges in the three months ended August 31, 2005 included $2.0 million for severance and outplacement costs and $1.4 million for facilities-related charges and long-term asset write-downs as we consolidated facilities and vacated leased offices.

See Note 4 to Condensed Consolidated Financial Statements for a more detailed discussion of restructuring charges.

Gain (loss) on Investments, Net

Net gains on investments were $2.3 million in the three months ended August 31, 2006 primarily reflecting a $2.4 million gain from the sale of certain investment portfolios. Net loss on investments was $0.4 million in the three months ended August 31, 2005 primarily due to fair value adjustments of investments in limited partnership venture capital funds, which have subsequently been sold.

Interest Income, Net

Interest income, net was $10.1 million in the three months ended August 31, 2006, an increase of $4.3 million compared to the corresponding period in the previous fiscal year. This increase is primarily attributable to the inclusion of H-3C s cash balance in the current period and higher interest rates applicable to cash, cash equivalents and short term investments in the SCN segment.

Other Income, Net

Other income, net was $4.7 million in the three months ended August 31, 2006, an increase of $4.6 million compared to the three months ended August 31, 2005. The increase was primarily due to other income from H-3C for an operating subsidy program by the Chinese tax authorities funded by VAT taxes collected by H-3C from purchasers of certain software products. Future subsidy payments are subject to the discretion of the Chinese tax authorities

Income Tax (Provision) Benefit

Our income tax provision was $1.4 million, an increase of $0.4 million for the three months ended August 31, 2006 when compared to the previous fiscal period. The income tax provision increase was primarily due to the inclusion of H-3C s results in the current period. The income tax provision in both periods was the result of providing for taxes in certain state and foreign jurisdictions. Chinese tax authorities approved a change in H-3C s enacted tax rate from a 24% rate before tax holidays to a 15% rate before tax holidays. Consequently, we currently expect the H-3C statutory rate to be 7.5% for the calendar years 2006, 2007 and 2008.

Equity Interest in Loss of Unconsolidated Joint Venture

In the three months ended August 31, 2005 we accounted for our investment in H-3C by the equity method. In the three months ended August 31, 2005, we recorded an insignificant charge representing our share of the net loss reported by H-3C in its three months ended June 30, 2005. In fiscal 2007 H-3C is consolidated for accounting purposes.

Minority Interest of Huawei in the Income of Consolidated Huawei-3Com Joint Venture

In the three months ended August 31, 2006 we recorded an allocation to minority interest of $8.9 million representing Huawei s 49% interest in the net income reported by the H-3C joint venture for the three months ended June 30, 2006. In the three months ended August 31, 2005 H-3C was accounted for under the equity method.

Net Loss

Our net loss in the three months ended August 31, 2006 was $14.1 million, a $27.9 million reduction in net loss when

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compared to the previous fiscal period. This improvement is driven by an $18.6 million improvement in the overall performance of our SCN segment and a net $9.3 million improvement from our ownership in our H-3C segment.

LIQUIDITY AND CAPITAL RESOURCES

Cash and equivalents and short-term investments as of August 31, 2006 were $915.7 million, an increase of $51.4 million compared to the balance of $864.3 million as of May 31, 2006. The following table shows the major components of our condensed consolidated statements of cash flows for the three months ended August 31, 2006 and 2005:

(In millions)	Three Months Ended August 31,	
	2006	2005
Cash and equivalents, beginning of period	$ 501.1	$ 268.5
Net cash provided by (used in) operating activities	3.3	(55.7)
Net cash provided by (used in) investing activities	17.3	(44.8)
Net cash provided by (used in) financing activities	2.7	(0.0)
Other	0.8	0.5
Cash and equivalents, end of period	$ 525.2	$ 168.5

In the three months ended August 31, 2005 H-3C was accounted for under the equity method. The three months ended August 31, 2006 include $196.4 million of H-3C cash and equivalents.

Net cash provided by operating activities was $3.3 million in the three months ended August 31, 2006, primarily reflecting our net loss of $14.1 million, gains on sales of assets of $10.0 million, and increased deferred income taxes of $3.7 million, more than offset by $20.1 million of depreciation and amortization, the minority interest in H-3C of $8.9 million and $3.3 million of stock based compensation. Changes in assets and liabilities resulted in a net use of cash of $1.1 million, with inventory increasing $21.7 million primarily due to increased inventory positions in our H-3C segment, largely offset by $18.5 million in increased other liabilities, primarily in our H-3C segment.

Net cash provided by investing activities was $17.3 million for the three months ended August 31, 2006, consisting of $33.1 million of proceeds from the sale of the Santa Clara facility and insurance proceeds for the previously disclosed damage to our Hemel Hemstead facility, partially offset by $9.8 million of net outflows related to purchases, sales and maturities of investments and by $6.0 million of outflows related to purchases of property and equipment. We made investments totaling $190.3 million in the three months ended August 31, 2006 in municipal and corporate bonds and government agency instruments. In the three months ended August 31, 2006 proceeds from maturities and sales of investments includes sales of municipal and corporate bonds and government agency instruments of $163.5 million. In August 2006 we sold certain limited partnership interests and generated cash of approximately $17.0 million with a gain on sale of investments of $2.4 million and eliminated our future capital call requirements.

