CAREER EDUCATION CORP
Form 10-Q
August 04, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2010

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission File Number: 0-23245

CAREER EDUCATION CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**36-3932190**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2895 Greenspoint Parkway, Suite 600, Hoffman Estates, Illinois	**60169**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (847) 781-3600

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company, as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes ¨ No x

Number of shares of registrant s common stock, par value $0.01, outstanding July 30, 2010: 81,264,590

Table of Contents

CAREER EDUCATION CORPORATION

INDEX

		Page
PART I FINANCIAL INFORMATION		
Item 1.	Financial Statements	3
	Unaudited Consolidated Balance Sheets	3
	Unaudited Consolidated Statements of Operations	4
	Unaudited Consolidated Statements of Cash Flows	5
	Notes to Unaudited Consolidated Financial Statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	25
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	42
Item 4.	Controls and Procedures	42
PART II OTHER INFORMATION		
Item 1.	Legal Proceedings	44
Item 1A.	Risk Factors	44
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	58
Item 6.	Exhibits	58
SIGNATURES		59

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

UNAUDITED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

	June 30, 2010	December 31, 2009
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 150,326	$ 284,473
Short-term investments	162,361	200,379
Total cash and cash equivalents and short-term investments	312,687	484,852
Student receivables, net of allowance for doubtful accounts of $39,852 and $34,963 as of June 30, 2010 and December 31, 2009, respectively	74,796	57,823
Receivables, other, net	7,219	5,256
Prepaid expenses	43,879	41,090
Inventories	12,468	11,271
Deferred income tax assets, net	12,982	12,983
Other current assets	5,902	9,442
Assets of discontinued operations	5,208	6,118
Total current assets	475,141	628,835
NON-CURRENT ASSETS:		
Property and equipment, net	309,902	306,279
Goodwill	378,732	377,515
Intangible assets, net	179,821	178,520
Assets of discontinued operations	23,556	24,401
Student receivables, net of allowance for doubtful accounts of $28,840 and $18,394 as of June 30, 2010 and December 31, 2009, respectively	19,861	21,455
Deferred income tax assets, net	4,207	3,659
Other assets, net	23,564	23,178
TOTAL ASSETS	$ 1,414,784	$ 1,563,842
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current maturities of capital lease obligations	$ 739	$ 880
Accounts payable	48,732	51,108
Accrued expenses:		
Payroll and related benefits	59,076	88,439
Advertising and production costs	24,839	21,436
Income taxes	12,927	17,849
Earnout payments	21,591	18,009
Other	47,201	46,182
Deferred tuition revenue	137,691	184,411
Liabilities of discontinued operations	14,903	13,695
Total current liabilities	367,699	442,009

NON-CURRENT LIABILITIES:		
Capital lease obligations, net of current maturities	1,348	2,262
Deferred rent obligations	91,036	91,725
Liabilities of discontinued operations	50,538	62,997
Earnout payments	11,641	23,680
Other liabilities	15,251	19,124
Total non-current liabilities	169,814	199,788
SHARE-BASED AWARDS SUBJECT TO REDEMPTION	164	521
STOCKHOLDERS EQUITY:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; none issued or outstanding		
Common stock, $0.01 par value; 300,000,000 shares authorized; 96,389,791 and 95,399,192 shares issued, 81,278,144 and 85,785,478 shares outstanding as of June 30, 2010 and December 31, 2009, respectively	964	954
Additional paid-in capital	256,928	244,992
Accumulated other comprehensive income	(10,734)	8,408
Retained earnings	1,008,955	889,057
Cost of 15,111,647 and 9,613,714 shares in treasury as of June 30, 2010 and December 31, 2009, respectively	(379,006)	(221,887)
Total stockholders equity	877,107	921,524
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,414,784	$ 1,563,842

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

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
REVENUE:				
Tuition and registration fees	$ 509,256	$ 420,601	$ 1,019,009	$ 836,275
Other	18,616	17,072	38,545	34,261
Total revenue	527,872	437,673	1,057,554	870,536
OPERATING EXPENSES:				
Educational services and facilities	158,018	148,461	318,315	295,077
General and administrative	257,266	235,734	521,794	454,631
Depreciation and amortization	17,217	16,390	33,970	32,491
Total operating expenses	432,501	400,585	874,079	782,199
Operating income	95,371	37,088	183,475	88,337
OTHER (EXPENSE) INCOME:				
Interest income	253	484	500	1,642
Interest expense	(32)	(12)	(45)	(22)
Miscellaneous expense	(991)	(729)	(1,266)	(766)
Total other (expense) income	(770)	(257)	(811)	854
PRETAX INCOME	94,601	36,831	182,664	89,191
Provision for income taxes	29,430	13,258	61,538	31,725
INCOME FROM CONTINUING OPERATIONS	65,171	23,573	121,126	57,466
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(853)	(17,083)	(1,586)	(27,719)
NET INCOME	$ 64,318	$ 6,490	$ 119,540	$ 29,747
NET INCOME (LOSS) PER SHARE BASIC:				
Income from continuing operations	$ 0.82	$ 0.27	$ 1.50	$ 0.64
Loss from discontinued operations	(0.01)	(0.20)	(0.02)	(0.31)
Net income per share	$ 0.81	$ 0.07	$ 1.48	$ 0.33
NET INCOME (LOSS) PER SHARE DILUTED:				
Income from continuing operations	$ 0.81	$ 0.27	$ 1.48	$ 0.64
Loss from discontinued operations	(0.01)	(0.20)	(0.02)	(0.31)
Net income per share	$ 0.80	$ 0.07	$ 1.46	$ 0.33

WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	79,348	87,496	80,846	89,696
Diluted	80,459	87,833	81,887	90,073

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

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	For the Six Months Ended June 30, 2010	For the Six Months Ended June 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 119,540	$ 29,747
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	33,970	33,695
Bad debt expense	45,569	24,842
Compensation expense related to share-based awards	10,034	10,020
(Gain)/loss on disposition of property and equipment	(474)	1,086
Changes in operating assets and liabilities	(160,774)	(47,686)
Net cash provided by operating activities	47,865	51,704
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available-for-sale investments	(172,569)	(263,758)
Sales of available-for-sale investments	210,460	378,954
Purchases of property and equipment	(43,156)	(30,136)
Earnout payments	(8,457)	
Business acquisition, net of acquired cash	(6,194)	
Other	(5)	(322)
Net cash (used in) provided by investing activities	(19,921)	84,738
CASH FLOWS FROM FINANCING ACTIVITIES:		
Purchase of treasury stock	(154,913)	(140,330)
Issuance of common stock	1,718	1,058
Tax benefit associated with stock option exercises	195	23
Payment of assumed loans upon business acquisition	(4,279)	
Payments of capital lease obligations	(450)	1,249
Net cash used in financing activities	(157,729)	(138,000)
EFFECT OF FOREIGN CURRENCY EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS:	(4,960)	559
NET DECREASE IN CASH AND CASH EQUIVALENTS	(134,745)	(999)
DISCONTINUED OPERATIONS CASH ACTIVITY INCLUDED ABOVE:		
Add: Cash balance of discontinued operations, beginning of the period	599	2,004
Less: Cash balance of discontinued operations, end of the period	1	1,610
CASH AND CASH EQUIVALENTS, beginning of the period	284,473	242,854
CASH AND CASH EQUIVALENTS, end of the period	$ 150,326	$ 242,249

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

5

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

1. DESCRIPTION OF THE COMPANY

The colleges, schools and universities that are part of the Career Education Corporation (CEC) family offer high-quality education to a diverse student population of over 104,000 students across the world in a variety of career-oriented disciplines. The more than 90 campuses that serve these students are located throughout the U.S. and in France, Italy, the United Kingdom and Monaco, and offer doctoral, master s, bachelor s and associate degrees and diploma and certificate programs. Approximately 44% of our students attend the web-based virtual campuses of American InterContinental University, Colorado Technical University, International Academy of Design & Technology and Le Cordon Bleu College of Culinary Arts.

CEC is an industry leader whose brands are recognized globally. Those brands include, among others, American InterContinental University (AIU); Brooks Institute; Colorado Technical University (CTU); Harrington College of Design; INSEEC Group (INSEEC) Schools, including the International University of Monaco (IUM); International Academy of Design & Technology (IADT); Istituto Marangoni; Le Cordon Bleu North America (LCB); and Sanford-Brown Institutes and Colleges. Through our schools, CEC is committed to providing high-quality education, enabling students to graduate and pursue rewarding careers.

For more information, see CEC s website at www.careered.com. The website includes a detailed listing of individual campus locations and web links to CEC s colleges, schools, and universities.

As used in this Quarterly Report on Form 10-Q, the terms we, us, our, and CEC refer to Career Education Corporation and our wholly-owned subsidiaries. The terms school and university refer to an individual, branded, proprietary educational institution, owned by us and includes its campus locations. The term campus refers to an individual main or branch campus operated by one of our schools or universities.

2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments, including normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

The unaudited consolidated financial statements presented herein include the accounts of CEC. All inter-company transactions and balances have been eliminated.

On January 15, 2010, we realigned our resources to more effectively execute our new strategic growth plan. We began the integration of our schools which previously comprised the Art & Design Strategic Business Unit (SBU) alongside AIU and CTU, within the University SBU. This realignment will facilitate synergies between the programs in Art & Design and University, especially in the areas of fashion design, merchandising and interior design and technology. It will also enable the sharing of student-focused online platforms and expertise and aid IADT as it pursues its longer-term strategy of regional accreditation. Harrington College of Design, Collins College and Brooks Institute joined the IADT schools in the alignment of the Art & Design group into the University SBU. The realignment also shifted Brown College and Briarcliffe College into the Health Education SBU. We expect Briarcliffe s regional accreditation to be beneficial in providing greater opportunity for Sanford-Brown students to enroll in higher degree programs. This realignment resulted in new reportable segments, and prior period results have been revised to reflect these new reportable segments. See Note 14 Segment Reporting of the notes to our unaudited consolidated financial statements for further discussion.

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

In addition to the realignment, we completed a detailed review of our shared service costs to determine which of these costs should be charged to the SBUs as well as how these shared service costs should be allocated. These services include legal, finance, human resources, marketing, certain academic functions and certain centralized activities related to student finance, including financial aid processing, student account posting and collections. These costs, recorded within Corporate and other, were previously allocated to our SBUs based upon a percentage of revenue. Improved data and analytical capabilities have provided us insight into costs being incurred to support the SBUs versus costs being incurred to support the corporation as a whole. The new methodology allocates costs based on usage and consumption factors such as student population, employee headcount, advertising spend, number of financial aid recipients and revenue where appropriate. In the case of certain services which are shared evenly across the SBUs, we allocate evenly. The new methodology is intended to provide improved transparency into the costs of the shared services. The effect of these changes impacts the costs reported within each SBU and reduces the level of unallocated shared service costs. Results beginning in 2010 are presented under the new methodology and prior period results have been revised to be comparable to the current reporting.

3. BUSINESS ACQUISITION

On April 15, 2010, the Company acquired 100% of the issued and outstanding stock of International University of Monaco (IUM) for a purchase price of $6.3 million plus assumption of $4.3 million related to outstanding loans which were immediately paid after the acquisition closed. The purchase price was funded with cash generated from operating activities. IUM is a leading international business university located in Monte Carlo, offering bachelor s, master s and doctoral programs in such areas as finance, international business and luxury goods and services, and its current enrollment includes nearly 400 students representing 62 countries. IUM has joined the INSEEC group and will position INSEEC for continued growth as a leader in postsecondary education in Europe.

The following table summarizes the preliminary estimated fair values of assets acquired and liabilities assumed as of April 15, 2010 (dollars in thousands):

Current assets (including cash of $80)	$ 550
Property and equipment	524
Intangible assets not subject to amortization	
Trade names	2,383
Accreditation rights	740
Intangible assets subject to amortization	
Program curriculum (useful life of 15 years)	407
Covenant not to compete (useful life of 4 years)	62
Goodwill	8,369
Other assets	17
Total assets acquired	13,052
Assumed loans	4,279
Deferred tuition revenue	1,104
Other current liabilities	1,396
Total liabilities assumed	6,779
Net assets acquired	$ 6,273

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

Goodwill of $8.4 million represents the premium the Company paid over the fair value of the net tangible and intangible assets it acquired. The Company paid this premium due to the strategic location and brand recognition that IUM contributes to its international operations. We do not expect any portion of this goodwill balance to be deductible for income tax reporting purposes. Acquisition costs of approximately $0.6 million were incurred in conjunction with this acquisition and are recorded in general and administrative expense on our unaudited consolidated statements of operations. IUM s operating results are included in our unaudited consolidated financial statements from the date of acquisition.

Subsequent adjustments may be made to the purchase price in accordance with the purchase agreement. However, we do not believe that any such adjustments will be significant.

Supplemental pro forma financial statement disclosures have not been included as this acquisition was not material to our unaudited consolidated financial position or results of operations.

4. RECENT ACCOUNTING PRONOUNCEMENTS

In October 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*, which provides guidance on whether multiple deliverables exist and how arrangement consideration should be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-13, which is effective for fiscal years beginning on or after June 15, 2010, is effective for us on January 1, 2011. Management is currently evaluating the impact that the adoption of ASU 2009-13 will have on our financial condition, results of operations, and disclosures.

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU requires new disclosures regarding transfers within the fair value hierarchy and the Level 3 reconciliation, and clarifies existing disclosure requirements. This guidance is effective for interim and annual reporting periods beginning after December 15, 2009, except for the requirement to present the Level 3 roll forward on a gross basis, which is effective for fiscal years beginning after December 15, 2010. Management has fully considered this guidance when determining the fair value and related disclosures of our financial assets as of June 30, 2010 and our adoption did not have a material impact on our unaudited consolidated financial statements.

In January 2009, the Securities and Exchange Commission (SEC) issued Release No. 33-9002, *Interactive Data to Improve Financial Reporting*. The rule requires all companies to provide their financial statements and financial statement schedules to the SEC and on their corporate websites in interactive data format using the eXtensible Business Reporting Language (XBRL), which is an electronic language specifically for the communication of business and financial data. The intention of XBRL is to improve its usefulness to users and to automate regulatory filings and business information processing. Interactive data has the potential to improve efficiencies and the analyses of financial disclosures by investors and other users. We were required to adopt this rule by June 15, 2010. We elected to early adopt this rule in the first quarter of 2010 and have made the necessary filings. The adoption of this rule did not have a material impact on our financial statements or other reporting.

5. DISCONTINUED OPERATIONS

As of June 30, 2010, the results of operations for schools that have ceased operations or were sold are presented within discontinued operations. We expect to incur approximately $9.0 million by the fourth quarter 2010 of future remaining lease obligations upon the closure of our AIU Los Angeles, CA campus. The results for this campus will be recast as a component of discontinued operations upon the completion of its teach out.

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

Results of Discontinued Operations

Combined summary unaudited results of operations for our discontinued operations for the three and six months ended June 30, 2010 and 2009, are as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
	(Dollars in thousands)			
Revenue	$	$ 3,025	$	$ 7,622
Pretax loss	$ (1,344)	$ (26,233)	$ (2,472)	$ (42,367)
Income tax benefit	(491)	(9,150)	(886)	(14,648)
Loss from discontinued operations	$ (853)	$ (17,083)	$ (1,586)	$ (27,719)

Assets and Liabilities of Discontinued Operations

Assets and liabilities of discontinued operations on our unaudited consolidated balance sheets as of June 30, 2010 and December 31, 2009 include the following:

	June 30, 2010	December 31, 2009
	(Dollars in thousands)	
Assets:		
Current assets:		
Cash and cash equivalents	$ 1	$ 599
Receivables, net	176	242
Prepaid expenses	1,569	1,813
Deferred income tax assets	3,462	3,462
Other current assets		2
Total current assets	5,208	6,118
Non-current assets:		
Deferred income tax assets	21,474	21,474
Other assets, net	2,082	2,927
Total assets of discontinued operations	$ 28,764	$ 30,519
Liabilities:		
Current liabilities:		
Accounts payable	$ 69	$ 173
Accrued payroll and related benefits	3	1,722
Accrued expenses	2,662	4,190

Deferred tuition revenue		44
Remaining lease obligations	12,169	7,566
Total current liabilities	14,903	13,695
Non-current liabilities:		
Remaining lease obligations	50,538	62,997
Total liabilities of discontinued operations	$ 65,441	$ 76,692

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

Remaining Lease Obligations

A number of the campuses that have ceased operations in 2008 and 2009 have remaining lease obligations that range from two to nine years. A liability is recorded representing the fair value of the remaining lease obligation at the time in which the space is no longer being utilized. Changes in our future remaining lease obligations, which are reflected within current and non-current liabilities of discontinued operations on our unaudited consolidated balance sheets, for our discontinued operations for the three and six months ended June 30, 2010 and 2009, were as follows:

	Balance, Beginning of Period	Charges Incurred (1)	Net Cash Payments	Other (2)	Balance, End of Period
			(Dollars in thousands)		
For the three months ended June 30, 2010	$ 65,204	$ 669	$ (3,166)	$	$ 62,707
For the three months ended June 30, 2009	$ 23,340	$ 20,247	$ (17,646)	$	$ 25,941
For the six months ended June 30, 2010	$ 70,563	$ 698	$ (8,554)	$	$ 62,707
For the six months ended June 30, 2009	$ 14,468	$ 28,348	$ (19,885)	$ 3,010	$ 25,941

(1) Includes charges for newly vacated spaces and subsequent adjustments for accretion, revised estimates, and variances between estimated and actual charges.

(2) Includes existing deferred rent liability balances for newly vacated spaces that offset the losses incurred in the period recorded.

6. FINANCIAL INSTRUMENTS

Cash and Cash Equivalents and Investments

Cash and cash equivalents and investments from our continuing operations consist of the following as of June 30, 2010 and December 31, 2009:

	June 30, 2010 (Dollars in thousands)			
		Gross Unrealized		
	Cost	Gain	(Loss)	Fair Value
Cash and cash equivalents:				
Cash	$ 77,405	$	$	$ 77,405
Money market funds	68,689	233		68,922
U.S. Treasury bills	4,000		(1)	3,999
Total cash and cash equivalents	150,094	233	(1)	150,326

Short-term investments (available-for-sale):				
U.S. Treasury bills	162,352	17	(8)	162,361
Total cash and cash equivalents and short-term investments	$ 312,446	$ 250	$ (9)	$ 312,687
Long-term investments:				
Municipal bonds	$ 12,325	$	$ (503)	$ 11,822

10

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

	December 31, 2009 (Dollars in thousands)			
		Gross Unrealized		
	Cost	Gain	(Loss)	Fair Value
Cash and cash equivalents:				
Cash	$ 180,571	$	$	$ 180,571
Money market funds	103,530	372		103,902
Total cash and cash equivalents	284,101	372		284,473
Short-term investments (available-for-sale):				
U.S. Treasury bills	200,320	61	(2)	200,379
Total cash and cash equivalents and short-term investments	$ 484,421	$ 433	$ (2)	$ 484,852
Long-term investments:				
Municipal bonds	$ 12,325	$	$ (745)	$ 11,580

In the table above, unrealized holding losses as of June 30, 2010 relate to cash equivalents and available-for-sale investments that have been in a continuous unrealized loss position for less than one year. The table also includes unrealized holding losses that relate to our long-term investments in municipal bonds, which are auction rate securities (ARS). When evaluating our investments for possible impairment, we review factors such as the length of time and extent to which fair value has been less than the cost basis, the financial condition of the investee, and our ability and intent to hold the investment for a period of time that may be sufficient for anticipated recovery in fair value. The decline in the fair value of our municipal bonds through June 30, 2010 is attributable to the continued lack of activity in the ARS market, exposing these investments to liquidity risk.