Net cash provided by financing activities was $2.7 million in the three months ended August 31, 2006. During the three months ended August 31, 2006, we repurchased $.2 million of shares of restricted stock awards upon vesting from employees including those shares to satisfy the tax withholding obligations that arise in connection with such vesting. This was offset by proceeds of $2.9 million from issuances of our common stock upon exercise of stock options. On March 23, 2005, our Board of Directors approved a stock repurchase program providing for expenditures of up to $100.0 million through March 31, 2007. Under the stock repurchase program, we may repurchase shares of our common stock having an aggregate purchase price of up to $100.0 million in the open market, in privately negotiated transactions with shareholders or using derivative transactions; provided, however, that all repurchases must be pre-approved by the Audit and Finance Committee of the Board of Directors. We have not made any purchases to date under this program. There is no requirement that we repurchase shares under the program and the program may be discontinued at any time.

During the year ended May 31, 2005, we entered into an agreement facilitating the issuance of standby letters of credit and bank guarantees required in the normal course of business. As of August 31, 2006, such bank-issued standby letters of credit and guarantees totaled $6.8 million, including $6.1 million relating to potential foreign tax, custom, and duty assessments.

We currently have no material capital expenditure purchase commitments other than ordinary course purchases of computer hardware, software and leasehold improvements.

We currently believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our

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anticipated cash requirements for at least the next 12 months.

EFFECTS OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standard (SFAS) No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute of tax positions taken or expected to be taken on a tax return. This Interpretation is effective for the first fiscal year beginning after December 15, 2006. We are currently evaluating the impact FIN 48 will have on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS No. 157 will have on our results of operations or financial condition.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We hold marketable equity traded securities that have a brief trading history and are highly subject to market price volatility. We do not believe the equity security price fluctuations of plus or minus 50 percent would have a material impact on the value of these securities as of August 31, 2006.

There have been no material changes in market risk exposures from those disclosed in our Annual Report on Form 10-K for the fiscal year ended May 31, 2006.

ITEM 4. CONTROLS AND PROCEDURES

Our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of our quarter ended September 1, 2006 pursuant to Exchange Act Rule 13a-15(b). The term disclosure controls and procedures, as defined under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of our quarter ended September 1, 2006, our disclosure controls and procedures were effective.

The annual evaluation of internal control over financial reporting will first include H-3C with respect to our fiscal year ending June 1, 2007 and the related annual report on Form 10-K. We anticipate that we will incur considerable costs and use significant management time and other resources in the effort to bring H-3C into compliance with Section 404 and other requirements of the Sarbanes-Oxley Act.

There have been no changes in our internal control over financial reporting that occurred during the three months ended August 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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The information set forth in Note 13 to the Notes to the Condensed Consolidated Financial Statements is incorporated by reference herein.

ITEM 1A. RISK FACTORS

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

We have incurred significant net losses in recent fiscal periods, including $14 million for the three months ended August 31, 2006, $101 million for the year ended May 31, 2006, and $196 million for year ended May 31, 2005, and we may not be able to return to profitability.

Although we are taking steps designed to improve our results of operations, such as the restructuring we announced in June 2006, we cannot provide assurance that we will return to profitability.

We have faced a number of challenges that have affected our operating results during the current and past several fiscal years. Specifically, we have experienced, and may continue to experience, the following, particularly in our SCN segment:

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

risk of increased excess and obsolete inventories;

excess facilities;

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

disruptions resulting from our workforce reductions and employee attrition.

If we do not respond effectively to increased competition caused by industry volatility and consolidation our business could be harmed.

Our business could be seriously harmed if we do not compete effectively. We face competitive challenges that are likely to arise from a number of factors, including the following:

industry volatility resulting from rapid product development cycles;

increasing price competition due to maturation of basic networking technologies;

industry consolidation resulting in competitors with greater financial, marketing, and technical resources; and

the presence of existing competitors with greater financial resources together with the potential emergence of new competitors with lower cost structures and more competitive offerings.

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

Although we have implemented cost and expense reductions with the goal to achieve profitability, we may need to further reduce costs which may in turn reduce our sales. If we are not able to effectively reduce our costs and expenses, particularly in our SCN segment, we may not be able to generate positive net income or cash flow from operations. If we continue to experience negative cash flow from operations over a prolonged period of time or if we suffer unexpected cash outflows, our liquidity and ability to operate our business effectively could be adversely affected.

We are unable to predict the exact amount of cost reductions required for us to generate positive net income or cash flow from operations because it is difficult to predict the amount of our future sales and gross margins. The amount of our future sales depends, in part, on future economic and market conditions, which are difficult to forecast accurately.

Efforts to reduce operating expenses have involved, and could involve further, workforce reductions, closure of offices and sales or discontinuation of businesses, leading to reduced sales and other disruptions in our business.

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Our operating expenses as a percent of sales continue to be higher than our desired long-term financial model. We have taken, and will continue to take, actions to reduce these expenses. Such actions have and may in the future include reductions in our workforce, closure of facilities, relocation of functions and activities to lower cost locations, the sale or discontinuation of businesses, changes or modifications in IT systems or applications, or process reengineering. As a result of these actions, the employment of some employees with critical skills may be terminated and other employees have, and may in the future, leave our company voluntarily due to the uncertainties associated with our business environment and their job security. In addition, reductions in overall staffing levels could make it more difficult for us to sustain historic sales levels, to achieve our growth objectives, to adhere to our preferred business practices and to address all of our legal and regulatory obligations in an effective manner, which could, in turn, ultimately lead to missed business opportunities, higher operating costs or penalties.

We are significantly dependent on our H-3C joint venture in China and if H-3C is not successful, it could materially and adversely impact our business, business prospects and operating results.

H-3C, which is domiciled in Hong Kong and has its principal operations in Hangzhou, China, is subject to all of the operational risks that normally arise for a technology company with global operations including risks relating to research and development, manufacturing, sales, service, marketing, and corporate functions. Given the significance of H-3C to our financial results, if H-3C is not successful, our business will likely be adversely affected.

Our business, business prospects and operating results have significant dependencies upon product deliveries from H-3C and the results of our H-3C operating segment. In particular, our product development activities, product manufacturing and procurement of certain products, intellectual property and channel activities have become increasingly interdependent with those of H-3C.

Sales from our H-3C joint venture and therefore China constitute a material portion of our total sales, and our business, financial condition and results of operations will to a significant degree be subject to economic, political and social events in China.

Our sales are significantly dependent on China. We expect that a significant portion of our sales will be derived from China for the foreseeable future. As a result, our business, financial condition and results of operations are to a significant degree subject to economic, political, legal and social developments and other events in China and surrounding areas.

Our China joint venture, H-3C, is dependent on Huawei, our co-owner in this venture, in several material respects, including as an important customer; should Huawei reduce its business with or operational assistance to H-3C, our business could be materially affected.

H-3C derives a material portion of its sales from or through Huawei. In the three months ended August 31, 2006 for the H-3C segment Huawei accounted for 30% of the revenue for the segment. Should Huawei reduce its business with H-3C, H-3C s sales will suffer. Further, Huawei provides certain foreign office support platforms for H-3C. If Huawei ceases this support, international operations will be more burdensome and expensive for H-3C. Huawei also provides certain information technology, software licensing and rental of premises to H-3C.

If we fail to adequately evolve our financial and managerial control and reporting systems and processes, including the management of our H-3C segment, our ability to manage and grow our business will be negatively affected.

Our ability to successfully offer our products and implement our business plan in a rapidly evolving market depends upon an effective planning and management process. We will need to continue to improve our financial and managerial control and our reporting systems and procedures in order to manage our business effectively in the future. If we fail to implement improved systems and processes, our ability to manage our business and results of operations could be adversely affected. For example, now that we control and consolidate our joint venture in China, H-3C, we are spending additional time, resources and capital to manage its business, operations and financial results. We will need to adequately incentivize H-3C management and other key employees. We will also need to manage the multiple channels to our markets. If we are not able to successfully manage our H-3C venture, our business results could be adversely affected.

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We may not be able to complete or finance a transaction with Huawei to purchase additional interest in our joint venture, H-3C, on favorable terms or at all; if we cannot complete a transaction, our strategy to further invest in H-3C may not occur, we will be subject to the risks of the bid process described below and our business may suffer.

On August 8, 2006, we announced that we will begin negotiations with Huawei for the purchase by us of an additional equity interest in H-3C. We currently own 51% of H-3C and Huawei owns 49%. Under the terms of our existing shareholders agreement, and as previously disclosed, we each have the right, commencing on and after November 15, 2006, to initiate a bid process to purchase the equity interest in H-3C held by the other. The negotiations are intended to result in an agreement outside of the bid process. We cannot provide assurance that we will be able to negotiate acceptable terms with Huawei or that the transaction will be consummated at all. In addition, any such transaction is subject to regulatory approval by the Chinese government and we cannot provide assurance that such approval will be granted. We may need to raise equity or debt capital in order to finance any such transaction, and such financing may not be available on terms acceptable to us. Any equity financing would be dilutive to our existing stockholders. Any debt financing would involve using cash generated from operations to service the interest and pay down the principal, diverting funds that might otherwise be invested in our businesses. We may also use existing cash to finance a portion of the consideration for any such transaction, which, if used, would reduce available cash on hand. If we cannot complete a transaction, the bid process risks described below would apply. If we cannot complete a transaction, our strategy to increase our investment in H-3C may not be available to us and our business may suffer as a result unless we employ successful alternative strategies.