Included in cash and cash equivalents above are amounts related to certain of our European campuses that are operated on a not-for-profit basis. The cash and cash equivalents related to these schools have restrictions which require that the funds be utilized for these particular not-for-profit schools. The amount of cash and cash equivalents of our not-for-profit schools with restrictions was $35.4 million and $49.9 million at June 30, 2010 and December 31, 2009, respectively. Restrictions on cash balances have not affected our ability to fund operations.

Money market funds. Money market funds are mutual funds that invest in lower risk securities and generate low yields. Such funds maintain clear investment guidelines and seek to limit credit, market and liquidity risks.

Municipal bonds: Municipal bonds represent debt obligations issued by states, cities, counties, and other governmental entities, which earn federally tax-exempt interest. ARS generally have stated terms to maturity of greater than one year. We classify investments in ARS as non-current on our unaudited consolidated balance sheets within other assets. Auctions can fail when the number of sellers of the security exceeds the buyers for that particular auction period. In the event that an auction fails, the interest rate resets at a rate based on a formula determined by the individual security. The ARS for which auctions have failed continue to accrue interest and are auctioned on a set interval until the auction succeeds, the issuer calls the securities, or they mature. As of June 30, 2010, we have determined these investments are at risk for impairment due to the nature of the liquidity of the market over the past year. Cumulative unrealized losses as of June 30, 2010, amount to $0.5 million and are reflected within other comprehensive income as a component of stockholders equity. We believe this impairment is temporary, as we do not intend to sell the investments and it is unlikely we will be required to sell

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

the investments before recovery of their amortized cost basis. Municipal bonds in the above table that are invested in ARS were $11.8 million and $11.6 million at June 30, 2010 and December 31, 2009, respectively.

U.S. Treasury bills: Debt obligations issued by the U.S. government that pay interest at maturity. U.S. Treasury bills are traded at discounts to par value and mature in one year or less.

Fair Value Measurements

The fair value measure of accounting for financial instruments establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of June 30, 2010, our long term student receivables, net, balances are presented within non-current assets on the consolidated balance sheets. It is not practicable to estimate the fair value of these financial instruments, since observable market data is not readily available.

As of June 30, 2010, we held investments that are required to be measured at fair value on a recurring basis. Investments (available-for-sale) consist of U.S. Treasury bills that are publicly traded and for which market prices are readily available.

As of June 30, 2010, we also held investments in auction rate securities, which are classified as available-for-sale and reflected at fair value. The auction events for these investments have failed for the past year. The fair values of these securities are estimated utilizing a discounted cash flow analysis as of June 30, 2010. These analyses consider, among other items, the collateralization underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, and the expectation of the next time the security is expected to have a successful auction. These securities were also compared, when possible, to other observable market data with similar characteristics.

Investments measured at fair value on a recurring basis subject to the disclosure requirements issued by the FASB ASC under Topic 820 *Fair Value Measurements and Disclosures* at June 30, 2010, were as follows:

	As of June 30, 2010 (Dollars in thousands)			
	Level 1	**Level 2**	**Level 3**	**Total**
Municipal bonds	$	$	$ 11,822	$ 11,822
U.S. Treasury bills	162,361			162,361
Totals	$ 162,361	$	$ 11,822	$ 174,183

The following table presents our assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined in FASB ASC Topic 820 at June 30, 2010:

(Dollars in thousands)

Balance at December 31, 2009	$ 11,580
Unrealized gain	242
Balance at June 30, 2010	$ 11,822

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

Credit Agreement

As of June 30, 2010, we had letters of credit totaling $8.8 million outstanding under our $185.0 million U.S. Credit Agreement. Credit availability under our U.S. Credit Agreement as of June 30, 2010, was $176.2 million.

7. RECEIVABLES

Student Receivables Valuation Allowance

Changes in our short-term and long-term receivables allowance for the three and six months ended June 30, 2010 and 2009 were as follows (dollars in thousands):

	Balance, Beginning of Period	Charges to Expense (1)	Amounts Written-off	Balance, End of Period
For the three months ended June 30, 2010	$ 64,241	$ 19,549	$ (15,098)	$ 68,692
For the three months ended June 30, 2009	$ 47,209	$ 14,986	$ (12,748)	$ 49,447
For the six months ended June 30, 2010	$ 53,357	$ 45,931	$ (30,596)	$ 68,692
For the six months ended June 30, 2009	$ 47,895	$ 24,920	$ (23,368)	$ 49,447

(1) For the six months ended June 30, 2010, amount includes pretax expense of $8.1 million related to an increase in reserve rates applied to outstanding student receivable balances attributed to our extended payment plan programs and our previously terminated recourse loan program.

Recourse Loan Agreements

Previously, we had recourse loan agreements with Sallie Mae and Stillwater National Bank and Trust Company (Stillwater) which required us to repurchase loans originated by them to our students after a certain period of time. Our recourse loan agreement with Stillwater was terminated on April 29, 2007. Our recourse loan agreement with Sallie Mae ended on March 31, 2008. Sallie Mae continues to offer its non-recourse products to our students but has made its underwriting criteria stricter.

Outstanding net recourse loan receivable balances for continuing operations as of June 30, 2010 and December 31, 2009 were $3.6 million and $8.5 million, respectively. These receivables are reported under non-current assets as a component of student receivables, net within the unaudited consolidated balance sheets.

8. GOODWILL

Changes in the carrying amount of goodwill for continuing operations for the six months ended June 30, 2010, are as follows by segment:

	University	Health Education	Culinary Arts	International	Transitional	Total
			(Dollars in thousands)			
Goodwill balance as of December 31, 2009	$ 120,192	$ 136,610	$ 75,148	$ 45,565	$	$ 377,515
Acquisition of IUM				8,369		8,369
Effect of foreign currency exchange rate changes				(7,152)		(7,152)
Goodwill balance as of June 30, 2010	$ 120,192	$ 136,610	$ 75,148	$ 46,782	$	$ 378,732

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

As a result of the realignment of our IADT schools, Harrington College of Design, Collins College and Brooks Institute into the University SBU as well as Briarcliffe College and Brown College into the Health Education SBU as of January 15, 2010, we reassigned the goodwill balances to each reporting unit in accordance with FASB ASC Topic 350 *Intangibles Goodwill and Other.*

Based upon our preliminary fair value allocation for the acquisition of IUM, we have recorded goodwill of approximately $8.4 million.

9. COMMITMENTS AND CONTINGENCIES

Litigation

We are, or were, a party to the following legal proceedings that are outside the scope of ordinary routine litigation incidental to our business.

Student Litigation

Amador, et al. v. California Culinary Academy and Career Education Corporation; Adams, et al. v. California Culinary Academy and Career Education Corporation. On September 27, 2007, Allison Amador and 36 other current and former students of the California Culinary Academy (CCA) filed a complaint in the California Superior Court in San Francisco. Plaintiffs plead their original complaint as a putative class action and allege four causes of action: fraud; constructive fraud; violation of the California Unfair Competition Law; and violation of the California Consumer Legal Remedies Act. Plaintiffs contend that CCA made a variety of misrepresentations to them, primarily oral, during the admissions process. The alleged misrepresentations relate generally to the school s reputation, the value of the education, the competitiveness of the admissions process, and the students employment prospects upon graduation, including the accuracy of statistics published by CCA.

On April 3, 2008, the same counsel representing plaintiffs in the Amador action filed the Adams action on behalf of Jennifer Adams and several other unnamed members of the Amador putative class. The Adams action also is styled as a class action and is based on the same allegations underlying the Amador action and attempts to plead the same four causes of action pled in the Amador action. The Adams action has been deemed related to the Amador action and is being handled by the same judge. The Adams action has been stayed.

Plaintiffs filed a Fourth Amended Complaint on or about March 19, 2010 alleging the same causes of action, but including new claims based on: (1) violations of the California Education Code, which was recently reinstated by the California legislature. The Company has filed a motion to dismiss these new claims. The motion is expected to be heard in August 2010.

The parties have conducted discovery, including discovery on class certification issues in the Amador action, but the Court has not yet set a briefing schedule or a hearing date on a motion for class certification. The parties have also been engaged in mediation sessions and settlement discussions regarding the Amador and Adams actions. These discussions are ongoing.

Lilley, et al. v. Career Education Corporation, et al. On February 11, 2008, a class action complaint was filed in the Circuit Court of Madison County, Illinois, naming as defendants Career Education Corporation and Sanford-Brown College, Inc. Plaintiffs filed an amended complaint on September 5, 2008. The five plaintiffs named in the amended complaint are current or former students who allegedly attended a medical assistant program at Sanford-Brown College located in Collinsville, Illinois, and the class is alleged to be all persons who

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

enrolled in that program. The amended class action complaint asserts claims for unfair conduct and deceptive conduct under the Illinois Consumer Fraud and Deceptive Business Practices Act (the Act), as well as common law claims of fraudulent misrepresentation and fraudulent omission. The amended complaint alleges that defendants made misrepresentations and omissions relating to the quality of education, quantity of financial aid, fixed tuition, graduate employability and salaries and clinical externships. Plaintiffs seek unspecified compensatory and punitive damages.

Defendants filed a motion to dismiss Plaintiffs claims of unfair practices under the Act and fraudulent omission. By Order dated June 24, 2009, the Court granted Defendants motion to dismiss Plaintiffs fraudulent omission claim (Count IV of the Amended Complaint), and denied Defendants motion to dismiss Plaintiffs Illinois Consumer Fraud Act Claim. Defendants have filed answers and affirmative defenses in response to the amended complaint. The parties have exchanged written discovery and document production is underway. The case is set for a case management conference on August 25, 2010.

Schuster, et al. v. Western Culinary Institute, Ltd. and Career Education Corporation. On March 5, 2008, original named plaintiffs Shannon Gozzi and Megan Koehnen filed a complaint in Portland, Oregon in the Circuit Court of the State of Oregon in and for Multnomah County. Plaintiffs filed the complaint individually and as a putative class action and alleged two claims for equitable relief: violation of Oregon s Unlawful Trade Practices Act and unjust enrichment. Plaintiffs filed an amended complaint on April 10, 2008, which added two claims for money damages: fraud and breach of contract. Plaintiffs allege that Western Culinary Institute, Ltd. (WCI) made a variety of misrepresentations to them, relating generally to WCI s placement statistics, students employment prospects upon graduation from WCI, the value and quality of an education at WCI, and the amount of tuition students could expect to pay as compared to salaries they may earn after graduation. On May 21, 2008, plaintiffs filed a second amended complaint in which they simply changed the statement Claims Subject to Mandatory Arbitration on the caption to Claims *Not* Subject to Mandatory Arbitration (emphasis added). WCI and CEC filed an answer on June 13, 2008 and WCI subsequently moved to dismiss certain of plaintiffs claims under Oregon s Unlawful Trade Practices Act; that motion was granted on September 12, 2008. Shannon Gozzi subsequently withdrew as a named plaintiff and is now asserting claims merely as an absent class member, and former named plaintiff Meghan Koehnen s claims have been dismissed. Jennifer Schuster was then the sole named Plaintiff, and she filed a third amended complaint on November 20, 2008. Defendants filed an answer on December 5, 2008. Plaintiffs filed their most recent operative pleading, a fourth amended complaint, on September 2, 2009, and Defendants filed an answer on October 15, 2009. The parties completed written discovery on class issues. Plaintiffs filed their motion for class certification on August 31, 2009, and oral argument on the motion was heard on October 29, 2009. On February 5, 2010, the Court entered a formal Order granting class certification on part of the UTPA and fraud claims purportedly based on omissions, denying certification of the rest of those claims and denying certification of the breach of contract and unjust enrichment claims. On April 30, 2010, the Court addressed the issue of whether the class should include students who enrolled prior to March 5, 2006, provided that they were attending the school on or after March 6, 2006. Defendants argued that the class cannot include pre-March 6, 2006 enrollees (two years prior to the filing of the lawsuit, corresponding with the two year statute of limitations on the fraud claim) because of the individual questions associated with determining whether the statute of limitations may be tolled. The Court agreed with Defendants position and limited the class as Defendants suggested. Because Schuster was not a member of the certified class (she enrolled before March 5, 2006), Plaintiff s counsel is proposing to substitute in a new class representative for her named Nathan Surrett. The parties are negotiating the terms of that potential substitution, allowing WCI the right to challenge whether the new class representative is adequate (with Plaintiff retaining the burden of proof on that issue). Class notice has not been sent due to the complications associated with the impending withdrawal of the named Plaintiff and potential substitution of a new plaintiff. The parties are

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

currently engaged in merits discovery. The class will consist of students who enrolled at WCI between March 5, 2006 and March 1, 2010, excluding those who dropped out or were dismissed from the school for academic reasons.

Vasquez, et al. v. California School of Culinary Arts, Inc. and Career Education Corporation. On June 23, 2008, a putative class action lawsuit was filed in the Los Angeles County Superior Court entitled *Daniel Vasquez and Cherish Herndon v. California School of Culinary Arts, Inc. and Career Education Corporation*. The plaintiffs allege causes of action for fraud, constructive fraud, violation of the California Unfair Competition Law and violation of the California Consumer Legal Remedies Act. The plaintiffs allege improper conduct in connection with the admissions process during the alleged class period. The alleged class is defined as including all persons who purchased educational services from California School of Culinary Arts, Inc. (CSCA), or graduated from CSCA, within the limitations periods applicable to the herein alleged causes of action (including, without limitation, the period following the filing of the action). Defendants successfully demurred to the constructive fraud claim and the Court has dismissed it. The parties are engaged in class discovery. The Court has not yet set a briefing schedule or a hearing date on a motion for class certification.

Due to the inherent uncertainties of litigation, we cannot predict the ultimate outcome of these matters. An unfavorable outcome of any one or more of these matters could have a material adverse impact on our business, results of operations, cash flows, and financial position.

False Claims Act

False Claims Act Lawsuit. On July 28, 2009, we were served with a complaint filed in the U.S. District Court for the Northern District of Georgia, Atlanta Division. The complaint was originally filed under seal on July 14, 2008 by four former employees of the Dunwoody campus of our American InterContinental University on behalf of themselves and the federal government. The case is captioned *United States of America, ex rel. Melissa Simms Powell, et al. v. American InterContinental University, Inc., a Georgia Corporation, Career Education Corp., a Delaware Corporation and John Doe Nos. 1-100.*

On July 27, 2009, the Court ordered the complaint unsealed and we were notified that the U.S. Department of Justice declined to intervene in the action. When the federal government declines to intervene in a False Claims Act action, as it has done in this case, the private plaintiffs may elect to pursue the litigation on behalf of the federal government and, if they are successful, receive a portion of the federal government s recovery. The action alleges violations of the False Claims Act, 31 U.S.C. § 3729(a)(1) and (2), and promissory fraud, including allegedly providing false certifications to the federal government regarding compliance with certain provisions of the Higher Education Act and accreditation standards. On September 1, 2009, we timely filed a Motion to Dismiss all of the claims. It was denied by the Court in its Order of June 2, 2010. On June 16 and 17, 2010, we filed separate Motions for Reconsideration, for Certification for Interlocutory Appeal, and to Strike certain allegations in the complaint. Briefing on these Motions was completed on July 15, 2010. Discovery in the matter is stayed pending their resolution.

Other Litigation

In addition to the legal proceedings and other matters described above, we are also subject to a variety of other claims, suits, and investigations that arise from time to time in the ordinary conduct of our business, including, but not limited to, claims involving students or graduates and routine employment matters. While we currently believe that such claims, individually or in aggregate, will not have a material adverse impact on our

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

financial position, cash flows, or results of operations, the litigation and other claims noted above are subject to inherent uncertainties, and management s view of these matters may change in the future. Were an unfavorable final outcome to occur in any one or more of these matters, there exists the possibility of a material adverse impact on our business, reputation, financial position, cash flows, and the results of operations for the period in which the effect becomes probable and reasonably estimable.

Accrediting Body and Federal Regulatory Matters

AIU s accrediting agency, the Higher Learning Commission of the North Central Association of Colleges and Schools (HLC), commissioned an advisory team to visit AIU in January 2010. The advisory team conducted a review of AIU, with particular focus on program integrity. Based on the results of its review, the HLC advisory team did not cite AIU for any violations of any HLC accreditation criteria, including but not limited to those related to program length and credit hours, and did not recommend any sanction or limitation on AIU s accreditation status. The advisory team recommended a focused visit for 2011 or 2012 to evaluate AIU s transition to a new undergraduate credit structure which was introduced in February 2010. All new undergraduate students starting at AIU are enrolled in programs with this new credit structure. The recommended focused visit will supersede the focused visit concerning credit equivalence previously scheduled for 2010.

In accordance with HLC policy, the advisory team s recommendation that HLC conduct a focused visit to evaluate AIU s transition to a new undergraduate structure was subject to review and approval by the HLC Institutional Actions Council (IAC) and validation by the HLC Board of Trustees. The advisory team s recommendation was approved by the IAC on June 14, 2010, and the decision of the IAC was validated by the HLC Board of Trustees on June 23, 2010. AIU s updated Statement of Affiliation Status and Organizational Profile were posted to the HLC s website on Friday, July 9, 2010.

In addition and as previously disclosed, in connection with HLC s initial accreditation of AIU in May 2009, AIU was required to submit a progress report to HLC relating to curricula design and AIU s graduate programs student learning outcomes. AIU submitted the progress report to HLC in March 2010. Following its submission of the progress report, AIU was advised by the HLC staff that it had accepted AIU s report and that no further reporting on that subject would be required.

Due to their participation in Title IV programs, our schools and universities are subject to periodic program reviews by the U.S. Department of Education (ED) for the purpose of evaluating an institution s compliance with Title IV requirements, identifying any liabilities to the ED caused by errors in compliance, and improving future institutional capabilities.

As previously disclosed, the ED conducted a program review of AIU in November 2009. On July 14, 2010, AIU received a copy of the ED s Program Review Report, which is a preliminary report of the ED s findings from its program review. The Program Review Report identified six findings, two of which were deemed to be systemic findings by the ED s program review team. These two findings relate to AIU s policy for determining student attendance in online courses for purposes of determining such students enrollment status, withdrawal dates and associated timing respecting the return of unearned Title IV funds. AIU disagrees with these two findings and intends to contest the program review team s proposed determination of what constitutes appropriate documentation or verification of online academic activity. The remaining findings were isolated and generally relate to processing errors. We believe the amounts involved in these four findings are immaterial. AIU has 90 days from its receipt of the Program Review Report to submit a response to the findings contained therein. After the ED receives AIU s response, it will issue a Final Program Review Determination letter that will specify any required corrective action and amounts owed to the ED, if any.

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

In addition, an ED program review report for Gibbs College Livingston, New Jersey (school closed) and final determination letters for Briarcliffe College and Katharine Gibbs School New York, New York (school closed) are currently pending. The program review report and/or final determination letter will, generally, cover a school s main campus and any branch campuses. We are committed to resolving all issues identified in connection with these program reviews to the ED s satisfaction and ensuring that our schools operate in compliance with all ED regulations.

Our schools and universities are also subject to periodic audits by various regulatory bodies, including the U.S. Department of Education s Office of Inspector General (OIG). The OIG audit services division commenced a compliance audit of CTU in June 2010, covering the period July 1, 2009 to June 30, 2010, to determine whether CTU has policies and procedures to ensure that CTU administers Title IV and other federal program funds in accordance with applicable federal regulations. The OIG audit is ongoing.