We, and our joint venture partner, Huawei, each have the right, starting in November 2006, to initiate a bid process to buy the other out of our China joint venture, H-3C; if Huawei wins the bid process, we will no longer be able to consolidate H-3C s results and may, over time, lose the right to source and resell H-3C s products.

Starting in November 2006, Huawei and 3Com each can initiate a bid process to purchase the equity interest in H-3C owned by the other. Under the bid process, if one party makes a bid to buy out the other, the party receiving the bid offer must either accept that offer or make its own, higher, bid to buy out the other party. The bidding process would alternate until one party either accepts the other s bid or fails to make a higher bid. If Huawei wins the bid process to buy out our equity ownership in H-3C, upon consummation of the closing of that transaction we will no longer be able consolidate H-3C s results with ours. Our OEM agreement with H-3C, pursuant to which we source products from H-3C and resell them, has an initial five-year term ending November 2008. This agreement automatically renews for successive two-year terms unless a party gives the other party at least 180-days prior written notice that it does not wish to renew the agreement. Should Huawei win the bid process, it may cause H-3C to terminate its OEM agreement with us effective November 2008 or during one of the successive terms. Because we source networking products from H-3C for resale and such products are material to our success, if H-3C terminated its OEM agreement with us it would adversely impact our financial results.

We may not be successful at identifying and responding to new and emerging market and product opportunities, or at responding quickly enough to technologies or markets that are in decline.

The markets in which we compete are characterized by rapid technology transitions and short product life cycles. Therefore, our success depends on our ability to do the following:

identify new market and product opportunities;

predict which technologies and markets will see declining demand;

develop and introduce new products and solutions in a timely manner;

gain market acceptance of new products and solutions, particularly in targeted emerging markets; and

rapidly and efficiently transition our customers from older to newer enterprise networking technologies.

Our financial position or results of operations could suffer if we are not successful in achieving these goals. For example, our business would suffer if any of the following occurs:

there is a delay in introducing new products;

we lose certain channels of distribution or key partners;

our products do not satisfy customers in terms of features, functionality or quality; or

our products cost more to produce than we expect.

Because we will continue to source products from OEMs and from H-3C and rely on original design manufacturers to assist in product design, we may not be able to independently identify current product and technology trends or to respond to such

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trends through the design and production of new products as well as if we were working independently.

Our success is dependent on continuing to hire and retain qualified managers and other personnel; if we are not successful in attracting and retaining these personnel, our business will suffer.

Competition for qualified employees is intense. If we fail to attract, hire, or retain qualified personnel, our business will be harmed. We have experienced significant turnover in our management team in the last several years and we may continue to experience change at this level. If we cannot retain qualified senior managers, our business may not succeed. In addition, in order to calculate our stock-based compensation charge, we make assumptions regarding several factors, including the forfeiture rate for our equity instruments. If we are successful in retaining management and other key employees with significant equity compensation, we will likely decrease our future forfeiture rate assumptions, which will in turn likely increase our stock-based compensation charge.

We expect to utilize strategic relationships and other alliances as key elements in our strategy. If we are not successful in forming desired ventures and alliances or if such ventures and alliances are not successful, our ability to achieve our growth and profitability goals could be adversely affected.

We have announced alliances with third parties, such as IBM, Trapeze Networks and Siemens Business Services. In the future, we expect to evaluate other possible strategic relationships, including joint ventures and other types of alliances, and we may increase our reliance on such strategic relationships to broaden our sales channels, complement internal development of new technologies and enhancement of existing products, and exploit perceived market opportunities.

If we fail to form the number and quality of strategic relationships that we desire, or if such strategic relationships are not successful, we could suffer missed market opportunities, channel conflicts, delays in product development or delivery, or other operational difficulties. Further, if third parties acquire our strategic partners or if our competitors enter into successful strategic relationships, we may face increased competition. Any of these difficulties could have an adverse effect on our future sales and results of operations.

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

We continue to look for ways to decrease cost and improve efficiency by contracting with other companies to perform functions or operations that, in the past, we have performed ourselves. We have outsourced the majority of our manufacturing and logistics for our SCN products. We now rely on outside vendors to meet the majority of our manufacturing needs as well as a significant portion of our IT needs for the SCN segment. Additionally, we outsource certain functions to Siemens Business Services for technical support and product return services. To achieve future cost savings or operational benefits, we may expand our outsourcing activities to cover additional services which we believe a third party may be able to provide in a more efficient or effective manner than we could do internally ourselves.

Although we believe that outsourcing will result in lower costs and increased efficiencies, this may not be the case. Because these third parties may not be as responsive to our needs as we would be ourselves, outsourcing increases the risk of disruption to our operations. In addition, our agreements with these third parties sometimes include substantial penalties for terminating such agreements early or failing to maintain minimum service levels. Because we cannot always predict how long we will need the services or how much of the services we will use, we may have to pay these penalties or incur costs if our business conditions change.

Our reliance on industry standards, technological change in the marketplace, and new product initiatives may cause our sales to fluctuate or decline.

The enterprise networking industry in which we compete is characterized by rapid changes in technology and customer requirements and evolving industry standards. As a result, our success depends on:

the convergence of technologies, such as voice, data and video on single, secure networks;

the timely adoption and market acceptance of industry standards, and timely resolution of conflicting U.S. and international industry standards; and

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our ability to influence the development of emerging industry standards and to introduce new and enhanced products that are compatible with such standards.

Slow market acceptance of new technologies, products, or industry standards could adversely affect our sales or overall results of operations. In addition, if our technology is not included in an industry standard on a timely basis or if we fail to achieve timely certification of compliance to industry standards for our products, our sales of such products or our overall results of operations could be adversely affected.

We focus on enterprise networking, and our results of operations may fluctuate based on factors related entirely to conditions in this market.

Our focus on enterprise networking may cause increased sensitivity to the business risks associated specifically with the enterprise networking market and our ability to execute successfully on our strategies to provide superior solutions for larger and multi-site enterprise environments. To be successful in the enterprise networking market, we will need to be perceived by decision making officers of large enterprises as committed for the long-term to the high-end networking business. Also, expansion of sales to large enterprises may be disruptive in a variety of ways, such as adding larger systems integrators that may raise channel conflict issues with existing distributors, or a perception of diminished focus on the small and medium enterprise market.

A significant portion of our SCN sales is derived from a small number of resellers. If any of these partners reduces its business with us, our business could be seriously harmed.

We distribute many of our products through two-tier distribution channels that include distributors, systems integrators and Value Added Resellers (VARs). A significant portion of our sales is concentrated among a few distributors; our two largest distributors accounted for a combined 35 percent of SCN sales for the three months ended August 31, 2006, a combined 34 percent of SCN sales for the year ended May 31, 2006 and a combined 34 percent of SCN sales for year ended May 31, 2005. If either of these distributors reduces its business with us, our sales and overall results of operations could be adversely affected.

We depend on distributors who maintain inventories of our products. If the distributors reduce their inventories of our products, our sales could be adversely affected.

We work closely with our distributors to monitor channel inventory levels and ensure that appropriate levels of products are available to resellers and end users. Our target range for channel inventory levels is between three and five weeks of supply on hand at our distributors. Partners with a below-average inventory level may incur stock outs that would adversely impact our sales. Our distribution agreements typically provide that our distributors may cancel their orders on short notice with little or no penalty. If our channel partners reduce their levels of inventory of our products, our sales would be negatively impacted during the period of change.

If we are unable to successfully develop relationships with system integrators, service providers, and enterprise VARs, our sales may be negatively affected.

As part of our sales strategy, we are targeting system integrators (SIs), service providers (SPs), and enterprise VARs (eVARs). In addition to specialized technical expertise, SIs, SPs and eVARs typically offer sophisticated services capabilities that are frequently desired by larger enterprise customers. In order to expand our distribution channel to include resellers with such capabilities, we must be able to provide effective support to these resellers. If our sales, marketing or services capabilities are not sufficiently robust to provide effective support to such SIs, SPs, and eVARs, we may not be successful in expanding our distribution model and current SI, SP, and eVAR partners may terminate their relationships with us, which would adversely impact our sales and overall results of operations.

The members of the board of our China joint venture designated by our co-owner, Huawei, have protective rights over the approval of certain matters; accordingly if Huawei does not agree with us on these matters, these rights could harm 3Com s business by preventing us from taking desired actions.

The governance documents applicable to our joint venture in China, H-3C, include the requirement that certain actions be approved by an affirmative vote of two-thirds of H-3C s board of directors, including at least one director appointed by

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3Com Corporation and one director appointed by Huawei. This right gives Huawei s board members the right to approve certain matters at the H-3C level, including the following:

any amendment to the Articles or charter documents;

any voluntary bankruptcy, liquidation, dissolution or winding up;

changes in authorized capital stock or the issuance of capital stock (or rights to acquire capital stock);

any significant merger, acquisition, disposition or other corporate reorganization;

determining the amount of dividends to pay and whether to pay special dividends not required by the dividend policy;

related party transactions, including loans and capital contributions;

incurrence of debt over a specified amount that falls outside of the approved budget; and

any sale, exclusive license or other transfer or disposition of any significant technology or intellectual property.

If there are disagreements between us and Huawei with respect to these matters, we may not be able to implement certain actions and the success of this joint venture may be adversely affected.

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

As Huawei expands its international operations, there could be increasing instances where we compete directly with Huawei in the enterprise networking market. As a co-owner and OEM customer of H-3C, Huawei has access to many of H-3C s products thereby enhancing Huawei s current ability to compete directly with us. We could lose a competitive advantage in markets where we compete with Huawei, which could have a material adverse effect on our sales and overall results of operations.