While we believe that our schools operate in substantial compliance with applicable statutes and regulations, we cannot predict the outcome of these matters, and any unfavorable outcomes could have a material adverse effect on our business, results of operations, cash flows and financial position.

10. INCOME TAXES

The determination of the annual effective tax is based upon a number of significant estimates and judgments, including the estimated annual pretax income in each tax jurisdiction in which we operate and the ongoing development of tax planning strategies during the year. In addition, our provision for income taxes can be impacted by changes in tax rates or laws, the finalization of tax audits and reviews, as well as other factors that cannot be predicted with certainty. As such, there can be significant volatility in interim tax provisions.

The following is a summary of our income tax provision and effective tax rate for continuing operations (dollars in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Pretax income	$ 94,601	$ 36,831	$ 182,664	$ 89,191
Provision for income taxes	$ 29,430	$ 13,258	$ 61,538	$ 31,725
Effective tax rate	31.1%	36.0%	33.7%	35.6%

The decrease in our effective tax rate for the three and six months ended June 30, 2010 as compared to the prior year was primarily due to the recording of a $4.2 million tax benefit in the current quarter resulting from a recently closed federal tax audit for credits associated with curriculum development. Approximately $0.5 million of this benefit applies to the first quarter 2010, $1.4 million applies to 2009 and the remaining $2.3 million applies to fiscal years 2006 2008. This tax credit reduced our effective tax rate by 4.5% and 2.3% for the three and six months ended June 30, 2010, respectively. In addition, the current year results include lower levels of both non-profit income and tax-exempt interest as a percentage of pretax income.

We estimate that it is reasonably possible that the liability for unrecognized tax benefits for a variety of uncertain tax positions will decrease by up to $9.0 million in the next twelve months as a result of the completion of various tax audits currently in process and the expiration of the statute of limitations in several jurisdictions. The income tax rate for the three and six months ended June 30, 2010 does not take into account the possible

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

reduction of the liability for unrecognized tax benefits. The impact of a reduction to the liability will be treated as a discrete item in the period the reduction occurs. We recognize interest and penalties related to unrecognized tax benefits in tax expense. As of June 30, 2010, we had accrued $3.4 million as an estimate for reasonably possible interest and accrued penalties.

Our tax returns are routinely audited by federal, state and foreign tax authorities and these audits are at various stages of completion at any given time. The Internal Revenue Service completed its examination of our U.S. income tax returns through our tax year ending December 31, 2007.

11. STOCK REPURCHASE PROGRAM

During the three months ended June 30, 2010, we repurchased approximately 2.1 million shares of our common stock for approximately $65.3 million at an average price of $31.57 per share. During the six months ended June 30, 2010, we repurchased 5.4 million shares of our common stock for approximately $155.0 million at an average price of $28.56 per share.

As of June 30, 2010, approximately $290.5 million was available under our authorized stock repurchase program to repurchase outstanding shares of our common stock. Stock repurchases under this program may be made on the open market or in privately negotiated transactions from time to time, depending on various factors, including market conditions and corporate and regulatory requirements. The stock repurchase program does not have an expiration date and may be suspended or discontinued at any time. The repurchase of shares of our common stock reduces the amount of cash available to pay cash dividends to our stockholders. We have never paid cash dividends on our common stock.

12. SHARE-BASED COMPENSATION

Overview of Share-Based Compensation Plans

On May 13, 2008, the stockholders of CEC approved the Career Education Corporation 2008 Incentive Compensation Plan (the 2008 Plan). The 2008 Plan authorizes awards of stock options, stock appreciation rights, restricted stock, restricted stock units, deferred stock, performance units, annual incentive awards, and substitute awards. Any shares of CEC common stock that are subject to awards of stock options or stock appreciation rights payable in shares will be counted as 1.0 share for each share granted for purposes of the aggregate share limit and any shares of CEC common stock that are subject to any other form of award will be counted as 1.67 shares for each share granted for purposes of the aggregate share limit. The 2008 Plan replaced our 1998 Employee Incentive Compensation Plan, as amended (the 1998 Employee Plan) and our 1998 Non-Employee Directors Stock Option Plan (the Directors Plan). As of June 30, 2010 there were approximately 5.7 million shares of common stock available for future share-based awards under the 2008 Plan.

As of June 30, 2010, we estimate that pretax compensation expense of $26.7 million will be recognized over the next four years for all unvested share-based awards that have been granted to participants, including both stock options and shares of restricted stock. We expect to satisfy the exercise of stock options and future distribution of shares of restricted stock by issuing new shares of common stock or by using treasury shares.

Stock Options. The exercise price of stock options granted under each of the plans is equal to the fair market value of our common stock on the date of grant. Employee stock options generally become exercisable 25% per year over a four-year service period beginning on the date of grant and expire ten years after the date of grant, unless an earlier expiration date is set at the time of the grant. Non-employee directors stock options expire ten years after the date of grant and generally become exercisable as follows: one-third on the grant date,

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

one-third on the first anniversary of the grant date, and one-third on the second anniversary of the grant date. Both employee stock options and non-employee director stock options are subject to possible earlier vesting and termination in certain circumstances. Generally, if a plan participant terminates his or her employment for any reason other than by death or disability during the vesting period, he or she forfeits the right to unvested stock option awards. Since the inception of the plans, grants of stock options have only been subject to the service conditions discussed previously. No stock option grants have included performance or market conditions or other factors that affect stock option vesting.

Stock option activity during the six months ended June 30, 2010, under all of our stock option plans was as follows (options in thousands):

	Options	Weighted Average Exercise Price
Outstanding as of December 31, 2009	3,213	$ 28.30
Granted	627	29.53
Exercised	(40)	15.38
Forfeited		
Cancelled	(71)	38.19
Outstanding as of June 30, 2010	3,729	28.46
Exercisable as of June 30, 2010	2,484	$ 30.39

Restricted Stock. Shares of restricted stock generally become vested either three years after the date of grant or 25% per year over a four-year service period beginning on the date of grant. Generally, if a plan participant terminates his or her employment for any reason other than by death or disability during the vesting period, he or she forfeits the right to the unvested shares of restricted stock. The vesting of shares of restricted stock is subject to possible acceleration in certain circumstances. Certain of the shares of restricted stock that we have granted to plan participants are subject to performance conditions that, even if the requisite service period is met, may reduce the number of shares of restricted stock that vest at the end of the requisite service period or result in all shares being forfeited. These awards are referred to as performance-based restricted stock.

The following table summarizes information with respect to all outstanding shares of restricted stock under our plans during the six months ended June 30, 2010 (shares in thousands):

	Shares	Weighted Average Grant-Date Fair Value Per Share
Outstanding as of December 31, 2009	1,708	$ 20.46
Granted	1,031	29.02
Vested	(222)	29.32
Forfeited	(137)	22.12
Outstanding as of June 30, 2010	2,380	$ 23.25

Change in Control Provisions

Each of the share-based awards granted under the 2008 Plan, the 1998 Employee Plan and the Directors Plan, including stock options and shares of restricted stock, are subject to change in control provisions that accelerate vesting of outstanding equity awards under the plans under certain circumstances. As defined by these

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

plans, a change in control generally is deemed to have occurred if, among other things, any corporation, person, or other entity (other than CEC, a majority-owned subsidiary of CEC or any of CEC s subsidiaries, or an employee benefit plan sponsored or maintained by CEC), including a group as defined in Section 13(d)(3) of the Exchange Act, becomes the beneficial owner of our common stock representing more than 20% under our 1998 Employee Plan and Directors Plan, or 35% under our 2008 Plan, of the combined voting power of our then outstanding common stock. Under the 1998 Plans, accelerated vesting of outstanding awards occurs upon a change in control; under the 2008 Plan, which is a double-trigger plan, accelerated vesting occurs only when an award holder is terminated involuntarily not for cause within two years after a change in control of the Company.

On February 20, 2009, the Company entered into Option Extension and Amendment Agreements with its non-employee directors regarding outstanding option grants held by the Company s non-employee directors under the Directors Plan and the 1998 Employee Plan, as applicable. These agreements amend such outstanding option grants to (i) increase the stock ownership threshold upon which a change in control is deemed to occur from twenty percent (20%) to thirty-five percent (35%) and (ii) amend all such outstanding option grants to extend the post-termination exercise period of such options to the earlier of (a) three (3) years following termination of service as a director of the Company, and (b) the original expiration date of the option, except in the case of termination of service as a director of the Company at a time when Cause , as defined in the 2008 Plan, exists. As a result of these agreements, all outstanding awards under the Directors Plan are subject to the thirty-five percent (35%) stock ownership threshold at which a change in control is deemed to occur, rather than the twenty percent (20%) threshold specified in the Directors Plan.

On February 20, 2009, the Company entered into Option and Restricted Stock Amendment Agreements with the Company s Section 16 reporting officers (each, an Officer) amending all outstanding Company options and restricted stock held by such Officers under the 1998 Employee Plan. These agreements amend such outstanding options and restricted stock awards to (i) increase the stock ownership threshold upon which a change in control is deemed to occur from twenty percent (20%) to thirty-five percent (35%) and (ii) provide that, upon any Officer s Termination of Employment by the Company without Cause, as such terms are defined in the 1998 Employee Plan, the options held by such Officer under the 1998 Employee Plan shall become fully exercisable and the shares of restricted stock held by such Officer under the 1998 Employee Plan shall become fully vested.

The amendments approved on February 20, 2009 represent modifications to the original equity awards and resulted in additional compensation expense of approximately $0.5 million being recorded by the Company in 2009.

If any person or entity, including a group, beneficially owned 20% or more, of the combined voting power of our then outstanding common stock as of June 30, 2010, triggering the accelerated vesting provisions of our 1998 Employee Plan discussed above, we would have recognized accelerated share-based compensation expense of approximately $1.9 million during the second quarter of 2010.

As of June 30, 2010, we are not aware of any person or entity, including a group, who beneficially owns 20% or more of the combined voting power of our outstanding common stock. As of June 30, 2010, no individual shareholder owned more than 19.7% of the combined voting power of our then outstanding common stock.

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

13. WEIGHTED AVERAGE COMMON SHARES

The weighted average numbers of common shares used to compute basic and diluted net income per share for the three and six months ended June 30, 2010 and 2009 were as follows (shares in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Basic common shares outstanding	79,348	87,496	80,846	89,696
Common stock equivalents	1,111	337	1,041	377
Diluted common shares outstanding	80,459	87,833	81,887	90,073

During the three months ended June 30, 2010 and 2009, we issued less than 0.1 million shares, respectively, and during the six months ended June 30, 2010 and 2009, we issued less than 0.1 million shares, respectively, of our common stock upon the exercise of employee stock options and the purchase of common stock pursuant to our employee stock purchase plan.

Included in stock options outstanding as of June 30, 2010 and 2009, are options to purchase 2.3 million and 2.4 million shares, respectively, of our common stock that were not included in the computation of diluted net income per share during the three months ended June 30, 2010 and 2009. Included in stock options outstanding as of June 30, 2010 and 2009, are options to purchase 2.3 million and 2.5 million shares, respectively, of our common stock that were not included in the computation of diluted net income per share during the six months ended June 30, 2010 and 2009. These shares were excluded because the options exercise prices were greater than the average market price of our common stock during the periods, and, therefore, the effect would have been anti-dilutive.

14. SEGMENT REPORTING

During the first quarter of 2010, we realigned our resources more effectively by integrating our schools which previously comprised our Art & Design SBU alongside AIU and CTU within the University SBU. Harrington College of Design, Collins College and Brooks Institute joined the IADT schools in the alignment of the Art & Design group into the University SBU. The realignment also shifted Brown College and Briarcliffe College into the Health Education SBU.

As a result of the realignment, the Company now has five reportable segments consisting of University, Health Education, Culinary Arts, International and Transitional schools.

University includes our AIU, CTU, IADT, Harrington College of Design, Collins College and Brooks Institute schools. These schools collectively offer regionally and nationally accredited academic programs in the career-oriented disciplines of business studies, visual communications and design technologies, film and video production, photography, health education, information technology, criminal justice, and education in an online, classroom or laboratory setting.

Health Education includes our Sanford-Brown schools, along with Brown College, Briarcliffe College, Missouri College and Gibbs College Boston, MA. These schools collectively offer academic programs in the career-oriented disciplines of health education, complemented by certain programs in business studies and information technology in a classroom, laboratory or online setting.

22

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

Culinary Arts includes our LCB schools that collectively offer culinary arts programs in the career-oriented disciplines of culinary arts, baking and pastry arts, and hotel and restaurant management in a classroom, kitchen or online setting.

International includes our INSEEC schools, including IUM, and Istituto Marangoni schools located in France, Italy, the United Kingdom and Monaco, which collectively offer academic programs in the career-oriented disciplines of business studies, health education, fashion and design, visual communications and technologies and luxury goods and services in a classroom or laboratory setting.

Transitional Schools includes those schools that are currently being taught out. As of June 30, 2010, AIU Los Angeles, CA is the only school included in Transitional Schools. We anticipate AIU-Los Angeles will complete its teach out by the fourth quarter 2010, and the results of its operations for all periods presented will be then reflected within Discontinued Operations.

Segment performance is evaluated by the Company and its chief operating decision maker based on operating income. Adjustments to reconcile segment results to unaudited consolidated results are included under the caption Corporate and other, which primarily includes unallocated corporate activity and eliminations.

Summary financial information by reportable segment is as follows (dollars in thousands):

	Revenue		Operating Income (Loss)	
	For the Three Months Ended June 30,		For the Three Months Ended June 30,	
	2010	2009	2010	2009
University	$ 297,107	$ 250,079	$ 79,463	$ 45,880
Health Education	107,971	86,390	11,606	7,224
Culinary Arts	92,822	74,242	12,395	(3,098)
International	29,979	26,277	2,997	3,083
Transitional Schools	132	823	(1,440)	(1,350)
Subtotal	528,011	437,811	105,021	51,739
Corporate and other	(139)	(138)	(9,650)	(14,651)
Total	$ 527,872	$ 437,673	$ 95,371	$ 37,088

	Revenue		Operating Income (Loss)	
	For the Six Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
University	$ 587,771	$ 489,018	$ 148,171	$ 88,368
Health Education	211,835	169,487	22,614	17,022
Culinary Arts	185,576	149,524	20,600	(4,248)
International	72,317	60,786	16,429	14,448
Transitional Schools	389	1,920	(2,848)	(2,666)
Subtotal	1,057,888	870,735	204,966	112,924
Corporate and other	(334)	(199)	(21,491)	(24,587)

Total	$ 1,057,554	$ 870,536	$ 183,475	$ 88,337

Table of Contents

CAREER EDUCATION CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(In thousands, except per share amounts)

	Total Assets as of (1)	
	June 30, 2010	December 31, 2009
University	$ 289,926	$ 255,522
Health Education	271,174	279,001
Culinary Arts	369,297	357,472
International	206,528	242,214
Transitional Schools	3,607	3,955
Subtotal	1,140,532	1,138,164
Corporate and other	245,488	395,159
Discontinued Operations	28,764	30,519
Total	$ 1,414,784	$ 1,563,842

(1) Total assets do not include intercompany receivable or payable activity between schools and corporate.

15. TOTAL COMPREHENSIVE INCOME

The following table presents the components of comprehensive income for the periods presented (dollars in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Net income	$ 64,318	$ 6,490	$ 119,540	$ 29,747
Other comprehensive income (loss):				
Foreign currency translation adjustments	(11,380)	7,113	(19,137)	2,176
Unrealized gains/(losses) on investments, net of tax	154	(56)	(5)	(322)
Total comprehensive income	$ 53,092	$ 13,547	$ 100,398	$ 31,601

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

The discussion below contains forward-looking statements, as defined in Section 21E of the Securities Exchange Act of 1934, as amended, that reflect our current expectations regarding our future growth, results of operations, cash flows, performance and business prospects, and opportunities, as well as assumptions made by, and information currently available to, our management. We have tried to identify forward-looking statements by using words such as anticipate, believe, plan, expect, intend, will, and similar expressions, but these words are not the exclusive means of identifying these forward-looking statements. These statements are based on information currently available to us and are subject to various risks, uncertainties, and other factors, including, but not limited to, those discussed in Part II, Item 1A Risk Factors in this Quarterly Report on Form 10-Q, that could cause our actual growth, results of operations, cash flows, performance, business prospects and opportunities to differ materially from those expressed in, or implied by, these statements. Except as expressly required by federal securities laws, we undertake no obligation to update such factors or to publicly announce the results of any of the forward-looking statements contained herein to reflect future events, developments, or changed circumstances, or for any other reason.

Overview

The colleges, schools and universities that are part of the Career Education Corporation (CEC) family offer high-quality education to a diverse student population of over 104,000 students across the world in a variety of career-oriented disciplines. The more than 90 campuses that serve these students are located throughout the U.S. and in France, Italy, the United Kingdom and Monaco, and offer doctoral, master s, bachelor s and associate degrees and diploma and certificate programs. Approximately 44% of our students attend the web-based virtual campuses of American InterContinental University, Colorado Technical University, International Academy of Design & Technology and Le Cordon Bleu College of Culinary Arts.

CEC is an industry leader whose brands are recognized globally. Those brands include, among others, American InterContinental University (AIU); Brooks Institute; Colorado Technical University (CTU); Harrington College of Design; INSEEC Group (INSEEC) Schools, including the International University of Monaco (IUM); International Academy of Design & Technology (IADT); Istituto Marangoni; Le Cordon Bleu North America (LCB); and Sanford-Brown Institutes and Colleges. Through our schools, CEC is committed to providing high-quality education, enabling students to graduate and pursue rewarding careers.

On January 15, 2010, we realigned our resources to more effectively execute our new strategic growth plan. We began the integration of our schools which previously comprised the Art & Design Strategic Business Unit (SBU) alongside AIU and CTU, within the University SBU. This realignment will facilitate synergies between the programs in Art & Design and University, especially in the areas of fashion design, merchandising and interior design and technology. It will also enable the sharing of student-focused online platforms and expertise and aid IADT as it pursues its longer-term strategy of regional accreditation. Harrington College of Design, Collins College and Brooks Institute joined the IADT schools in the alignment of the Art & Design group into the University SBU. The realignment also shifted Brown College and Briarcliffe College into the Health Education SBU. We expect Briarcliffe s regional accreditation to be beneficial in providing greater opportunity for Sanford-Brown students to enroll in higher degree programs. This realignment resulted in new reportable segments, and prior period results have been revised to reflect these new reportable segments. See Note 14 Segment Reporting of the notes to our unaudited consolidated financial statements for further discussion.

In addition to the realignment, we completed a detailed review of our shared service costs to determine which of these costs should be charged to the SBUs as well as how these shared service costs should be allocated. These services include legal, finance, human resources, marketing, certain academic functions and certain centralized activities related to student finance, including financial aid processing, student account posting and collections. These costs, recorded within Corporate and other, were previously allocated to our SBUs based upon a percentage of revenue. Improved data and analytical capabilities have provided us insight into costs being

incurred to support the SBUs versus costs being incurred to support the corporation as a whole. The new methodology allocates costs based on usage and consumption factors such as student population, employee headcount, advertising spend, number of financial aid recipients and revenue where appropriate. In the case of certain services which are shared evenly across the SBUs, we allocate evenly. The new methodology is intended to provide improved transparency into the costs of the shared services. The effect of these changes impacts the costs reported within each SBU and reduces the level of unallocated shared service costs. Results beginning in 2010 are presented under the new methodology and prior period results have been revised to be comparable to the current reporting.