We may pursue acquisitions of other companies that, if not successful, could adversely affect our business, financial position and results of operations.

In the future, we may pursue acquisitions of companies to enhance our existing capabilities. There can be no assurances that acquisitions that we might pursue will be successful. If we pursue an acquisition but are not successful in completing it, or if we complete an acquisition but are not successful in integrating the acquired company s technology, employees, products or operations successfully, our business, financial position or results of operations could be adversely affected.

We may be unable to manage our supply chain successfully, which would adversely impact our sales, gross margin and profitability.

Current business conditions and operational challenges in managing our supply chain affect our business in a number of ways:

in the past, some key components have had limited availability;

as integration of networking features on a reduced number of computer chips continues, we are increasingly facing competition from parties who are our suppliers;

our ability to accurately forecast demand is diminished;

our reliance on, and long-term arrangements with, third-party manufacturers places much of the supply chain process out of our direct control and heightens the need for accurate forecasting and reduces our ability to transition quickly to alternative supply chain strategies; and

we may experience disruptions to our logistics.

Some of our suppliers are also our competitors. We cannot be certain that in the future our suppliers, particularly those who are also in active competition with us, will be able or willing to meet our demand for components in a timely and cost-effective manner.

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There has been a trend toward consolidation of vendors of electronic components. Our reliance on a smaller number of vendors and the inability to quickly switch vendors increase the risk of logistics disruptions, unfavorable price fluctuations, or disruptions in supply, particularly in a supply-constrained environment.

Supplies of certain key components can become tighter as industry demand for such components has increased. If the resulting increase in component costs and time necessary to obtain these components persists, we may experience an adverse impact to gross margin.

If overall demand for our products or the mix of demand for our products is significantly different from our expectations, we may face inadequate or excess component supply or inadequate or excess manufacturing capacity. This would result in orders for products that could not be manufactured in a timely manner, or a buildup of inventory that could not easily be sold. Either of these situations could adversely affect our market share, sales, and results of operations or financial position.

Our strategies to outsource the majority of our manufacturing requirements to contract manufacturers may not result in meeting our cost, quality or performance standards. The inability of any contract manufacturer to meet our cost, quality or performance standards could adversely affect our sales and overall results from operations.

The cost, quality, performance, and availability of contract manufacturing operations are and will be essential to the successful production and sale of many of our products. We may not be able to provide contract manufacturers with product volumes that are high enough to achieve sufficient cost savings. If shipments fall below forecasted levels, we may incur increased costs or be required to take ownership of inventory. In addition, a significant component of maintaining cost competitiveness is the ability of our contract manufacturers to adjust their own costs and manufacturing infrastructure to compensate for possible adverse exchange rate movements. To the extent that the contract manufacturers are unable to do so, and we are unable to procure alternative product supplies, then our own competitiveness and results of operations could be adversely impacted.

We have implemented a program with our manufacturing partners to ship products directly from regional shipping centers to customers. Through this program, we are relying on these partners to fill customer orders in a timely manner. This program may not yield the efficiencies that we expect, which would negatively impact our results of operations. Any disruptions to on-time delivery to customers would adversely impact our sales and overall results of operations.

China s governmental and regulatory reforms and changing economic environment may impact our ability to do business in China.

As a result of the historic reforms of the past several decades, multiple government bodies are involved in regulating and administrating affairs in the enterprise networking industry in China. These government agencies have broad discretion and authority over all aspects of the networking, telecommunications and information technology industry in China; accordingly their decision may impact our ability to do business in China. While we anticipate that the basic principles underlying the reforms China has made will remain unchanged, any of the following changes in China s political and economic conditions and governmental policies could have a substantial impact on our business:

- the promulgation of new laws and regulations and the interpretation of those laws and regulations;
- enforcement and application of rules and regulations by the Chinese government;
- the introduction of measures to control inflation or stimulate growth; or
- any actions that limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

Furthermore, China s economic environment has been changing as a result of China s entry, in December of 2001, into the World Trade Organization, or the WTO. If China s entry into the WTO results in increased competition or has a negative impact on China s economy, our business could suffer. Since early 2004, the Chinese government has implemented certain measures to control the pace of economic growth. Such measures may cause a decrease in the level of economic activity in China, which in turn could adversely affect our results of operations and financial condition.

Uncertainties with respect to the Chinese legal system may adversely affect us.

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We conduct our business in China primarily through our joint venture, H-3C, a Hong Kong entity which in turn owns a Chinese entity. These entities are generally subject to laws and regulations applicable to foreign investment in China. In addition, there are uncertainties regarding the interpretation and enforcement of laws, rules and policies in China. Because many laws and regulations are relatively new and the Chinese legal system is still evolving, the interpretations of many laws, regulations and rules are not always uniform. Moreover, the interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Finally, enforcement of existing laws or contracts based on existing law may be uncertain, and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management s attention.

If tax benefits available to our China joint venture, H-3C, are reduced or repealed, our business could suffer.