Our reportable segments are:

University includes our AIU, CTU, IADT, Harrington College of Design, Collins College and Brooks Institute schools. These schools collectively offer regionally and nationally accredited academic programs in the career-oriented disciplines of business studies, visual communications and design technologies, film and video production, photography, health education, information technology, criminal justice, and education in an online, classroom or laboratory setting.

Health Education includes our Sanford-Brown schools, along with Brown College, Briarcliffe College, Missouri College and Gibbs College Boston, MA. These schools collectively offer academic programs in the career-oriented disciplines of health education, complemented by certain programs in business studies and information technology in a classroom, laboratory or online setting.

Culinary Arts includes our LCB schools that collectively offer culinary arts programs in the career-oriented disciplines of culinary arts, baking and pastry arts, and hotel and restaurant management in a classroom, kitchen or online setting.

International includes our INSEEC schools, including IUM, and Istituto Marangoni schools located in France, Italy, the United Kingdom and Monaco, which collectively offer academic programs in the career-oriented disciplines of business studies, health education, fashion and design, visual communications and technologies and luxury goods and services in a classroom or laboratory setting.

Transitional Schools includes those schools that are currently being taught out. As of June 30, 2010, AIU Los Angeles, CA is the only school included in Transitional Schools. We anticipate AIU-Los Angeles will complete its teach out by the fourth quarter 2010, and the results of its operations for all periods presented will be then reflected within Discontinued Operations.

See Note 14 Segment Reporting of the notes to our unaudited consolidated financial statements for further discussion.

2010 Second Quarter Overview

During the second quarter 2010, we continued to focus on our strategic initiatives of leveraging our leading technology to grow online education offerings, increasing the number of students in our bachelor s and master s programs, further distinguishing our universities AIU and CTU, and continuing the expansion of our Health Education institutions to meet the high demand for skills in this sector. These initiatives each contributed to the 20.6% increase in revenue over the prior year quarter. We continue to invest in key areas such as preparing students for success in their chosen field or career as well as focus on student engagement in the process of life-long learning which will position us for long-term growth in student population.

Operating income increased 157.1% over the prior year quarter and operating margin increased by 960 basis points to 18.1% during the second quarter 2010 over the prior year quarter as we continued to gain operating leverage. Student population grew 23% over the prior year as second quarter new student starts increased by 18%. Through our continued commitment and dedication to student success, the Company has graduated nearly 480,000 students as of June 30, 2010.

Table of Contents

Also, during the second quarter 2010 the Company acquired for approximately $6.3 million (plus assumption of $4.3 million in loans which were immediately paid) the International University of Monaco (IUM), a leading international business university located in Monte Carlo with annual revenues of approximately $4.5 million. IUM offers bachelor s, master s and doctoral programs in such areas as finance, international business and luxury goods and services. Its current enrollment includes nearly 400 students representing 62 countries. IUM joined the INSEEC group as the acquisition expands our European presence and positions INSEEC for continued growth as a leader in postsecondary education in Europe. IUM s operating results are included in our unaudited consolidated financial statements from the date of acquisition.

Our University segment grew student population by 18% in the second quarter, driven by strong new student starts in CTU and AIU. As a result, revenue increased approximately 19% compared to the prior year quarter and operating margins increased to approximately 27% from approximately 18%. New student starts grew 11% in the second quarter. IADT new student starts declined 36% over the prior year quarter due to changes in the academic calendar. This impact was more than offset by 26% new student start growth in CTU and 14% new student starts in AIU over the prior year quarter, driven by actions undertaken to optimize marketing channels and increase admissions effectiveness, which began positively impacting results in the third quarter 2009 and continued through the first half of 2010. The prior year quarter results reflected lower new student starts as the effectiveness of our admissions model initiated in 2008 had not reached the level we anticipated until the third quarter 2009. As a result, we expect both AIU and CTU new student start growth for the remainder of 2010 to be lower than the second quarter 2010 as we begin to compare against higher new student start growth rates from 2009.

As previously disclosed, AIU s accrediting agency, the Higher Learning Commission of the North Central Association of Colleges and Schools (HLC), commissioned an advisory team to visit AIU in January 2010. The advisory team conducted a comprehensive review of AIU, with particular focus on program integrity. Based on the results of its review, the HLC advisory team did not cite AIU for any violations of any HLC accreditation criteria, including but not limited to those related to program length and credit hours, and did not recommend any sanction or limitation on AIU s accreditation status. The advisory team recommended a focused visit for 2011 or 2012 to evaluate AIU s transition to a new undergraduate credit structure which was introduced in February 2010. All new undergraduate students starting at AIU are enrolled in programs with this new credit structure.

In accordance with HLC policy, the advisory team s recommendation that HLC conduct a focused visit to evaluate AIU s transition to a new undergraduate structure was subject to review and approval by the HLC Institutional Actions Council (IAC) and validation by the HLC Board of Trustees. The advisory team s recommendation was approved by the IAC on June 14, 2010, and the decision of the IAC was validated by the HLC Board of Trustees on June 23, 2010. AIU s updated Statement of Affiliation Status and Organizational Profile were posted to the HLC s website on Friday, July 9, 2010.

Throughout the quarter, we continued to experience significant growth in Health Education, which reported a 32% increase in new student starts as compared to the prior year quarter and a 25.0% revenue increase as compared to the prior year quarter. Operating income increased by $4.4 million or approximately 61% as compared to the prior year quarter. In 2009, we opened eight new locations, seven of which were within Health Education, allowing us to expand the strong operating model and market opportunity of our Sanford-Brown Institutes and Colleges. In addition, we opened four new campuses within Health Education in 2010; SBC Hillside Hillside, IL and SBI Cranston Cranston, RI opened in the first quarter of 2010, and SBC Tinley Park Tinley Park, IL and SBC Indianapolis Indianapolis, IN opened in second quarter of 2010. We expect to open at least two new Health Education schools during the balance of the current year. These locations provide us with the opportunity to expand our presence in key locations in the U.S.

Within our international segment, both INSEEC and Istituto Marangoni continued to experience positive results. Revenue increased approximately 14% as compared to the prior year quarter, while operating income remained relatively flat compared to the prior year quarter. Excluding the $2.8 million and $0.8 million

unfavorable impact of foreign currency exchange rates, revenue grew 24.7% and operating income grew 24.6% as compared to the prior year quarter, respectively. This revenue growth is attributable to strong student population growth at both institutions and strong student retention at INSEEC as well as revenue earned by IUM of $1.4 million for the period of April 16, 2010 through June 30, 2010.

In the second quarter 2010, Culinary Arts increased new student starts by 21% resulting in a 34% increase in student population as compared to the prior year quarter. The increase in student population has driven a 25.0% increase in revenue for the second quarter 2010 as compared to the prior year quarter. Through leverage of existing cost structures, we were able to improve our operating margin by 17.6% to 13.4% in the current year quarter as compared to a loss in the prior year quarter. The increased revenue and operating cost efficiencies were offset by increased bad debt expense as a percentage of revenue over the prior year quarter. We continue to monitor the student payment practices of our payment plans to ensure adequacy of the allowance for doubtful accounts. Additionally, we believe the introduction of the 21-month Culinary Arts program that began its rollout in January 2009 along with our implementation of student support activities at each Culinary Arts campus, continues to help attract new students lost as a result of the severe contraction of the student loan market which occurred in the second quarter of 2008. By assisting our students throughout their entire course of study, including providing the opportunity for an additional year of Title IV funding with the decelerated 21-month program, we have improved the overall student experience and growth prospects of our culinary institutions.

Our acquisition of the outright rights to the LCB brand in North America in 2009 has allowed us to rebrand our existing Culinary Arts campuses with the LCB name resulting in efficiencies in our marketing campaigns, as we align our messages around this strong brand. Additionally, it solidified a core asset essential to the future growth of our Culinary Arts segment.

The results of operations for those campuses previously taught out or sold are reflected as a component of discontinued operations. Currently, we estimate 2010 charges totaling approximately $9.0 million related to real estate actions resulting from the closure of our Transitional School, AIU Los Angeles, CA. The AIU Los Angeles, CA campus is the one remaining Transitional School, and it is scheduled to cease operations by the end of the fourth quarter 2010. See Note 5 Discontinued Operations of the notes to our unaudited consolidated financial statements for further discussion of our accounting for discontinued operations.

Effective January 19, 2010, we entered into a real estate lease for our new campus support center and portions of our AIU Online and CTU Online campuses in Schaumburg, Illinois. Consolidating our campus support center will reduce the number of our leased buildings and related square footage and allow us to maximize efficiencies and reduce overhead expenses. The lease for the new location results in a $48.1 million real estate obligation through 2022. In addition, we intend to make capital improvements to our new campus support center totaling approximately $52.0 million over the next two years, with the majority of the investment expected in 2010.

Industry Environment

We operate in a highly regulated industry subject to changes in government regulations as well as changes in academic accreditation agencies and state education regulatory authorities. We have instituted systems, processes and programs in all of our schools to ensure substantial compliance with all regulations. Some recent changes proposed by the U.S. Department of Education (ED) may impact several key areas related to Title IV Program funding within the industry.

On June 18, 2010, the ED issued a Notice of Proposed Rulemaking (NPRM) following a year-long negotiated rulemaking process between the ED and the higher education community on 14 program integrity issues that include lender and general student loan issues, accreditation, discretionary grants, general and non-loan programmatic issues, safe harbors under incentive compensation rules for admissions recruiters, and program integrity in the Title IV Programs through the rulemaking process under HEA.

The June 18, 2010 NPRM addressed 13 of 14 program integrity issues in their entirety and partially addressed the 14th issue, which involves the definition of gainful employment; the ED issued a separate NPRM on gainful employment metrics on July 26, 2010. Public comment is due on the June 18, 2010 NPRM no later than August 2, 2010 and for the July 26, 2010 NPRM is due 45 days from the date of publication. The ED has stated that it intends to review all comments it receives with the goal of publishing a final rule by November 1, 2010 that would take effect beginning July 2011.

As proposed, these NPRMs could materially and adversely affect our business. Among the most significant of the proposed rules for our business are:

- the elimination of 12 safe harbors that had allowed, under limited circumstances, payment of incentive compensation to employees involved in student enrollment, certain recruiting, admissions or financial aid activities;
- establishing a definition of gainful employment for purposes of the foundational requirement for Title IV student financial aid that a program of study prepare students for gainful employment in a recognized occupation;
- linking the definition of gainful employment with a two-part test: measuring the relationship between the debt students incur and their incomes after program completion; and measuring the rate at which all enrollees, regardless of completion, repay their loans on time;
- defining a credit hour for purposes of determining program eligibility for Title IV student financial aid; and
- significantly broadening institutional liability for substantial misrepresentation that would, among other things, subject institutions to sanctions for statements containing inadvertent errors and for statements made to non-students, including any member of the public, impose vicarious liability on institutions for the conduct of others, and expose institutions to third-party litigation and encourage private rights of action.

We cannot predict the outcome of this rulemaking process at this time, or predict with certainty the impact of any new regulations on our operations. These rules could affect the manner in which we conduct our business and compliance with these rules, which if adopted could be effective as early as July 1, 2011, could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Table of Contents

CONSOLIDATED RESULTS

The summary of selected financial data table below should be referenced in connection with a review of the following discussion of our results of operations for the three months ended June 30, 2010 and 2009.

	For the Three Months Ended June 30,				% Change
	2010	% of Total Revenue	2009	% of Total Revenue	2010 vs. 2009
	(Dollars in thousands)				
TOTAL REVENUE	$ 527,872		$ 437,673		20.6%
OPERATING EXPENSES					
Educational services and facilities	158,018	29.9%	148,461	33.9%	6.4%
General and administrative:					
Advertising	74,563	14.1%	72,049	16.5%	3.5%
Admissions	54,874	10.4%	47,646	10.9%	15.2%
Administrative	108,280	20.5%	101,053	23.1%	7.2%
Bad debt	19,549	3.7%	14,986	3.4%	30.4%
Total general and administrative expense	257,266	48.7%	235,734	53.9%	9.1%
Depreciation and amortization	17,217	3.3%	16,390	3.7%	5.0%
OPERATING INCOME	95,371	18.1%	37,088	8.5%	157.1%
PRETAX INCOME	94,601	17.9%	36,831	8.4%	156.9%
PROVISION FOR INCOME TAXES	29,430	5.6%	13,258	3.0%	122.0%
Effective tax rate	*31.1%*		*36.0%*		
INCOME FROM CONTINUING OPERATIONS	$ 65,171	12.3%	$ 23,573	5.4%	176.5%
LOSS FROM DISCONTINUED OPERATIONS, net of tax	(853)	-0.2%	(17,083)	-3.9%	-95.0%
NET INCOME	$ 64,318	12.2%	$ 6,490	1.5%	891.0%

Educational services and facilities expense includes costs directly attributable to the educational activities of our schools, including, among other things, (1) salaries and benefits of faculty, academic administrators, and student support personnel, (2) costs of educational supplies and facilities, including rents on school leases, certain costs of establishing and maintaining computer laboratories, costs of student housing, and owned and leased facility costs, (3) royalty fees paid to Le Cordon Bleu Limited through August 2009, and (4) certain student financing costs. Also included in educational services and facilities expense are costs of other goods and services provided by our schools, including, among other things, costs of textbooks, laptop computers, dormitory services, restaurant services, contract training and cafeteria services.

General and administrative expense includes salaries and benefits of personnel in corporate and school administration, marketing, admissions, financial aid, accounting, human resources, legal and compliance. Costs of promotion and development, advertising and production of marketing materials, occupancy of the corporate offices and bad debt expense are also included in this expense category.

Three Months Ended June 30, 2010 as Compared to Three Months Ended June 30, 2009

Revenue

Total revenue increased $90.2 million, or 20.6% as compared to the prior year quarter, driven by revenue growth in all of our operating segments: University, Health Education, Culinary Arts and International. The overall increase in revenue is due to a 23% increase in student

population resulting from an 18% increase in new student starts for the second quarter 2010 as well as strong student population at the beginning of the period. The

increase in International s revenue as compared to the prior year quarter was negatively impacted by a $2.8 million unfavorable impact of foreign currency exchange rates which was partially offset with increased revenue related to IUM of approximately $1.4 million.

Educational Services and Facilities Expense

Educational services and facilities expense increased $9.6 million, or 6.4% as compared to the prior year quarter. The increase is mainly a result of an increase in academics expense, as University, Health Education and International invested in the expansion and support of academic functions in order to support the growing student population. As a percentage of revenue, educational services and facilities decreased 4.0% as compared to the prior year quarter as University, Health Education and Culinary Arts continue to closely monitor academic costs.

General and Administrative Expense

General and administrative expense increased $21.5 million, or 9.1% as compared to the prior year quarter driven by increases in our overall student population. As a percentage of revenue, expenses declined as we continue to leverage our existing infrastructure. Advertising expense decreased 2.4% as a percentage of revenue quarter over quarter, driven by continued focus on cost effectiveness in key acquisition channels. The $7.2 million increase in each of the categories of admissions expense and administrative expense was driven by the expansion of student population.

Bad debt expense incurred by each of our reportable segments during the quarters ended June 30, 2010 and 2009 was as follows (dollars in thousands):

				For th					$	(0.36)
Loss from discontinued operations				(0.02)		(0.01)		(0.19)		
Cumulative effect of change in accounting principle								(0.13)		
Net loss	$	(0.22)	$	(0.22)	$	(0.88)	$	(0.68)		

Employee stock options and restricted stock totaling 11.0 million shares, 2.4 million shares, 7.5 million shares, and 2.8 million shares for the three months ended February 27, 2004 and February 28, 2003 and the nine months ended February 27, 2004 and February 28, 2003, respectively, were not included in the diluted weighted average shares calculation as the effects of these securities were anti-dilutive.

6. Inventories

Inventories consist of (in thousands):

		February 27, 2004		May 30, 2003
Finished goods	$	20,311	$	15,891
Work-in-process		669		3,228
Raw materials		191		7,949
Total	$	21,171	$	27,068

7. Investment in Unconsolidated Joint Venture

On November 17, 2003, 3Com formed the Huawei-3Com Joint Venture (H-3C) with a subsidiary of Huawei Technologies, Ltd. (Huawei). H-3C is domiciled in Hong Kong with principal operations in Hangzhou, China. At the time of formation, 3Com contributed cash of $160.0 million, assets related to its operations in China and Japan with a carrying value of $0.1 million, and licenses related to certain intellectual property in exchange for 49 percent of the outstanding common shares of H-3C. 3Com recorded its initial investment in H-3C at $160.1 million, reflecting 3Com s carrying value for the assets contributed in exchange for the common shares received. Huawei contributed its enterprise networking business assets, including Local Area Network switches and routers, engineering and sales and marketing resources and personnel, and licenses to its related intellectual property in exchange for a 51 percent ownership interest.

Two years after formation of H-3C, 3Com has the one-time option to purchase an additional two percent ownership interest from Huawei for an amount not to exceed $28 million. Three years after formation of H-3C, 3Com and Huawei each have the right to purchase all of the other partner s ownership interest

11

through a bid process.

3Com accounts for its investment in H-3C under the equity method. Under this method, 3Com records its proportionate share of H-3C s net income or loss based on the most recently available quarterly financial statements of H-3C. Since H-3C has adopted a calendar year basis of reporting, 3Com has reported its equity in H-3C s net loss for H-3C s first fiscal period ending December 31, 2003 in 3Com s results of operations for the third quarter of fiscal 2004 under the caption Equity interest in loss of unconsolidated joint venture. The reported loss for the third quarter of fiscal 2004 was $4.2 million. Prospectively, 3Com will continue to report its equity in H-3C s net income or loss based on H-3C s most recent quarterly financial statements, two months in arrears. Also, at the time of formation of H-3C, 3Com recorded a charge of $12.6 million representing 3Com s ownership share (49 percent) of the value attributed to in-process technology contributed to H-3C by Huawei that had not yet reached technological feasibility and had no alternative future use. This charge was included in 3Com s results of operations for the second quarter of fiscal 2004 under the caption Equity interest in loss of unconsolidated joint venture. For the first nine months of fiscal 2004, 3Com s reported loss related to H-3C totaled $16.8 million.

Summarized information from the balance sheet and statement of operations for H-3C as of the end of its first fiscal period on December 31, 2003, and as of the date of its formation on November 17, 2003 were as follows (in thousands):

	December 31, 2003	November 17, 2003
Current assets	$ 208,252	$ 160,000
Non-current assets	198,502	204,088
Current liabilities	50,869	
Sales	15,478	
Gross margin	5,321	
Net loss	8,187	25,700

In determining 3Com s share of the net loss of H-3C for its first fiscal period, certain adjustments were made to H-3C s financial statements. These adjustments included the deferral of profit for products sold to 3Com that were part of 3Com s inventory as of the end of December 31, 2003, as well as the elimination of expense for the amortization of intangible assets that 3Com contributed to H-3C at the time of formation. After such adjustments, 3Com recorded a loss of $4.2 million as its share of H-3C s net loss for H-3C s first fiscal period ended December 31, 2003; this loss is included in 3Com s results of operations for the third quarter and first nine months of fiscal 2004 under the caption Equity interest in loss of unconsolidated joint venture.

3Com and H-3C are parties to agreements for the sale of certain products from 3Com to H-3C as well as from H-3C to 3Com. In addition, 3Com provides certain services to H-3C related to warranty for its products sold to H-3C, as well as information technology services. For the three months ended February 27, 2004, 3Com recorded sales to H-3C of approximately $3 million, and made purchases of approximately $4 million. As of February 27, 2004, 3Com had trade receivables and payables with H-3C of approximately $3 million and $4 million, respectively, which are included in the captions Accounts receivable and Accounts payable, respectively, in the accompanying consolidated balance sheet. Also as of February 27, 2004, 3Com had an additional receivable from H-3C of approximately $1 million related to the reimbursement of costs paid on their behalf, and is included in the caption Other current assets in the accompanying consolidated balance sheet.

8. Property and Equipment

As a result of 3Com s workforce reductions and relocation of its headquarters from Santa Clara to

Marlborough, Massachusetts during fiscal 2004, 3Com has excess office space in several buildings it owns in Santa Clara. During the first quarter of fiscal 2004, 3Com decided to consolidate its office space and relocate from its current locations into a smaller, vacant facility that was classified as held for sale as of May 30, 2003, and had a carrying value of $10.1 million. Due to this decision, 3Com reclassified this previously held-for-sale facility as held for use. No impairment charge was recorded as a result of this reclassification because the carrying value of the facility, which reflected fair value, was less than what the net book value would have been had depreciation continued on the facility during the period it was classified as held-for-sale. During the third quarter of fiscal 2004, 3Com relocated into this smaller facility and classified the previously occupied Santa Clara facility as held for sale; the previously occupied facility had a carrying value of $33.9 million as of February 27, 2004.

In connection with 3Com s outsourcing of its manufacturing operations, as discussed in Note 3, 3Com classified certain land and facilities located in Dublin as held for sale at the end of the second quarter of fiscal 2004. The carrying value of such properties was approximately $25.7 million as of February 27, 2004.

In November 2003, 3Com completed the sale of certain properties in Santa Clara that were classified as held for sale as of May 30, 2003. These properties, consisting of approximately 876,000 square feet of office and manufacturing space and related furniture and fixtures, previously had been used by 3Com in its administrative, customer service, research and development, and manufacturing activities. Net proceeds from the sale were $62.4 million, resulting in a loss on the sale of $1.4 million that was recorded in restructuring charges in the second quarter of fiscal 2004.

In July 2003, 3Com completed the sale of its 511,000 square foot office and research and development facility in Rolling Meadows. Net proceeds from the sale were $35.8 million, resulting in a loss on the sale of $1.1 million that was recorded in restructuring charges in the first quarter of fiscal 2004. As part of the terms of the transaction, 3Com entered into an agreement to lease back approximately 43,000 square feet of space at then-prevailing market rates. This property was not classified as held for sale as of May 30, 2003 due to 3Com s intention to lease back a portion of the facility.

9. Intangible Assets, Net

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

	February 27, 2004	May 30, 2003
Developed and core technology, gross	$ 37,138	$ 42,574
Accumulated amortization	(30,657)	(30,619)
Net developed and core technology	6,481	11,955
Customer relationships, gross	420	476
Accumulated amortization	(420)	(396)
Net customer relationships		80

Total intangible assets, net	$	6,481	$	12,035

In the first quarter of fiscal 2004, 3Com recorded an impairment of intangible assets, consisting mainly of developed and core technology, associated with its acquisition of the Gigabit Ethernet network interface card business of Alteon Websystems in fiscal 2001. 3Com determined the amount of the impairment by comparing the carrying value of the intangible assets against the fair value, which was estimated as the present value of expected future net cash flows discounted at a rate of ten percent per year. The impairment resulted from reduced revenue and gross margin projections as compared to the initial projections at the time of the acquisition, due to the earlier-than-expected end of life of an acquired product. As a result of the impairment analysis, 3Com recorded a write down of $1.9 million, which is included in the caption Amortization and write down of intangibles in the condensed

consolidated statements of operations for the nine months ended February 27, 2004.

Based on the carrying value of 3Com s intangible assets as of February 27, 2004, amortization expense is expected to be $1.1 million for the fourth quarter of fiscal 2004, $3.5 million for fiscal 2005, and $1.9 million for fiscal 2006.

10. Accrued Warranty and Other Guarantees

Products are sold with varying lengths of warranty ranging from 90 days to the lifetime of the products. Allowances for estimated warranty costs are recorded in the period of sale, based on historical experience related to product failure rates and actual warranty costs incurred during the applicable warranty period. Also, on an ongoing basis, 3Com assesses the adequacy of its 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 nine months ended February 27, 2004 and February 28, 2003 (in thousands):

	First nine months of fiscal 2004	First nine months of fiscal 2003
Accrued warranty, May 30, 2003 and May 31, 2002, respectively	$ 44,775	$ 53,289
Cost of warranty claims	(26,340)	(32,768)
Accruals for warranties issued during the period	25,590	22,766
Adjustments to preexisting warranties	(23)	5,551
Net change associated with discontinued operations		(2,305)
Accrued warranty, February 27, 2004 and February 28, 2003, respectively	$ 44,002	$ 46,533

In prior years, 3Com entered into several agreements whereby it had sold product to resellers who had, in turn, sold the product to others, and 3Com has guaranteed the payments of the end users. If all end users under these agreements were to default on their payments as of February 27, 2004, 3Com would be required to pay approximately $5.6 million. However, since deferred revenue and other associated accruals related to such sales approximate the guaranteed amounts, any payments resulting from end user defaults would not have a material impact on 3Com s results of operations.

In connection with the development of its facility in Rolling Meadows, 3Com guaranteed a municipal bond in the amount of $2.5 million for site improvements. 3Com s obligation pursuant to the guarantee had been accrued as of May 30, 2003. In connection with the completion of the sale of the Rolling Meadows facility in the first quarter of fiscal 2004, as discussed in Note 3, 3Com repaid the $2.5 million municipal bond. As of February 27, 2004, 3Com s liabilities included $2.8 million for similar obligations related to various facilities that 3Com has vacated.

11. Stock Plans

In September 2003, 3Com s stockholders approved 3Com s 2003 Stock Plan (the new plan), which replaced the 1983 Stock Option Plan, the 1994 Stock Option Plan, the Director Plan, and the Restricted Stock Plan (the prior plans) for all stock awards granted subsequent to the approval date. In connection with the approval of the new plan, 3Com cancelled all shares available for issuance under the prior plans (other than those shares underlying outstanding awards), which included approximately 128 million shares at the time of approval; at the same time, 20 million shares were reserved for issuance under the new plan.

In addition, stockholders approved an increase of five million shares available for issuance under

3Com s 1984 Employee Stock Purchase Plan.

12. Business Segment Information

During fiscal 2003, 3Com reported its continuing operations in three segments. Two of these segments enterprise networking and connectivity represented ongoing business lines, and the third segment related to products that were exited prior to fiscal 2003. Effective for fiscal 2004, 3Com streamlined its management and operating structure, and merged its previous multiple operating segments into a single, integrated enterprise networking business. As a result, 3Com now presents financial information related to its business on the basis of a single segment.

Presented below are 3Com s sales by geography (in thousands):

	Three Months Ended		Nine Months Ended	
	February 27, 2004	**February 28, 2003**	**February 27, 2004**	**February 28, 2003**
Americas	$ 56,889	$ 75,696	$ 186,416	$ 323,054
Europe, Middle East, & Africa	86,451	101,188	238,249	310,591
Asia Pacific Rim	28,429	39,619	90,874	124,221
	$ 171,769	$ 216,503	$ 515,539	$ 757,866

13. Litigation

3Com is a party to lawsuits in the normal course of its business. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. 3Com believes that it has meritorious defenses in each of the cases set forth below in which it is named as a defendant and is vigorously contesting each of these matters. An unfavorable resolution of one or more of these lawsuits could adversely affect its business, results of operations, or financial condition. 3Com cannot estimate the loss or range of loss that may be reasonably possible for any of the contingencies described and accordingly has not recorded any associated liabilities in its condensed consolidated balance sheets.

On March 4, 2003, 3Com filed suit against PCTEL, Inc., (PCTEL) in the United States District Court for the Northern District of Illinois, Civil Action Number 03C 1582 alleging infringement of United States Patents Numbered 5,872,836, 5,646,983, 5,724,413, 6,097,794, 6,696,660, 5,532,898 and 5,777,836. On March 5, 2003, PCTEL filed suit against 3Com in the United States District Court for the Northern District of California, Civil Action Number C 03 0982 alleging infringement of United States Patent Number 4,841,561 entitled Operating default group selectable data communication equipment seeking damages and injunctive relief, and further seeking a declaration that PCTEL does not infringe 3Com Patents Numbered 5,872,836, 5,646,983, 5,724,413, 6,097,794, 6,696,660, 5,532,898 and 5,777,836, and that such patents are void and invalid. The action which 3Com initiated in the District Court for the Northern District of Illinois was transferred to the District Court for the Northern District of California on June 11, 2003 and assigned Civil Action Number C 03 2710. On August 18, 2003, that action was consolidated for certain purposes with the action PCTEL initiated against 3Com in the Northern District of California.

On May 30, 2003, PCTEL filed suit against 3Com in the Superior Court of the State of California in and for the County of Santa Clara, CV 817522, alleging violations of California unfair competition laws seeking damages and injunctive relief. 3Com removed the action to the United States District Court for the Northern District of California on July 3, 2003 and it was assigned Civil Action Number C 03 3124. On December 12, 2003, PCTEL voluntarily dismissed this suit without prejudice.

In November 2000, a shareholder derivative and class action lawsuit, captioned *Shaev v. Claflin, et al.*,

No. CV794039, was filed in California Superior Court. The complaint alleges that 3Com s directors and officers breached their fiduciary duties to 3Com in connection with the adjustment of employee and director stock options in connection with the separation of 3Com and Palm. On May 13, 2003, the Court dismissed the Second Amended Complaint. The plaintiff has appealed the Court s decision.

On April 28, 1997, Xerox Corporation (Xerox) filed suit against U.S. Robotics Corporation and U.S. Robotics Access Corporation in the United States District Court for the Western District of New York. 3Com completed its acquisition of these companies on June 14, 1997. The case is now captioned *Xerox Corporation v. 3Com Corporation, U.S. Robotics Corporation, U.S. Robotics Access Corporation, Palm Computing, Inc., and Palm, Inc.* (Civil Action Number 97-CV-6182T). Xerox alleged willful infringement of United States Patent Number 5,596,656, entitled Unistrokes for Computerized Interpretation of Handwriting. Xerox sought to recover damages and to permanently enjoin the defendants from infringing the patent in the future. In 2000, the District Court dismissed the case, ruling that there was no infringement. On appeal, the Court of Appeals for the Federal Circuit affirmed-in-part, reversed-in-part and remanded the case to the District Court for further action. On December 20, 2001, the District Court granted Xerox s motion for summary judgment that the patent is valid, enforceable, and infringed. The defendants then filed a Notice of Appeal. On February 22, 2002, the District Court denied Xerox s motion for an injunction prohibiting further alleged infringement during the appeal and ordered the defendants to post a bond in the amount of $50 million. Xerox then appealed the denial of the injunction. On February 20, 2003, the Court of Appeals issued its decision affirming in part and reversing in part the order of the trial court. The Court of Appeals affirmed the grant of summary judgment of infringement, reversed the grant of summary judgment of validity and remanded the case to the trial court to conduct a complete validity analysis. In connection with the separation of Palm from 3Com, pursuant to the terms of the Indemnification and Insurance Matters Agreement, dated February 26, 2000, between 3Com and Palm, Palm (since renamed palmOne) agreed to indemnify and hold 3Com harmless for any damages or losses that might arise out of the Xerox litigation.

On September 25, 2000 Northrop Grumman Corporation (Northrop) filed suit in the United States District Court for the Eastern District of Texas, Civil Action No. 1:00CV-652, against Intel Corporation, 3Com Corporation, Xircom, Inc., D-Link Systems, Inc. and The Linksys Group, Inc. alleging infringement of United States Patent Number 4,453,229 which was issued in 1982. Based on the trial court s claim construction after a Markman Hearing on June 8, 2001, and after briefing by the parties, the trial court entered a judgment of noninfringement in favor of defendants 3Com and Linksys Group, Inc., from which Northrop appealed. On March 31, 2003, the United States Court of Appeals for the Federal Circuit issued its ruling reversing the order of the trial court and remanding the case back to the trial court for further proceedings. 3Com and Northrop settled this matter in the first quarter of fiscal 2004.

3Com Corporation

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

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

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

Financial position and results of operations, including restoring 3Com to profitability, income from continuing operations, general and administrative expense, amortization expense, and total operating expenses;

Expected quarterly reductions of cost of sales and operating expenses resulting from restructuring activities, including the impact on cash from operations;

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

Sales growth, enhancement of our direct sales, service and support capabilities and the development of new sales channels;

Increased revenue and the sources and concentration of revenue;

Accounting treatment of our share of the net income / loss of the Huawei-3Com joint venture;

Channel inventory levels;

Development and expansion of our products and solutions and those of the Huawei-3Com joint venture, our sourcing of products from original equipment manufacturers and the Huawei-3Com joint venture, and our product mix, including the declining sales of our connectivity products;

Relationships with suppliers and strategic partners, including increased reliance on strategic relationships;

Consolidation of operations and the disposal of excess facilities;

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

Our restructuring and cost-reduction efforts, including facilities-related charges and severance costs and the effects of our restructuring efforts;

Sources of competition;

Prospects regarding certain litigation matters;

Research and development efforts, including our investment in new technologies;

Obligations related to leases, royalty and patent licensing arrangements and other commitments and liabilities;

Outsourcing of our manufacturing operations, information technology activities and other functions and operations, such as product testing and shipping; and

Results of the relocation of corporate headquarters and certain management functions, and the relocation of other functions, including development, administrative and transaction processing functions.

You can identify these and other forward-looking statements by the use of words such as may, will, should, expects, plans, anticipates, l estimates, predicts, intends, potential,

17

continue, or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements.

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

Business Overview

3Com was incorporated on June 4, 1979. A pioneer in the computer networking industry, we provide data and voice networking products and solutions, as well as support and maintenance services, for enterprises and public sector organizations of all sizes. Building on our historical success in the networking infrastructure market, 3Com is a leader in delivering innovative networking products and solutions that are feature-rich so they can support the increasingly more complex and demanding application environments in today s businesses, while remaining easy to install, use, and operate, and yet still affordable to own. 3Com is also a leading provider of easy-to-use, reliable, high-performance connectivity solutions at the edge of the network that enable users to access information. Our competitive strengths include our strong balance sheet, intellectual property portfolio, distributor and customer relationships, and brand identity.

3Com has undergone significant changes in recent years, including:

- exiting product lines that were not expected to yield a satisfactory return on investment in the short term;
- significant headcount reductions;
- outsourcing of information technology and other functions;
- outsourcing of all manufacturing activity; and
- selling excess facilities.

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

In the fourth quarter of fiscal 2001, we undertook several broad initiatives in an attempt to return 3Com to profitability. These initiatives included exiting certain product lines that were not expected to yield a satisfactory return on investment in the near term, and resulted in restructuring charges of $154.9 million in fiscal 2001. Excluding these exited product lines and our CommWorks business unit that we sold in fiscal 2003, our continuing operations included two business units Business Connectivity Company (BCC) and Business Networks Company (BNC). These business units operated throughout all of fiscal 2002. During fiscal 2002, we continued to experience declining revenue. In response to this decline, we undertook additional measures to further reduce costs, including headcount reductions, long term asset retirements, and outsourcing manufacturing operations. These measures led to restructuring charges of $109.0 million in fiscal 2002.

Outsourcing of our manufacturing operations, information technology activities and other functions and

In the first quarter of fiscal 2003, as our revenue and overall financial performance continued to decline, we undertook several additional broad initiatives to achieve further cost savings. The first of these actions included the integration of certain central functions of BCC and BNC in order to achieve cost savings, and restructuring charges resulted from this action. This integration did not substantially change our management and operating structure, however, and we continued to operate on the basis of two separate business units (excluding exited product lines and the CommWorks business unit as discussed above). In fiscal 2003, our business units were (1) connectivity, which included the majority of products previously managed under BCC, and (2) enterprise networking, which included all of the products previously managed under BNC as well as certain wireless and security offerings that were formerly part of BCC. Other actions pursued in fiscal 2003 were headcount reductions, outsourcing of certain information technology (IT) functions, and continuing efforts to sell excess facilities. All of these actions

generated restructuring charges totaling $184.9 million in fiscal 2003, but also resulted in reductions of ongoing sales and marketing, research and development, and general and administrative expenses for fiscal 2003 as compared to fiscal 2002.

In fiscal 2004, we are taking a number of actions, affecting both revenue and expenses, with the objective of restoring 3Com to profitability. To increase revenue, we are expanding our portfolio of products to include more Layer 3-plus and higher-end products, a full line of modular switches and routers, and a higher-end Voice-over-Internet Protocol (IP) offering. As part of this strategy, and as described in more detail below, we have formed the Huawei-3Com Joint Venture (H-3C) with Huawei Technologies, Ltd., which will allow us to expand our product portfolio further to include additional router and modular switching products. We believe that this expanded product portfolio will allow us to deliver converged voice and data networking solutions not only to our traditional customers but also to larger and multi-site enterprises. Also, in order to drive sales of these higher-end products, we are enhancing our direct touch sales, service and support capabilities, as well as developing new channels, such as system integrators and service providers.

We believe that we have begun to see the impact of some of these efforts. Revenue in the first nine months of fiscal 2004 included approximately $10 million related to certain router and switch products that we sourced from Huawei prior to the launch of H-3C and that are now being sourced from H-3C. We will continue to maintain a reseller agreement with Huawei for other products not sourced from H-3C.

Other efforts are focused on reducing expenses. These efforts include creating a simplified business model. Effective for fiscal 2004, we have combined the operations of our former enterprise networking and connectivity business units, and now manage and report our operations as a single, integrated business. The connectivity products, while still part of our product portfolio, are decreasing as a percentage of total revenue. The products formerly associated with the enterprise networking segment, managed from Marlborough, Massachusetts, are therefore increasing in importance. Our decision that was announced in May 2003 to move our corporate headquarters from Santa Clara, California to Marlborough was, in part, due to this trend. We expect that the relocation of our corporate headquarters and certain management functions to Marlborough will enable us to run the business more effectively and efficiently.

In June 2003, we announced a reduction in workforce, most of which impacted general and administrative expenses. In addition, we relocated certain transaction processing functions to lower cost locations. In September 2003, we announced an additional reduction of approximately one-third of our workforce. The majority of the employees impacted by this reduction in workforce were involved in manufacturing operations in Dublin, Ireland; we discontinued our internal manufacturing operations and outsourced them to contract manufacturers during the third quarter of fiscal 2004. The remaining employees impacted by this reduction in workforce are involved in certain product development functions that will be moved to lower-cost locations by the end of fiscal 2004. In March 2004, we made selected reductions in sales and marketing personnel as part of our ongoing efforts to restructure and enhance our workforce consistent with our increased focus on enterprise networking; we expect to make additional reductions over the remainder of the fourth quarter of fiscal 2004.

As a result of our restructuring efforts described above, including primarily the actions announced in both June and September of 2003, we recorded restructuring charges of $147.1 million in the first nine months of fiscal 2004. In addition, we expect to record additional restructuring charges of approximately $5 million in the fourth quarter of fiscal 2004. These actual and expected charges include the following main components:

$47 million for facilities-related, severance and other costs related to the outsourcing of our manufacturing operations in Dublin and other reductions in the supply chain workforce;

Outsourcing of our manufacturing operations, information technology activities and other functions and

$71 million for other facilities-related costs; and

$30 million for other severance costs.