The Chinese government is considering the imposition of a unified corporate income tax that would phase out, over time, the preferential tax treatment to which H-3C is currently entitled. While it is not certain whether the government will implement a unified tax structure or whether H-3C will receive grandfathered status from any new tax, if a new tax structure is implemented, such new tax structure may adversely affect our financial condition.

H-3C is subject to restrictions on paying dividends and making other payments to us.

Chinese regulations currently permit payment of dividends only out of accumulated profits, as determined in accordance with Chinese accounting standards and regulations. Our joint venture, a Hong Kong entity, does business through a Chinese entity that is required to set aside a portion of its after-tax profits according to Chinese accounting standards and regulations to fund certain reserves. The Chinese government also imposes controls on the conversion of Renminbi into foreign currencies and the remittance of currencies out of China. We may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currency. These restrictions may in the future limit our ability to receive dividends or repatriate funds from H-3C.

If we fail to maintain an effective system of internal control over financial reporting that includes our China joint venture, H-3C, we may not be able to accurately report our financial results or prevent fraud.

The annual evaluation of internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002 will first include H-3C with respect to our fiscal year ending June 1, 2007 and the related annual report on Form 10-K. If we cannot enhance H-3C s existing controls by the evaluation date, our management may conclude that our internal control over financial reporting at the end of that period is not effective. Moreover, even if our management concludes that our internal control over financial reporting is effective, our independent registered public accounting firm may not be able to attest to our management s conclusions or may reach an opposite conclusion. Furthermore, having effective internal control over financial reporting is necessary for us to produce reliable financial reports and is important to help prevent fraud. If we fail to achieve and maintain effective internal control over financial reporting on a consolidated basis, it could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our common stock. Furthermore, we anticipate that we will incur considerable costs and use significant management time and other resources in an effort to bring H-3C into compliance with Section 404 and the other requirements of the Sarbanes-Oxley Act.

We are subject to risks relating to currency rate fluctuations and exchange controls and we do not hedge this risk in China.

Due to our consolidation of our joint venture in China, a significant portion of our sales and a portion of our costs will be made in China and denominated in Renminbi. In July 2005, China uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move initially revalued the Renminbi by 2.1% against the U.S. dollar; however, it is uncertain what further adjustments may be made in the future. The Renminbi-U.S. dollar exchange rate could float, and the Renminbi could appreciate or depreciate relative to the U.S. dollar. Any movement of the Renminbi may materially and adversely affect our cash flows, revenues, operating results and financial position.

We do not currently hedge the currency risk in H-3C through foreign exchange forward contracts or otherwise and China employs currency controls restricting Renminbi conversion, limiting our ability to engage in currency hedging activities in

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China. Various foreign exchange controls are applicable to us in China, and such restrictions may in the future make it difficult for H-3C or us to repatriate earnings, which could have an adverse effect on our cash flows and financial position.

We may need to engage in complex and costly litigation in order to protect, maintain or enforce our intellectual property rights; in some jurisdictions, such as China, our rights may not be as strong as the rights we enjoy in the U.S.

Whether we are defending the assertion of intellectual property rights against us, or asserting our intellectual property rights against others, intellectual property litigation can be complex, costly, protracted, and highly disruptive to business operations because it may divert the attention and energies of management and key technical personnel. Further, plaintiffs in intellectual property cases often seek injunctive relief and the measures of damages in intellectual property litigation are complex and often subjective or uncertain. Thus, the existence of this type of litigation, or any adverse determinations related to such litigation, could subject us to significant liabilities and costs. If any of our OEM, Original Design Manufacturer, or ODM, or joint venture partners become involved in intellectual property disputes and are unable to hold us harmless, then we may incur liabilities or suffer disruption of our business. Any one of these factors could adversely affect our sales, gross margin, overall results of operations, cash flow or financial position.

In addition, the legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. For example, in China, the legal system in general, and the intellectual property regime in particular, are still in the development stage. It may be very difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights, and those of H-3C, in these jurisdictions.

We may not be able to defend ourselves successfully against claims that we are infringing the intellectual property rights of others.

Many of our competitors, such as telecommunications, networking, and computer equipment manufacturers, have large intellectual property portfolios, including patents that may cover technologies that are relevant to our business. In addition, many smaller companies, universities, and individual inventors have obtained or applied for patents in areas of technology that may relate to our business. The industry continues to be aggressive in assertion, licensing, and litigation of patents and other intellectual property rights.

In the course of our business, we receive claims of infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. We evaluate the validity and applicability of these intellectual property rights, and determine in each case whether we must negotiate licenses or cross-licenses to incorporate or use the proprietary technologies, protocols, or specifications in our products. If we are unable to obtain and maintain licenses on favorable terms for intellectual property rights required for the manufacture, sale, and use of our products, particularly those that must comply with industry standard protocols and specifications to be commercially viable, our financial position or results of operations could be adversely affected. In addition, if we are alleged to infringe the intellectual property rights of others, we could be required to seek licenses from others or be prevented from manufacturing or selling our products, which could cause disruptions to our operations or the markets in which we compete. Finally, even if we have indemnification rights in respect of such allegations of infringement, from our suppliers or licensors, we may not be able to recover our losses under those indemnity rights.