As a result of the aforementioned fiscal 2004 restructuring actions and related charges, and based on our current projections for revenues, costs and expenses, which are subject to significant uncertainty, we expect that cost of sales and operating expenses will be reduced by approximately $4 million per quarter and $16 million per quarter, respectively, from the levels reported for the fourth quarter of fiscal 2003. The expected reduction in cost of sales reflects the fact that a portion of the direct costs that we will avoid by outsourcing our manufacturing operations in Dublin will be incurred in the future as costs of products procured from contract manufacturers. The estimated reduction of $4 million per quarter is expected to be fully realized in the fourth quarter of fiscal 2004; additional reductions in cost of sales are expected in the fourth quarter of fiscal 2004 due to the absence of transition-related expenses related to the outsourcing of Dublin manufacturing operations that had been incurred in each of the first three quarters of fiscal 2004. The majority of the estimated reduction in operating expenses of $16 million is expected to be realized in the fourth quarter of fiscal 2004, and the full reduction is expected to be realized in the second quarter of fiscal 2005.

In November 2003, we formed H-3C with Huawei. At the time of formation, we contributed $160.0 million in cash, assets with a carrying value of $0.1 million related to our China and Japan operations, and licenses to certain intellectual property in exchange for a 49 percent ownership interest. Huawei contributed its enterprise networking business assets, including Local Area Network (LAN) switches and routers, engineering and sales and marketing resources and personnel, and licenses to its related intellectual property in exchange for a 51 percent ownership interest. Two years after formation of H-3C, we have the one-time option to purchase an additional two percent ownership interest from Huawei for an amount not to exceed $28 million. Three years after formation of H-3C, 3Com and Huawei each have the right to purchase all of the other partner s ownership interest through a bid process.

In China and Japan, H-3C sells its own products, as well as products it purchases directly from us and Huawei, in China and Japan. Outside of China and Japan, we resell H-3C s products under the 3Com® brand. Through this reseller agreement, we are expanding our product line to include router products and modular switching products. The addition of these products to our product portfolio increases the size of the market opportunity for which we can compete.

We account for our investment in H-3C under the equity method. At the time of formation of H-3C, we recorded a charge of $12.6 million representing our ownership share (49 percent) of the value attributed to in-process technology contributed to H-3C by Huawei that had not yet reached technological feasibility and had no alternative future use. This charge was included in our results of operations for the second quarter of fiscal 2004 under the caption Equity interest in loss of unconsolidated joint venture. Since the date of formation, we have recorded our proportionate share of H-3C s net loss based on the most recently available quarterly financial statements of H-3C. Accordingly, since H-3C reports on a calendar year basis, we have reported our equity in H-3C s net income or loss for the calendar quarter ending December 31, 2003 in our financial statements for the third quarter of fiscal 2004. For the first nine months of fiscal 2004, we have reported aggregate losses of $16.8 million related to our investment in H-3C. Prospectively, we will continue to report our equity in H-3C s net income or loss based on H-3C s most recent quarterly financial statements, two months in arrears. As H-3C is in the initial stages of its operations, we do not expect the impact of H-3C s results to significantly affect our results of operations in the near term.

We believe that the actions that we are taking in fiscal 2004 are consistent with our goals of increasing revenue and reducing expenses in order to achieve profitability over the longer term. However, we expect that some of the steps that we are taking to improve our business over the longer term will result in ongoing downward pressure on profitability in the near term. For example, we are incurring significant charges for severance costs and write downs of excess facilities. In addition, as we complete the transition of our business in China and Japan to H-3C, there could be continuing adverse impacts on volumes, as well as lower average selling prices since the pricing of products sold to H-3C under an original equipment manufacturer (OEM) agreement is lower than the pricing of products sold through the distribution channels. Over the next several quarters, we believe that we must continue to increase

both revenue and gross margin. In addition, based on our current projections for revenue and gross margin over the next several quarters, which are subject to significant uncertainty, we believe that we must reduce total operating expenses (including restructuring charges) to an amount less than $100 million per quarter, as compared to $143.8 million for the most recent quarter, in order to achieve profitability.

The assumptions underlying our planned actions in fiscal 2004 could prove to be inaccurate. If current economic conditions deteriorate, or if our actions are not successful in achieving our goals, there could be additional adverse impacts on our financial position, results of operations 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.

For information regarding our Critical Accounting Policies, we refer the reader to our annual report on Form 10-K for the year ended May 30, 2003.

Results of Operations

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

	Three months ended		**Nine months ended**	
	February 27, 2004	**February 28, 2003**	**February 27, 2004**	**February 28, 2003**
Sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	64.9	55.6	67.6	52.7
Gross margin	35.1	44.4	32.4	47.3
Operating expenses:				
Sales and marketing	36.0	28.5	36.9	23.5
Research and development	13.8	12.2	14.5	11.4
General and administrative	10.3	11.0	12.3	9.6
Amortization and write down of intangibles	0.6	0.8	1.1	1.2
Restructuring charges	23.0	24.1	28.5	17.0
Loss on land and facilities, net				0.1
Total operating expenses	83.7	76.6	93.3	62.8
Operating loss	(48.6)	(32.2)	(60.9)	(15.5)
Gain (loss) on investments, net	0.5	(6.7)	(2.2)	(4.4)
Interest and other income, net	2.1	2.3	2.2	2.5
Loss from continuing operations before income taxes, equity interest, and cumulative effect of change in accounting principle	(46.0)	(36.6)	(60.9)	(17.4)
Income tax provision (benefit)	1.0	(3.4)	(0.6)	0.0

Equity interest in loss of unconsolidated joint venture	(2.4)		(3.3)	
Loss from continuing operations before cumulative effect of change in accounting principle	(49.4)	(33.2)	(63.6)	(17.4)
Discontinued operations, net of tax	(0.4)	(3.4)	(0.5)	(9.0)
Loss before cumulative effect of change in accounting principle	(49.8)	(36.6)	(64.1)	(26.4)
Cumulative effect of change in accounting principle				(6.0)
Net loss	(49.8)%	(36.6)%	(64.1)%	(32.4)%

Sales

Sales in the third quarter of fiscal 2004 totaled $171.8 million, a decrease of $44.7 million, or 21 percent, compared to the same quarter one year ago. Sales in the first nine months of fiscal 2004 totaled $515.5 million, a decrease of $242.3 million, or 32 percent, compared to the same period one year ago.

Sales of our desktop, mobile, and server connectivity products in the third quarter and first nine months of fiscal 2004 decreased $27.5 million and $111.5 million, respectively, compared to the same periods one year ago. The decrease in sales of connectivity products was due to lower volumes and lower average selling prices. We believe the lower volumes resulted from a shift in technology towards alternative products; overall, product volumes decreased approximately 27 percent in the third quarter of fiscal 2004 as compared to the same quarter one year ago and 33 percent in the first nine months of fiscal 2004 as compared to the same nine-month period one year ago. Overall, average selling prices of connectivity products declined approximately 37 percent in the third quarter of fiscal 2004 as compared to the same quarter one year ago and 28 percent in the first nine months of fiscal 2004 as compared to the same nine-month period one year ago. Another factor contributing to the decrease in sales of

connectivity products in the first nine months of fiscal 2004 as compared to the same nine-month period one year ago was the one-time recognition of $15.0 million of royalty revenue from a paid-up license resulting from settlement of litigation with Xircom, Inc. in the second quarter of fiscal 2003. We anticipate that sales of connectivity products will decline approximately 40 percent sequentially in the fourth quarter of fiscal 2004, or approximately $9.0 million, due to both reduced demand for our product offerings and increasing pricing pressures.

Sales of our enterprise networking data and voice product lines in the third quarter and first nine months of fiscal 2004 decreased $16.2 million and $121.7 million, respectively, compared to the same periods one year ago. Although there were increases in unit volumes in enterprise networking data product lines, the overall decreases in sales were driven primarily by increased price competition across all key product lines, and secondarily to an unfavorable shift in product mix. Sales of most enterprise data products declined in both the quarterly and nine-month periods. However, sales of our Gigabit Ethernet LAN switch and Wireless offerings increased in the third quarter of fiscal 2004 as compared to the same quarter one year ago; sales of Gigabit Ethernet LAN switch products increased in the nine-month period also. Sales of modular switch and router products initially sourced from Huawei and now sourced from H-3C totaled approximately $5.0 million in the third quarter of fiscal 2004 and $10.4 million for the first nine months of fiscal 2004. The decrease in sales of our enterprise networking voice products in the third quarter and first nine months of fiscal 2004 was the result of both increased market competition as well as a slow transition to more competitive product offerings.

As compared to the third quarter and first nine months of one year ago, sales of services and exited products decreased $1.0 million and $9.1 million, respectively. While lower maintenance contract renewals contributed to declines in both periods, the decline in sales as compared to the same nine-month period one year ago was largely attributable to the recognition of revenue in the first quarter of fiscal 2003 related to exited products that was deferred as of the end of fiscal 2002.

By Geography. U.S. sales in the third quarter of fiscal 2004 represented 24 percent of total sales compared to 27 percent of total sales in the third quarter of fiscal 2003, and U.S. sales in the first nine months of fiscal 2004 represented 28 percent of total sales compared to 35 percent of total sales in the first nine months of fiscal 2003.In the third quarter of fiscal 2004, U.S. sales decreased 31 percent and international sales decreased 17 percent compared to the same period one year ago. In the first nine months of fiscal 2004, U.S. sales decreased 46 percent and international sales decreased 24 percent compared to the same period one year ago.

The declines in sales of connectivity products discussed above occurred in all geographic regions, but the declines were most pronounced in the U.S. market, where sales in the third quarter and first nine months of fiscal 2004 decreased by 62 percent and 66 percent, respectively, as compared to the same three and nine-month periods one year ago. This decline in sales of connectivity products in the U.S. market in the first nine months of fiscal 2004 includes the entirety of the $15 million of royalty revenue that resulted from settlement of litigation with Xircom, Inc. as discussed above. The decline in sales of enterprise networking data products in the third quarter of fiscal 2004 as compared to the same quarter one year ago occurred mainly in the Europe, Middle East, and Africa (EMEA) and Asia Pacific Rim regions, whereas the decline in the first nine months of fiscal 2004 as compared to the same nine-month period one year ago occurred across all regions. Declines in sales of enterprise networking voice products as compared to the same periods one year ago were largely confined to the U.S. market. The decline in sales of services and exited products in the third quarter of fiscal 2004 as compared to the same quarter one year ago occurred across all regions, whereas the decline in the first nine months of fiscal 2004 as compared to the same nine-month period one year ago occurred primarily in the U.S. market and, to a lesser extent, in the EMEA region.

Gross Margin

Gross margin as a percentage of sales declined 9.3 percentage points from 44.4 percent in the third quarter of fiscal 2003 to 35.1 percent in the third quarter of fiscal 2004. Gross margin as a percentage of

sales declined 14.9 percentage points from 47.3 percent in the first nine months of fiscal 2003 to 32.4 percent of sales in the first nine months of fiscal 2004. Significant components of the decrease in gross margins were as follows:

	Current quarter	Year to Date
Declines in standard-related margin	(3.5)%	(5.8)%
Dublin manufacturing facility closure	(2.6)	(1.7)
Duty refunds and proceeds from inventory previously written off	(1.2)	(1.8)
Volume-related impacts	(0.4)	(2.5)
Impact of royalty revenue		(1.1)
Other	(1.6)	(2.0)
Total	(9.3)%	(14.9)%

The decline in standard-related margin as compared to the same quarter and nine-month period one year ago was primarily the result of lower average selling prices (ASPs), and was secondarily due to an unfavorable shift in product mix. These unfavorable factors were partially offset by product cost reductions.

As a result of our decision to outsource our remaining manufacturing operations in Dublin, we recorded charges related to manufacturing assets and other transition-related costs of $4.5 million and $9.2 million in the third quarter and first nine months of fiscal 2004, respectively.

Gross margin in the third quarter and first nine months of fiscal 2004 did not benefit to any significant degree from duty refunds or proceeds from the sale of inventory that was previously written off. However, gross margin in the third quarter and first nine months of fiscal 2003 included benefits for duty refunds of $2.5 million and $13.9 million, respectively, related to such items.

Volume-related impacts include higher post-sale technical support costs, manufacturing overhead costs, and warranty costs as a percentage of sales. Since a portion of these costs is not directly variable with sales, these costs did not decline at the same rate as sales.

Revenue in the first nine months of fiscal 2003 included royalty revenue of $15.0 million related to the settlement of litigation with Xircom. This revenue did not have any associated costs of goods.

Operating Expenses

Total operating expenses in the third quarter of fiscal 2004 were $143.8 million compared to $165.8 million in the third quarter of fiscal 2003, or a net decrease of $22.0 million. Research and development and general and administrative expenses decreased by $2.6 million and $6.4 million, respectively. In addition, amortization and write down of intangibles and restructuring charges decreased by $0.6 million and $12.6 million,

respectively. Sales and marketing expenses overall were relatively flat, increasing $0.2 million.

Total operating expenses in the first nine months of fiscal 2004 were $481.3 million compared to $475.6 million in the first nine months of fiscal 2003, or a net increase of $5.7 million. Sales and marketing expenses increased by $11.6 million. In addition, restructuring charges increased by $18.1 million. Offsetting these increases were lower research and development expenses ($11.0 million), general and administrative expenses ($8.8 million), amortization and write down of intangibles ($3.3 million) and reduced losses from asset disposals ($0.9 million).

As a percent of sales, total operating expenses in the third quarter of fiscal 2004 were 83.7 percent, compared to 76.6 percent in the third quarter of fiscal 2003. In aggregate, sales and marketing, research and development, and general and administrative expenses were 60.1 percent of sales in the third quarter

of fiscal 2004, compared to 51.7 percent in the third quarter of fiscal 2003. As a percent of sales, total operating expenses in the first nine months of fiscal 2004 were 93.3 percent, compared to 62.8 percent in the first nine months of fiscal 2003. In aggregate, sales and marketing, research and development, and general and administrative expenses were 63.7 percent of sales in the first nine months of fiscal 2004, compared to 44.5 percent in the first nine months of fiscal 2003. To a significant degree, these expenses are controllable and discretionary over time, but they are not directly variable with sales levels within a particular period.

We allocate and report IT and facilities-related expenses as a component of cost of sales and operating expenses. On an overall basis, total operating expenses for the third quarter and first nine months of 2004 reflected a decrease in IT-related expenses, as compared to the same three and nine month periods one year ago, largely as a result of employee reductions and asset write offs associated with our IT outsourcing initiatives during fiscal 2003. Partially offsetting the decrease in IT-related expenses was a net increase in facilities-related expenses due to a reduction in rental and sublease income received. Such rental and sublease income is recorded as an offset to the associated facilities-related expenses.

Following is a more detailed discussion of the factors affecting each major component of total operating expenses.

Sales and Marketing. Sales and marketing expenses in the third quarter of fiscal 2004 increased $0.2 million as compared to the third quarter of fiscal 2003, primarily due to increased workforce-related and travel and entertainment expenses, reflecting the addition of direct-touch sales representatives in connection with our increased focus on the enterprise market, and an increase in facilities-related expenses. Largely offsetting these increases were reduced IT expenses, as well as reduced marketing expenses as a result of a shift in spending towards more focused, product and channel specific programs. Sales and marketing expenses in the first nine months of fiscal 2004 increased $11.6 million as compared to the comparable period of fiscal 2003, primarily due to increased workforce-related, travel and entertainment and facilities-related expenses as discussed above. Partly offsetting these increases were reduced IT expenses and reduced marketing spending as discussed above.

Research and Development. Research and development expenses in the third quarter of fiscal 2004 decreased $2.6 million as compared to the third quarter of fiscal 2003 due to reduced IT expenses and reduced workforce expenses as a result of restructuring activities. Partly offsetting these reductions were increased use of third parties for development work, as well as an increase in facilities-related expenses. Research and development expenses in the first nine months of fiscal 2004 decreased $11.0 million as compared to the first nine months of fiscal 2003, due to reduced IT expenses, depreciation expense related to engineering assets reflecting write-downs and disposals associated with our restructuring initiatives, and spending for project tools and materials. Partly offsetting these reductions were increased third-party development work and facilities-related expenses.

General and Administrative. General and administrative (G&A) expenses in the third quarter of fiscal 2004 decreased $6.4 million as compared to the third quarter of fiscal 2003, due to several factors. Factors that had the effect of decreasing G&A expenses as compared to the same quarter one year ago included reduced legal and professional services costs related to the formation of H-3C; reduced workforce-related expenses due to our restructuring initiatives, and reduced IT expenses. Partially offsetting these reductions were increased bad debt expenses. G&A expenses in the first nine months of fiscal 2004 decreased $8.8 million as compared to the first nine months of fiscal 2003, due to several factors. Factors that had the effect of decreasing G&A expenses as compared to the same quarter one year ago included reduced workforce-related, IT and bad debt expenses. Partially offsetting these reductions was the impact of sales tax refunds in the prior year period that did not recur in the current year.

Amortization and Write Down of Intangibles. Amortization and write down of intangibles decreased $0.6 million in the third quarter of fiscal 2004 as compared to the third quarter of fiscal 2003. This decrease was due to reduced amortization expenses reflecting a lower base of

intangible assets as a result of an impairment charge during the first quarter of fiscal 2004. Amortization and write down of

intangibles decreased $3.3 million in the first nine months of fiscal 2004 as compared to the first nine months of fiscal 2003 due to reduced impairment charges, as well as reduced amortization expenses as discussed above. In the first nine months of fiscal 2004, there was an impairment charge of $1.9 million related to developed and core technology associated with the acquisition of assets from Alteon Websystems in fiscal 2001; in the prior year period, there was an impairment charge of $3.2 million related to developed and core technology associated with the acquisition of NBX Corporation in fiscal 1999.

Restructuring Charges. Restructuring charges in the third quarter and first nine months of fiscal 2004 were $39.5 million and $147.1 million, respectively. Restructuring charges in the third quarter of fiscal 2004 included $25.9 million in facilities-related charges, including $26.0 million of accelerated depreciation and impairments related to the Dublin and Santa Clara facilities. These restructuring charges were offset by a credit of $0.1 million for revised estimates related to lease terminations. Restructuring charges in the third quarter of fiscal 2004 also included $17.2 million for severance-related costs and $1.1 million for other restructuring costs, primarily relating to long-term asset write downs. These restructuring charges were offset by a net credit of $4.7 million, which was mainly the result from a settlement of the outsourcing-related obligations in Dublin at amounts less than originally estimated. Restructuring charges in the first nine months of fiscal 2004 included $94.8 million in facilities-related charges, including $75.6 million of accelerated depreciation and impairments related to the Hemel Hempstead, Dublin and Santa Clara facilities, $13.7 million in charges for the write down and sale of certain properties in Santa Clara and Rolling Meadows, Illinois, and $5.5 million of other facilities-related charges. Restructuring charges in the first nine months of fiscal 2004 also included $48.2 million in severance-related charges and $4.1 million related to other restructuring costs. These charges were primarily the result of cost reduction efforts initiated in fiscal 2004. Additional charges of approximately $5 million, primarily for severance costs, are expected in the fourth quarter of fiscal 2004.

Restructuring charges in the third quarter and first nine months of fiscal 2003 were $52.1 million and $128.9 million, respectively. Restructuring charges in the third quarter of fiscal 2003 primarily consisted of facilities-related charges, including a $41.4 million of accelerated depreciation and impairments of facilities in Santa Clara (which were later sold in the second quarter of fiscal 2004) and $5.2 million of lease termination costs. Other restructuring charges in the third quarter of fiscal 2003 included $5.5 million related to long-term asset write downs, severance costs, and other facilities-related charges. Restructuring chargers in the first nine months of fiscal 2003 primarily consisted of facilities-related charges, including $99.1 million of accelerated depreciation and impairments of facilities in Santa Clara, Marlborough, Hemel Hempstead and Dublin and $6.8 million of lease termination costs. In addition to these charges, restructuring charges in the first nine months of fiscal 2003 included $16.3 million related to additional severance costs and $6.7 million related to long-term asset write downs and other restructuring charges. Restructuring charges in the first nine months of fiscal 2003 were primarily the result of cost reduction efforts initiated in fiscal 2003.

Loss on Land and Facilities, Net. The net loss on land and facilities was $0.9 million for the first nine months of fiscal 2003, primarily related to our Salt Lake City facility that was sold in the second quarter of fiscal 2003. This property was classified as held for sale prior to the inception of our restructuring initiatives and, therefore, the net losses associated with it were not the result of restructuring actions and were not recorded as part of restructuring charges.

Gain (Loss) on Investments, Net

Net gain on investments of $0.9 million in the third quarter of fiscal 2004 was mainly the result of a gain recognized upon the sale of an investment in a privately-held company ($4.3 million), partially offset by write downs of long term equity investments ($3.8 million). Net loss on investments of $14.6 million in the first nine months of fiscal 2004 was mainly the result of the gain recognized upon the sale of an investment in a privately-held company mentioned above ($4.3 million), offset by write downs of long term equity investments ($16.0 million). Net loss on investments in the third quarter and first nine months of fiscal 2003 was due primarily to market value adjustments of limited partner venture funds

26

and write downs of long term equity investments. Also included in the first nine months of fiscal 2003 were losses on the sale of investments in limited partner venture funds.

Interest and Other Income, Net

Interest and other income, net of $3.6 million in the third quarter of fiscal 2004 decreased $1.6 million compared to the third quarter of fiscal 2003. The decrease reflected a reduction in interest income of $2.9 million that resulted from lower interest rates, partially offset by reductions of $1.3 million in other expenses, mainly lower interest expense resulting from the repayment of all outstanding borrowings.

Interest and other income, net, in the first nine months of fiscal 2004 decreased $7.3 million as compared to the first nine months of fiscal 2003, with reduced interest income ($12.6 million) being partially offset by decreases in other expenses ($5.3 million). Interest income decreased due to lower interest rates overall as well as lower interest income relating to income tax refunds, which generated $1.4 million and $5.1 million of interest income in the first nine months of fiscal 2004 and 2003, respectively. Partially offsetting the decrease in interest income were lower interest expense that resulted from the repayment of borrowings, as well as reduced costs associated with warrants issued to Broadcom Corporation that expired in December 2003.

Equity Interest in Loss of Unconsolidated Joint Venture

As described more fully above, we account for our investment in H-3C under the equity method. In the third quarter of fiscal 2004, we recorded a charge of $4.2 million representing our share of the net loss incurred by H-3C during the quarter ended December 31, 2003. At the time of formation of H-3C, we recorded a charge of $12.6 million representing our ownership share (49 percent) of the value attributed to in-process technology contributed to H-3C by Huawei that had not yet reached technological feasibility and had no alternative future use; this charge is reflected in our results for the first nine months of fiscal 2004.

Income Tax Provision (Benefit)

Our tax provision in the third quarter of fiscal 2004 was the result of providing for taxes in certain state and foreign jurisdictions. Our income tax benefit for the first nine months of fiscal 2004 included the benefit of a foreign net operating loss carryback of $8.5 million, partially offset by a provision of $5.6 million for taxes in certain state and foreign jurisdictions. The tax provision in the third quarter and first nine months of fiscal 2003 was the result of providing for taxes in certain state and foreign jurisdictions.

Discontinued Operations

Discontinued operations relate to our CommWorks business unit that was sold in the fourth quarter of fiscal 2003. We recorded losses of $0.7 million and $2.5 million in the third quarter and first nine months of fiscal 2004, respectively, due to adjustments to previous estimates of

liabilities related to the sale of CommWorks. In the third quarter and first nine months of fiscal 2003, the loss relating to the operations of CommWorks was $7.3 million and $68.0 million, respectively, and included $0.3 million and $0.9 million of tax expense, respectively.

Cumulative Effect of Change in Accounting Principle

As a result of our adoption of SFAS 142, we conducted a transitional goodwill impairment evaluation of the $66.5 million of goodwill recorded as of May 31, 2002 and wrote off goodwill totaling $45.4 million relating to continuing operations as a change in accounting principle effective June 1, 2002. We also wrote off $20.2 million of goodwill relating to the CommWorks business unit, which is included in

discontinued operations.

Liquidity and Capital Resources

Cash and equivalents and short-term investments were $1,366.0 million at February 27, 2004, a decrease of approximately $118.6 million compared to the balance of $1,484.6 million as of May 30, 2003.

Net cash used in operating activities was $148.9 million in the first nine months of fiscal 2004, primarily reflecting our loss from continuing operations of $328.0 million. Also included in net cash used in operating activities for the first nine months of fiscal 2004 was the impact of a favorable settlement of an intellectual property dispute. Under this settlement, we collected $8.0 million in the third quarter of fiscal 2004, and recorded a receivable for the remaining $8.0 million, which will be collected in four equal installments of $2.0 million each on the settlement anniversary date. The total settlement of $16.0 million was deferred as of the settlement date and is being amortized to licensing revenue through fiscal 2009. Significant commitments that will require the use of cash in future periods include obligations under lease, royalty, patent licensing and IT outsourcing agreements. Total future lease obligations as of February 27, 2004 were $56.7 million, of which $19.7 million will be paid over the next twelve months. Obligations under royalty and patent licensing arrangements as of February 27, 2004 were approximately $22.2 million, of which $10.2 million is expected to be paid over the next twelve months. Under our IT outsourcing agreements, we are subject to service level commitments providing for minimum payments of $5.1 million annually through December 2013. Termination of such agreements prior to this date would result in early termination penalties that decline over time. If we were to terminate the agreements at the beginning of the fourth quarter of fiscal 2004, such penalties would be approximately $4.3 million.

We expect that cash flows from operating activities will be negative over the next several quarters, and possibly longer, due to continuing net losses. There are no assurances that we can reduce our net losses and negative cash flow in the foreseeable future, or that we can raise capital as needed to fund our operations on an ongoing basis. However, based on current business conditions and our current operating and financial plans, but subject to the discussion in Business Environment and Industry Trends below, we believe that our existing cash and equivalents and short-term investments will be sufficient to satisfy our anticipated cash requirements for at least the next twelve months. As a result of the aforementioned fiscal 2004 restructuring actions and related charges, and based on our current projections for revenues, costs and expenses, which are subject to significant uncertainty, we expect net cash flow from operations to be improved by approximately $18 million per quarter from the levels reported for the fourth quarter of fiscal 2003. This improvement excludes the impact of cash disbursements to be made in settlement of liabilities accrued as of February 27, 2004, the majority of which liabilities are expected to be fully settled during the first quarter of fiscal 2005.

Net cash provided by investing activities was $41.8 million for the first nine months of fiscal 2004, primarily resulting from approximately $114.1 million of net proceeds related to sales, maturities and purchases of debt and equity securities and $87.7 million of net proceeds related to sales and purchases of fixed assets, partially offset by our $160.0 million investment in H-3C.

For the first nine months of fiscal 2004, we received proceeds of approximately $776.8 million from maturities and sales of investments, almost all of which related to municipal and corporate bonds and government agency instruments. Offsetting these proceeds were investments totaling $660.3 million in municipal and corporate bonds and government agency instruments, as well as investments totaling $2.4 million in equity securities.

Our investments in equity securities include investments made by 3Com Ventures. Through 3Com Ventures, we selectively make strategic investments in privately held companies and in limited partnership venture capital funds, which in turn invest in privately held companies. These investment activities are entered into with the intention of complementing our business strategies and research and development efforts, and may include a strategic commercial or technology relationship, such as a component supply agreement or technology license arrangement, with these privately held companies.

3Com Ventures has made strategic investments of $2.4 million in the first nine months of fiscal 2004 and has committed to make additional capital contributions to venture capital funds totaling $10.6 million. We are contractually obligated to provide funding upon calls for capital. The expiration dates for such capital calls are generally five to eight years from the inception of the fund, and the amounts and timing of such calls during that period are entirely at the discretion of the funds general partners. We estimate that we will pay approximately $4.4 million over the next twelve months as capital calls are made.

During the first nine months of fiscal 2004, we made capital expenditures of $12.6 million for new property and equipment. Also, during this same period, we collected $100.2 million from sales of property and equipment, primarily relating to the sale of our Rolling Meadows facility in July 2003 and certain properties in Santa Clara in November 2003. As of February 27, 2004, capital expenditure commitments outstanding were not material.

Net cash provided by financing activities was $114.6 million in the first nine months of fiscal 2004, including the collection of the final installments totaling $8.4 million due under a note receivable related to the sale of warrants to Broadcom during fiscal 2002 and $106.5 million of proceeds from the issuance of common stock, offset by $0.3 million for payments due under capital leases. There were no borrowings or repayments under our revolving line of credit during the first nine months of fiscal 2004. As of February 27, 2004, we were eligible for borrowing under the revolving line of credit of up to $32 million, had no amounts outstanding, and had $9.4 million of bank-issued standby letters of credit and bank guarantees.

We did not repurchase any shares of common stock in the first nine months of fiscal 2004. Our current stock repurchase program permits expenditures of up to $100.0 million through March 2005. We may use cash in future periods to repurchase shares of our common stock pursuant to this authorization.

In the first nine months of fiscal 2004, we issued 22.3 million shares of stock under our employee stock option and stock purchase plans and collected $106.5 million related to such issuances. As of February 27, 2004, our outstanding stock options as a percentage of outstanding shares were 16 percent. This potential dilution to existing stockholders is mainly the result of the effect of our distribution of Palm, Inc. common stock in the first quarter of fiscal 2001. As a result of the Palm distribution, the number of shares subject to option grants was adjusted to preserve the intrinsic value of the stock options, resulting in an increase of 134 million options, and bringing the total option shares outstanding to 169 million at the time of the distribution. The potential dilution has been an area of focus for senior management. As a result of reductions in the number of employees, stock option exercises, and management of new grants, the number of outstanding options has been reduced approximately 64 percent since the Palm distribution. In addition, the number of options available for future grant was reduced by a net 108 million shares due to approvals of proposals submitted to our stockholders at our annual stockholder meeting in September 2003.

Stock option activity during the first nine months of fiscal 2004 and stock option detail as of February 27, 2004, were as follows:

	Number of shares (in thousands)	Weighted average exercise price
Outstanding, May 30, 2003	85,502	$ 7.03
Granted	9,704	5.54
Exercised	(20,505)	4.99
Canceled	(13,360)	8.35
Outstanding, February 27, 2004	61,341	$ 7.18

Range of exercise prices	Outstanding options as of February 27, 2004		Exercisable at February 27, 2004	
	Number of shares (in thousands)	Weighted average exercise price	Number of shares (in thousands)	Weighted average exercise price
$ 0.13 - $ 4.29	5,840	$ 4.21	1,779	$ 4.09
4.30 - 5.10	8,394	4.83	5,142	4.82
5.12 - 5.54	13,380	5.38	7,486	5.49
5.55 - 6.09	10,345	5.92	9,604	5.94
6.10 - 10.09	13,721	8.20	10,656	8.30
10.11 - 21.57	9,661	13.44	7,931	13.40
Total	61,341	$ 7.18	42,598	$ 7.63

The following table summarizes our equity compensation plans as of February 27, 2004:

	Number of securities to be issued upon exercise of options (in thousands)	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in 1st column) (in thousands)
Equity compensation plans approved by stockholders	22,018	$ 7.75	27,912
Equity compensation plans not approved by stockholders*	39,012	6.88	
Total	61,030	$ 7.19	27,912

* Excludes 0.3 million outstanding options with an average exercise price of $5.67. These options were assumed in connection with acquisitions and no additional options are available for future issuance under such plans.

Options issued outside of the stockholder-approved plans were issued under our broad-based 1994 Stock Option Plan, as amended. Options granted from this plan were granted at fair value, vest over two to four years, and expire ten years after the date of grant. Effective September 2003, the 2003 Stock Plan was approved by stockholders and replaced the 1994 Stock Option Plan for all grants subsequent to the approval date. Also in September 2003, stockholders approved a five million share increase in the number shares available for issuance under the Employee Stock Purchase Plan.

Effects of Recent Accounting Pronouncements

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF 00-21 addresses certain aspects of the accounting by a vendor for arrangements under which the vendor will perform multiple revenue generating activities. EITF 00-21 is effective for fiscal periods beginning after June 15, 2003; for 3Com, EITF 00-21 became effective for the second quarter of fiscal 2004. 3Com s historical revenue recognition policies and practices conform to the requirements of EITF 00-21 and, thus, the adoption of EITF 00-21 did not have a material impact on our financial position or results of operations.

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

Business Environment and Industry Trends

Industry trends and specific risks may affect our future business and results. The matters discussed below could cause our future results to differ from past results or those described in forward-looking statements.

We have incurred significant net losses in recent fiscal periods, including $331 million for the first three quarters of fiscal 2004 and $284 million, $596 million and $965 million in fiscal years 2003, 2002 and 2001, respectively, and we may not be able to return to profitability.

We incurred a net loss of $331 million for the first three quarters of fiscal 2004, and net losses of $284 million, $596 million and $965 million in fiscal 2003, 2002 and 2001, respectively. Although we are taking steps designed to improve our results of operations, we cannot assure you that we will return to profitability. Further, if we do return to profitability, we cannot assure you that we will be able to sustain or increase such profitability in the future.

We have faced a number of challenges that have affected our operating results over the last several fiscal years. Specifically, we have experienced, and may continue to experience, the following:

declining revenue due to: (a) price competition and (b) reduced incoming order rate and customer backlog which we believe reflects decreased demand for our products resulting from the overall slowdown in the networking industry as well as technological changes and trends in the industry, such as the integration of networking, communications and computer processing functions on computer chips that can perform the same functions as some of our products;

increased risk of excess and obsolete inventories;

excess facilities;

Outsourcing of our manufacturing operations, information technology activities and other functions and

operating expenses (particularly general and administrative expenses) that, as a percentage of revenue, have exceeded our desired financial model; and

disruptions resulting from our workforce reductions and employee attrition.

We entered into a joint venture in China with Huawei that, if not successful, could materially and adversely impact our business, business prospects and operating results.

In November 2003, we announced the formation of a joint venture for enterprise networking products with Huawei, a leading Chinese company. 3Com currently has a 49 percent minority interest in the Huawei-3Com joint venture, which has Hangzhou, China as its primary base of operations. Pursuant to the joint venture agreements, 3Com has the right to market and support the Huawei-3Com products under the 3Com brand in all countries except China and Japan. In China and Japan, the joint venture will sell products sourced internally as well as from 3Com and Huawei under the joint venture s brand. The joint venture commenced operations in November 2003. In the third quarter of fiscal 2004, we began reflecting the operating results of the joint venture in our operating results to the extent of our ownership interest; the reported loss for the third quarter of fiscal 2004 was $4.2 million. Also, at the time of formation of the joint venture, 3Com recorded a charge of $12.6

million representing 3Com s ownership share (49 percent) of the value attributed to in-process technology contributed to the joint venture by Huawei that had not yet reached technological feasibility and had no alternative future use; this charge was included in 3Com s results of operations for the second quarter of fiscal 2004. 3Com s reported loss related to the joint venture for the first nine months of fiscal 2004 totaled $16.8 million.

The new joint venture is likely to confront numerous challenges in the future. For example, at the outset, integration of the business assets and operations being contributed by each partner will involve complex activities that must be completed in a short period of time. Going forward, there could be disagreements between 3Com and Huawei with respect to important strategic and operational decisions. The business of the joint venture will also be subject to all of the operational risks that would normally arise for a technology company with global operations pertaining to research and development, manufacturing, sales, service, marketing, and corporate functions. In addition, competition in the enterprise networking market will involve challenges from numerous, well-established companies with substantial resources and significant market share.

Our business, business prospects and operating results are heavily dependent upon the success of the Huawei-3Com joint venture. In particular, our product development activities will become increasingly interdependent with those of the joint venture. If the joint venture and our transactions with it are not successful or less successful than we anticipate, we may not introduce new products needed to broaden our high-end enterprise networks product line, which may adversely affect our revenues, business and business prospects. Even if the joint venture is successful, there may be disruption to our existing distribution channels and conflicts with our current channel partners resulting from the establishment of the joint venture s operations and distribution arrangements.

Our strategy of outsourcing functions and operations not central to our business may fail to reduce cost and may disrupt our operations.

We continue to look for ways to decrease cost and improve efficiency by contracting other companies to perform functions or operations that do not contribute to our core technology business. Up until recently, our efforts have focused on using outside vendors to meet some of our IT and manufacturing needs. In the third quarter of fiscal 2004, we completed the outsourcing of all manufacturing of our products. To achieve more cost savings or operational benefits, we may expand our outsourcing of IT activities, as well as aspects of the following operations: human resources, accounting, internal audit, security and engineering. Although we believe that outsourcing these functions will result in lower costs and increased efficiencies, this may not be the case. For example, outsourcing means that we will be relying upon third parties to meet our needs. Because these third parties may not be as responsive to our needs as we would be ourselves, outsourcing the services 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.

Our revenues may decrease, and we may not be able to compensate for such lower revenues with cost reductions sufficient to generate positive net income or cash flow.

We believe that we must implement strict cost and expense reductions if we are to generate positive net income and cash flow from operations in future quarters. If we are not able to effectively reduce our costs and expenses commensurate with, and at the same pace as, any further deterioration in our revenues, 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, our ability and efforts 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 we cannot accurately predict the amount of our future revenue. Our future revenue depends, in part, on future economic and market conditions, which we are unable to forecast accurately. We also cannot forecast the impact of new products. Although we cannot accurately predict the amount of our future revenue overall, we expect that revenue from sales of desktop, mobile and server connectivity

products, which represented approximately 14 percent of total revenue for the third quarter of fiscal

2004, will decline further due to pricing pressures and technological changes and trends in the networking industry.

Our efforts to consolidate our real estate portfolio and sell certain real estate holdings may not generate the expected level of cash proceeds or result in reductions of operating costs.

In connection with our ongoing restructuring and cost reduction activities, we are making efforts to consolidate our operations into fewer facilities and to dispose of excess facilities. We currently have excess facilities held for sale in Santa Clara, Dublin, and Hemel Hempstead. Despite our best efforts, our ability to dispose of our excess real estate holdings may be impaired by adverse conditions in the commercial real estate market. Additionally, if we continue to own excess facilities and are unable to lease the facilities to third parties, our operating results will be adversely affected by the continuing operating costs associated with the excess facilities.

Our workforce reductions, and the high cost of living in certain locations, may make it more difficult for us to retain and recruit the qualified employees and management personnel that are critical to our success.