Fluctuations in our operating results and other factors may contribute to volatility in the market price of our stock.

Historically, our stock price has experienced volatility. We expect that our stock price may continue to experience volatility in the future due to a variety of potential factors such as:

fluctuations in our quarterly results of operations and cash flow;

changes in our cash and equivalents and short term investment balances;

variations between our actual financial results and published analysts expectations; and

announcements by our competitors.

In addition, over the past several years, the stock market has experienced significant price and volume fluctuations that have affected the stock prices of many technology companies. These factors, as well as general economic and political conditions or investors concerns regarding the credibility of corporate financial statements and the accounting profession, may have a material adverse affect on the market price of our stock in the future.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table summarizes repurchases of our stock, including shares returned to satisfy employee tax withholding obligations, in the three months ended August 31, 2006:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1)	Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
June 3, 2006 through June 30, 2006	1,223(2)	$ 4.56		$ 100,000,000
July 1, 2006 through July 28, 2006	34,127(2)	5.04		$ 100,000,000
July 29, 2006 through September 1, 2006	2,093(2)	4.41		$ 100,000,000
Total	37,443	$ 4.99		$ 100,000,000

(1) On March 23, 2005, our Board of Directors approved a new stock repurchase program providing for expenditures of up to $100.0 million through March 31, 2007, provided that all repurchases are pre-approved by the Audit and Finance Committee of the Board of Directors. We did not repurchase shares of our common stock pursuant to this authorization in

the three months ended August 31, 2006. However, we may use cash to repurchase shares in future periods. Our last open market purchase was made in August, 2004 for 10,700,041 shares.

(2) Represents shares returned to us to satisfy tax withholding obligations that arose upon the vesting of restricted stock awards.

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ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
2.1	Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999	10-Q	002-92053	2.1	4/4/00	
2.2	Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc.	10-Q	002-92053	2.11	4/4/00	
2.3	Asset Purchase Agreement by and between the Registrant and UTStarcom, Inc. dated March 4, 2003	8-K	000-12867	10.1	6/9/03	
2.4	Agreement and Plan of Merger, dated December 13, 2004, by and among the Registrant, Topaz Acquisition Corporation and TippingPoint Technologies, Inc.	8-K	000-12867	2.1	12/16/04	
2.5	Securities Purchase Agreement by and among 3Com Corporation, 3Com Technologies, Huawei Technologies Co., Ltd. and Shenzen Huawei Investment & Holding Co., Ltd., dated as of October 28, 2005	8-K/A	000-12867	2.1	3/30/06	
3.1	Corrected Certificate of Merger filed to correct an error in the Certificate of Merger	10-Q	002-92053	3.4	10/8/99	
3.2	Registrant s Bylaws, as amended on March 23, 2005	8-K	000-12867	3.1	3/28/05	
3.3	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock	10-Q	000-12867	3.6	10/11/01	
4.1	Third Amended and Restated Preferred Shares Rights Agreement, dated as of November 4, 2002	8-A/A	000-12867	4.1	11/27/02	
10.1	3Com Corporation Employment Agreement, dated as of August 8, 2006 between the registrant and Edgar Masri *	8-K	000-12867	10.1	8/9/06	
10.2	3Com Corporation Stand Alone Stock Option Agreement dated September 5, 2006 by and between Edgar Masri and 3Com Corporation *					X
10.3	Form of 3Com Corporation 2003 Stock Plan Restricted Stock Unit Grant Award Agreement*					X
10.4	Executive Officer Fiscal 2007 Compensation*	8-K	000-12867	Text of Item 1.01	6/26/06	
10.5	3Com Corporation Consultant Services Agreement made as of August 8, 2006 by	8-K	000-12867	10.1	8/11/06	

	and between 3Com Corporation and Anik Bose					
10.6	Purchase and Sale Agreement made as of July 24, 2006 by and between 3Com Corporation and SSC II, L.P.	8-K	000-12867	10.1	7/26/06	
10.7	Agreement for the Lease of Hangzhou Real Property between Huawei Technologies Co. Ltd. and Hangzhou Huawei-3Com					X

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		Form	File No.	Exhibit	Filing Date	
	Technology Co., Ltd. dated January 1, 2004					
31.1	Certification of Principal Executive Officer					X
31.2	Certification of Principal Financial Officer					X
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X

* Indicates a management contract or compensatory plan

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

3Com Corporation
(Registrant)

Dated: October 10, 2006

By: /s/ DONALD M. HALSTED, III
Donald M. Halsted, III
Executive Vice President, Finance and Chief Financial Officer (Principal Financial and Accounting Officer and a duly authorized officer of the registrant)

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