Our success depends upon retaining and recruiting highly qualified employees and management personnel. However, the significant downturn in our business environment has had a negative impact on our operations. As a result, we have restructured our operations to reduce our workforce and implement other cost reduction activities. Although we believe these various changes and actions will improve our organizational effectiveness and competitiveness, they could lead, in the short term, to disruptions in our business, reduced employee morale and productivity, problems with retaining existing employees and recruiting future employees, and increased financial costs. Recruiting and retaining skilled personnel, including engineers, sales representatives and product marketing managers, continues to be difficult. In addition, at certain locations where we operate, the cost of living is extremely high and it may be difficult to attract and retain key employees and management personnel at a reasonable cost. If we cannot successfully recruit and retain qualified employees and management personnel, our product introduction schedules, customer relationships, results of operations and financial position may be impaired and our overall ability to compete may be adversely affected.

Efforts to reduce operating expenses could involve further workforce reductions and lead to reduced revenues and other disruptions in our business.

Our operating expenses, particularly general and administrative expenses, as a percent of revenue have been higher than our desired long-term financial model. We have taken, and will continue to take, actions to reduce these expenses. Future actions could include further reductions in our workforce, relocation of functions and activities to lower cost locations, changes or modifications in IT systems or applications and process reengineering. As a result of these actions, the employment of some employees with critical skills will be terminated, and other employees will leave our company voluntarily due to the uncertainties associated with our business environment and their job security. In addition, reductions in overall staffing levels might make it more difficult for us to achieve our revenue 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.

If future business conditions present unanticipated challenges, we may need to make further changes to our business structure or reductions to our workforce.

Outsourcing of our manufacturing operations, information technology activities and other functions and

In response to industry and market conditions, we have restructured our business and reduced our workforce. The assumptions underlying our restructuring efforts will be assessed on an ongoing basis and may prove to be inaccurate. We may have to restructure our business again to achieve additional cost savings and to strategically realign our resources. Our restructuring plan is based on certain assumptions regarding the outlook for the networking industry, our future revenue and the cost structure of our business, which may prove to be inaccurate. While restructuring, we have assessed, and will continue to assess, whether we should further reduce our workforce or further expand our outsourcing activities. We may not be able to successfully implement the initiatives we have undertaken in restructuring our business; even if successfully implemented, these initiatives may not be sufficient to meet and keep pace with changing industry and market conditions and to achieve positive net income and cash flow from operations.

Outsourcing of our manufacturing operations, information technology activities and other functions and

If our cash flow significantly deteriorates in the future, our liquidity and ability to operate our business could be adversely affected.

We incurred a significant net loss and negative cash flow from operations for the first three quarters of fiscal 2004. If we continue to incur significant net losses and negative cash flow from operations over a prolonged period, our liquidity and ability to operate our business could be adversely affected. For example, our ability to raise financial capital may be hindered due to the possibility of continuing net losses and negative cash flow in the future. An inability to raise financial capital would limit our operating flexibility.

The following items could require unexpected future cash payments or limit our ability to generate cash:

- inability to dispose of real estate holdings;
- taxes due upon the transfer of cash held in foreign locations; and
- taxes assessed by local authorities where we conduct business.

Our decision to move our corporate headquarters will result in costs for relocation, executive severance, and recruitment costs, and could result in disruptions to our business.

In fiscal 2004, we moved our corporate headquarters to our Marlborough facility, which is the primary location and base of operations for our ongoing enterprise networking business. Although only a relatively small percentage of our total workforce has been or will be affected by this move, ongoing efforts and expenses will be required to effect the relocation. For example, we have incurred and expect to continue to incur relocation costs, severance costs (for those employees not moving to Marlborough), and recruitment costs (for replacing the employees not moving to Marlborough). Also, although we believe the relocation will improve our organizational effectiveness, it could lead, in the short term, to disruptions in our business. The relocation process will be substantially completed during the fourth quarter of fiscal 2004.

We may not respond effectively to increased competition caused by industry volatility and consolidation.

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:

- 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;

Outsourcing of our manufacturing operations, information technology activities and other functions 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; and

greater competition for fewer customers as a result of consolidation in the reseller and distribution channels.

Our investment in technologies which are unproven or for which we have not yet demonstrated success in the marketplace may not produce the benefits we expect.

We are making significant investments in various technologies for emerging product lines. These investments have included XRN (eXpandable Resilient Networking) technology, Gigabit Ethernet technology, Internet Protocol (IP) telephony, wireless LANs, Layer 3+ switching, network security technology (such as our embedded firewall products), and Network Jack switches. We expect new products and solutions based on these technologies to contribute to future sales growth. However, the markets for some of these products and solutions are still emerging and the market potential for our products and solutions based on these technologies remains unproven. If customer demand for our products and solutions based on these technologies does not develop as we expect, or if our sales and marketing strategies for these technologies are not effective, our financial results could be adversely affected and we might need to change our business strategy.

We may not be successful at identifying and responding to new and emerging market and product opportunities.

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:

identify new market and product opportunities;

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

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

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

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

there is a delay in introducing new products;

there are fewer customers interested in our products than we expected;

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

our products cost more to produce than we expect.

Our business would suffer in particular if negative effects such as these were to occur in those product markets that we have identified as emerging high-growth opportunities. One factor that may cause greater difficulty for us in quickly and effectively introducing new products with the features, functionality, quality, and costs that are optimal for the market is our increased reliance on relationships with strategic partners, such as original design manufacturers (ODMs). Because ODMs manufacture the products of other companies as well as ours, the timeliness of the availability of our products depends, in part, on their production schedules. In addition, we are relying on ODMs to manufacture products that meet our specifications with regard to quality and cost. We will continue to source other products from OEMs and from the Huawei-3Com joint venture. Finally, since we rely on our strategic partners, we may not be able to independently identify current product and technology trends and to respond to such trends as well as if we were working independently.

A significant portion of our revenue is derived from sales to a small number of customers. If any of these customers 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. We also sell to personal computer manufacturers and telecommunications service providers. A significant portion of our revenue is concentrated among a few distributors and OEM customers; our two largest customers accounted for a combined 34 percent of total sales for the first three quarters of fiscal 2004, a combined 33 percent of total sales for the entirety of fiscal 2003, and a combined 28 percent of total sales for each of fiscal 2002 and fiscal 2001. There has been a trend of decreased demand for connectivity products from OEM customers such as Dell Computer Corporation and Hewlett-Packard Company, due to increased integration of networking connections with semiconductor components,

and also to factors specific to our OEM customers. Additionally, consolidation in our distribution channels and among personal computer (PC) manufacturers is reducing the number of customers in our domestic and international markets. In an effort to streamline our operations, we may increase the focus of our distribution sales resources on selected distribution channel customers.

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

Our distributors maintain inventories of our products. 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. We have improved certain of our supply chain processes so that deliveries to our channel partners can be done more rapidly, thereby enabling our channel partners to hold fewer weeks of supply of our products in their inventory. At the end of fiscal year 2003, channel inventory levels were at the upper end of our target range of four to six weeks supply on hand at our distributors. At the end of each of the first three quarters of fiscal 2004, channel inventory levels were at approximately 4.5 weeks supply. We expect to operate our business with no greater than 4.5 weeks of channel inventory for the remainder of fiscal 2004. At this level of channel inventory, some of our

channel partners will hold less than the average level of inventory, and others will be at a higher level. Partners with a below-average inventory level may incur stock outs that would adversely impact our revenues. If our channel partners further reduce their levels of inventory of our products, our sales would be negatively impacted during the period of change.

We are in the process of making adjustments to the manner in which we sell our products and services in the sales channel. If those adjustments are unsuccessful, our revenues may be negatively affected.

As part of our distribution strategy, we are targeting System Integrators (SIs), Service Providers (SPs), and enterprise Value Added Resellers (eVARs). These resellers typically have expertise in network design and implementation, which is important when deploying end-to-end networking infrastructure solutions in larger enterprises. In addition to specialized technical expertise, SIs, SPs and eVARS typically offer sophisticated services capabilities that are typically 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 services, marketing, or sales organization does not 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 results of operations.

Our strategies to outsource all of our manufacturing requirements to contract manufacturers, and for contract manufacturers to ship directly to our customers, 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 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. The inability of any contract manufacturer to meet our cost, quality, performance, and availability standards could adversely impact our financial condition or results of operations. 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 the inventory. Also, our ability to control the quality of products produced by contract manufacturers may be limited and quality issues may not be resolved in a timely manner, which could adversely impact our financial condition or results of operations. 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 financial performance. Any disruptions to on-time delivery to customers would adversely impact our business and revenues.

We may be unable to manage our supply chain successfully, which would adversely impact our revenues, gross margins, 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;

there are a smaller number of suppliers and we have narrowed our supplier base, including, in some cases, the sole sourcing of specific components from a single supplier;

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, especially in light of general economic weakness and uncertainty following wars and terrorist events;

our significantly increased 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.

Increasingly, we have been sourcing a greater number of components from a smaller number of vendors. Also, there has recently been a trend toward consolidation of vendors of electronic components. This greater reliance on a smaller number of suppliers 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.

Operation of the supply chain requires accurate forecasting of demand, which has become more challenging. 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, revenue, results of operations or financial position.

The increased integration of networking, communications, and computer processing functions on a reduced number of computer chips may adversely affect our future sales growth and operating results.

The integration of networking, communications, and computer processing functions on a reduced number of computer chips has become an industry trend. This trend is sometimes referred to as siliconization. Many of these integrated computer chips offer improved features and increased performance at lower cost. Some competitors that have a significant share of the PC chip market may sell chips that contain integrated connectivity at prices not significantly greater than prices for PC chips without connectivity. If we cannot compete successfully against current or future competitors or their product offerings, our business, results of operations or financial position could be adversely affected.

The contract manufacturers on whom we rely face currency exchange rate risk that may affect their ability to provide products on a cost competitive basis, which could in turn impact our operating results and our competitiveness.

We are entirely dependent upon external contract manufacturers for product supplies and, in turn, upon the ability of these contract manufacturers to remain cost competitive. A significant component of maintaining this cost competitiveness is the ability of the 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 operating results and our own competitiveness may be adversely impacted.

We are exposed to economic currency risk on products sourced from the Huawei-3Com joint venture in China.

Pursuant to our agreements with Huawei, we have the right to market the Huawei-3Com products under the 3Com brand in all countries except China and Japan. A key factor in the success of this activity is that product sourced from the joint venture remains cost competitive over time. Any future adverse exchange rate movements between the joint venture s local currency of operations and the U.S. Dollar may adversely impact our operating results.

Outsourcing of our manufacturing operations, information technology activities and other functions and

Our past and future decisions to exit certain product lines may have unforeseen negative impacts to our business.

In fiscal 2001, 2002 and 2003, we exited or sold some of our businesses and product lines. In some cases, we continue to be responsible pursuant to the original warranty obligations for these products. Our exiting of these business and product lines may have adversely affected our relationships with channel partners and end customers. Many of these channel partners and customers perceived our remaining products as not being part of a larger integrated or complementary solution, or questioned our commitment to their markets. Consequently, they

chose to purchase products from alternative vendors. We may consider exiting other businesses or product lines that do not meet our goal of delivering satisfactory financial returns. Future decisions to exit businesses or product lines could result in deterioration of our channel partner and customer relationships, increased employee costs (such as severance, outplacement and other benefits), contract termination costs, and asset impairments.

Our increasing reliance on strategic relationships may negatively impact our business.

As discussed above, in November 2003, we formed a joint venture in China for enterprise networking products. In addition, we recently announced alliances with Crossbeam Systems, Inc. and Aspect Communications Corporation. We expect to evaluate other possible strategic relationships, including joint ventures and other types of arrangements, and we may increase our reliance on such strategic relationships to complement internal development of new technologies and enhancement of existing products and to exploit perceived market opportunities. Strategic relationships can present challenges since we often compete in some business areas with companies with which we, at the same time, have strategic alliances in other business areas. If these companies fail to perform, or if these relationships fail to materialize as expected, we could suffer delays in product or market development or other operational difficulties. Strategic relationships may also lead to potential conflicts within our distribution channel. Furthermore, our results of operations or financial condition could be adversely affected if we experience difficulties managing relationships with our partners or if projects with partners are unsuccessful. In addition, if third parties acquire our strategic partners or if our competitors enter into successful strategic relationships, we may face increased competition.

Our reliance on industry standards, a favorable regulatory environment, technological change in the marketplace, and new product initiatives may cause our revenues to fluctuate or decline.

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

the emergence of new technology or the convergence of technologies such as voice and data networking or IP telephony;

our ability to develop new products to address changes in technologies and related customer requirements on a timely basis;

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

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

a favorable regulatory environment.

Slow market acceptance of new technologies, products, or industry standards could adversely affect our revenue or overall financial performance. 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 revenue from sales of such products or our overall financial performance could be

Outsourcing of our manufacturing operations, information technology activities and other functions and

adversely affected.

Failure to obtain all necessary regulatory approvals for our products or to comply with all applicable government regulations could adversely impact our revenue or overall financial performance or expose us to fines or other penalties. In addition, new or revised government regulations could adversely affect the basic business economics for new technologies or their rates of acceptance or adoption by potential customers; in turn, this could adversely impact our revenue or overall financial performance.

Our customer order fulfillment capabilities fluctuate and may negatively impact our operating results.

The timing and amount of our sales depend on a number of factors that make estimating future operating results difficult. Throughout our business, we do not typically maintain a significant amount of backlog, and sales are partially dependent on our ability to appropriately forecast product demand. In addition, our customers historically request fulfillment of orders in a short time period, resulting in limited visibility to sales trends and potential pricing pressures. Consequently, our operating results depend on the volume and timing of orders and

our ability to fulfill orders in a timely manner. Historically, sales in the third month of the quarter have been higher than sales in each of the first two months of the quarter. Non-linear sales patterns make business planning difficult, and increase the risk that our quarterly results will fluctuate due to disruptions in functions such as manufacturing, order management, information systems, and shipping.

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 is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights.

In the course of our business, we frequently 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 results of operations or financial position 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.

We may need to engage in complex and costly litigation in order to protect or maintain our intellectual property rights.

In addition to disputes relating to the validity or alleged infringement of other parties rights, we may become involved in disputes relating to our assertion of our intellectual property rights. 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 by diverting 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. To the extent that any of our OEM, ODM, or joint venture partners may become involved in intellectual property disputes and may be unable to hold us harmless, then we may incur liabilities or suffer temporary disruption of our business. Also, if we are asserting our intellectual property rights against others, we could be prevented from stopping others from manufacturing or selling competitive products. Any one of these factors could adversely affect our product margins, results of operations, financial position, or cash flows.

Our future quarterly operating results are subject to factors that can cause fluctuations in our stock price.

Historically, our stock price has experienced substantial 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 balances;

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

announcements by our competitors.

In addition, over the past several quarters, the stock market has experienced extreme 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.

We may not be fully able to protect our computer systems, including our financial systems, from breaches of security.

We use computer systems, including our enterprise-wide financial system, which may not include the most advanced security features available. There is a risk of unauthorized access to our computer systems and proprietary information, including our financial systems, intellectual property, and trade secrets. While management makes concerted efforts to assess risks and prevent and detect security breaches, including periodic audits and upgrades of our systems, our business, results of operations or financial position could be affected if any unauthorized access were to occur and not be detected through our normal internal control procedures.

In fiscal 2004 we are operating in a single business segment focused primarily on enterprise networking, and our results of operations may fluctuate based on factors related entirely to conditions in this market.

In fiscal 2004, we are operating in a single business segment focused primarily on enterprise networking. This single enterprise networking business reflects a streamlined management and operating structure encompassing all of our operations, including our connectivity business that we previously operated and reported as a separate segment and which we expect will continue to diminish. Our focus on enterprise networking may cause increased risk or volatility associated with decreased diversification of our business. There will be 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 overcome negative perceptions of our company held by certain chief information officers of large enterprises, who may be skeptical of our long-term commitment to the high-end networking business as a result of our withdrawal from that business in 2000. 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 any diminished focus on the small and medium enterprise market.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

3Com holds marketable equity securities that have a brief trading history and are highly subject to market price volatility. Equity security price fluctuations of plus or minus 50 percent would not have a material impact on the value of these securities as of the end of the third quarter of fiscal 2004.

For interest rate sensitivity and foreign currency exchange risk, reference is made to Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended May 30, 2003.

Item 4. Controls and Procedures

a. We carried out an evaluation, under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of our third fiscal quarter pursuant to Exchange Act Rule 13a-15(b). Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports that we file or submit 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.

Our review of our internal controls was made within the context of the relevant professional auditing standards defining internal controls, reportable conditions, and material weaknesses. Internal controls are processes designed to provide reasonable assurance that our transactions are properly authorized, our assets are safeguarded against unauthorized or improper use, and our transactions are properly recorded and reported, all to permit the preparation of our consolidated financial statements

in conformity with accounting principles generally accepted in the United States. Significant deficiencies are referred to as reportable conditions, or control issues that could have a significant adverse effect on our ability to properly authorize transactions, safeguard our assets, or record, process, summarize or report financial data in the consolidated financial statements. A material weakness is a particularly serious reportable condition where the internal control does not reduce to a relatively low level the risk that misstatements caused by error or fraud may occur in amounts that would be material in relation to the consolidated financial statements and not be detected within a timely period by employees in the normal course of performing their assigned functions. As part of our internal controls procedures, we also address other, less significant control matters that we identify, and we determine what revision or improvement to make, if any, in accordance with our on-going procedures.

b. There have been no changes in our internal control over financial reporting identified in connection with our evaluation as of the end of the third fiscal quarter that occurred during such quarter 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

The information set forth in Note 13 of Part I, Item 1 of this Form 10-Q is incorporated herein by reference.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

Share Repurchase Plan

During the fourth quarter of fiscal 2003, the Board of Directors approved a new stock repurchase program providing for expenditures of up to $100.0 million and authorized a two-year limit on such repurchases.

The following table summarizes repurchases of our stock in the quarter ended February 27, 2004:

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
November 29, 2003 through December 28, 2003				$ 100,000,000

December 29, 2003 through January 28, 2004	$	100,000,000
January 28, 2004 through February 27, 2004	$	100,000,000
Total	$	100,000,000

Item 3. Defaults Upon Senior Securities

None.

Item 4. **Submission of Matters to a Vote of Security Holders**

None.

Item 5. **Other Information**

None.

Item 6. **Exhibits and Reports on Form 8-K**

(a) Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date	Filed Herewith
2.1	Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999	10-Q	0-12867	2.1	04/04/00	
2.2	Tax Sharing Agreement between the Registrant and Palm, Inc.	10-Q	0-12867	2.7	04/04/00	
2.3	Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc.	10-Q	0-12867	2.11	04/04/00	
3.1	Corrected Certificate of Merger filed to correct an error in the Certificate of Merger	10-Q	0-12867	3.4	10/08/99	
3.2	Registrant s Bylaws, as amended on August 7, 2001	10-K	0-12867	3.5	08/02/02	
3.3	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock	10-Q	0-12867	3.6	10/11/01	
4.1	Third Amended and Restated Preferred Shares Rights Agreement, dated as of November 4, 2002	8-A/A	0-12867	4.1	11/27/02	
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

(b) Reports on Form 8-K

(i) On December 17, 2003, we furnished a Current Report on Form 8-K dated December 17, 2003 under Item 12 of Form 8-K, attaching a press release announcing our second quarter of fiscal 2004 operating results. This Current Report on Form 8-K shall not be deemed to be incorporated by reference into this Quarterly Report on Form 10-Q.

Outsourcing of our manufacturing operations, information technology activities and other functions and

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:	April 7, 2004	By:	/s/ Mark Slaven
			Mark Slaven
			Executive Vice President, Finance and
			Chief Financial Officer
			(Principal Financial and
			Accounting Officer)