SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2000

or

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

Commission File Number 1-9434

PICTURETEL CORPORATION
(Exact name of Registrant as specified in its Charter)

Delaware (State or other jurisdiction of incorporation or organization)	**04-2835972** (I.R.S. Employer Identification No.)
100 Minuteman Road, Andover, MA (Address of Principal Executive Offices)	**01810** (Zip Code)

Registrant's telephone number: (978) 292-5000

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock
(Title and Class)

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 last 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filings pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. ☒

The aggregate market value of the Registrant's Common Stock held by non-affiliates of the Registrant as of March 9, 2001 was $140,313,102. On such date, the average of the high and low price of the Common Stock was $3.13 per share. The Registrant has 45,095,941 shares of Common Stock outstanding as of March 9, 2001.

Documents Incorporated by Reference

Portions of the definitive 2001 Proxy Statement in connection with the Annual Meeting of Stockholders to be held June 14, 2001 are incorporated by reference into Part III.

A list of all Exhibits to this Annual Report on Form 10-K is located at 47 through 51.

Item 1. *Business*

PictureTel Corporation (the "Company" or "PictureTel") is a world leader in developing, manufacturing and marketing a full range of visual and audio collaboration solutions. Visual collaboration employs videoconferencing, video streaming and data collaboration technologies to facilitate productive meeting environments that may incorporate video, audio, and real-time and archived multimedia data. The Company's products and services enable businesses, schools, medical facilities, government and other organizations to eliminate the barrier of distance so they can work together more effectively. PictureTel markets a complete line of videoconferencing systems, multi-location servers, peripheral equipment and a full suite of enterprise-wide services.

PictureTel is organized into two business segments. The business segments are videoconferencing products and videoconferencing services. The videoconferencing products' direct sales organization and its worldwide sales channels currently also sell certain videoconferencing services' offerings.

PictureTel is a Delaware corporation organized in 1984, with executive offices at 100 Minuteman Road, Andover, Massachusetts 01810 (telephone: 978-292-5000).

Videoconferencing Products

The benefits of PictureTel's business since the Company's inception in 1984 has been the delivery of business solutions which improve productivity and quality of life by enhancing remote communications and reducing the costs and hassle of travel. PictureTel's core business has evolved into development, manufacture and marketing of a complete line of full-featured videoconferencing systems. PictureTel's videoconferencing systems deliver full-color video and high fidelity, FM radio-caliber audio, so customers can enjoy a natural, productive meeting environment whether they are in the same office complex or halfway around the world from each other. The video and audio signals are transmitted over either digital telephone lines, most often ISDN (Integrated Services Digital Network) lines, which are part of the public switched telephone network, or networks that use the Internet Protocol (IP). PictureTel has been, and remains, the world technology leader in its industry with more than twelve thousand organizations around the world using PictureTel systems to conduct face-to-face meetings with colleagues, partners, suppliers, customers and others.

The Company delivers a complete portfolio of products to the marketplace and its channels, so that the videoconferencing solution can be integrated into various network environments, expanded to multipoint conferencing, and customized for vertical and specialized applications and markets. The videoconferencing elements are developed by PictureTel and the peripheral elements are typically outsourced to third party manufacturers.

PictureTel's group videoconferencing systems was completely overhauled from 1997 to 2000 and the resulting breakthrough development (iPower™ architecture) was introduced to the market in mid 2000. iPower enables PictureTel to deliver to the market a range of products at a range of price points using a common software and hardware base. The PictureTel 900 Series was the first product using iPower. iPower is a completely new business tool which combines state of the art videoconferencing with easy information sharing and with typical meeting room tools and applications found in a conference room for extended value even when videoconferencing is not being used. The Company also continues to market its appliance type (single purpose) set-top videoconferencing system, the PictureTel 760XL™. This model has roots back to 1996 when PictureTel created the compact category of videoconferencing with the introduction of SwiftSite™, the world's first compact videoconferencing system. SwiftSite — and its follow-on SwiftSite II™ and PictureTel 760XL™ models — deliver high-quality performance in a simple, portable and affordable package. These compact-class products, which sit on top of the monitor to which they are connected, are optimized for use in smaller offices. They have proven popular in field sales offices, franchises and other similar locations where they can complement the larger group systems deployed at headquarters and other larger sites. The Company also markets Intel Corporation's TeamStation™, a PC-based videoconferencing system capable of operating on ISDN and IP networks, under the terms of an exclusive distribution agreement.

PictureTel also has a complete line of personal or desktop videoconferencing systems. These systems, which add videoconferencing capabilities to standard personal computers, are suited for use by individuals who not only need to videoconference with one or more sites, but also share any number of PC documents through the systems data-conferencing capabilities. PictureTel's desktop systems run on the most popular Microsoft® operating systems. PictureTel introduced its first PC-based personal systems in 1994, when that segment of the market was emerging. PictureTel's personal systems operate in much the same way as the Company's group systems. PictureTel markets several different models of personal videoconferencing systems under the PictureTel 550™ Personal Videoconferencing system brand. These systems operate over both ISDN lines and networks that use the Internet Protocol. Using IP network capabilities enables the systems to operate over many different types of IP-based networks, including Ethernet local area networks (LANs). These IP-based systems, which are becoming an increasingly significant part of PictureTel's product line, are expected to play an even more prominent role in the future of PictureTel and the videoconferencing industry in general.

When business people need to collaborate with colleagues across a city or halfway around the world, they often require network products that enable more than two systems to participate in the same conference. PictureTel markets three ISDN-based multi-location conferencing server lines: Montage™, Prism™ and Accord™ MCG-100. The MCG-100 and Montage are designed for large, reservation-based videoconferencing networks. Prism is a smaller system designed for use with personal videoconferencing systems and in situations where users want to conduct multi-location conferences more spontaneously. In the IP-conferencing market, PictureTel provides PictureTel 330™ NetConference multipoint server software. With the PictureTel 330, organizations can create virtual conference rooms on a variety of local area networks and the Internet for videoconferencing and data conferencing. In addition to multi-location servers, PictureTel's complete network products line includes scheduling software, gateway products that enable users to conduct conferences between ISDN- and IP-based videoconferencing systems, and management software that enables the user to control videoconference network traffic on their local area network.

PictureTel systems support international standards for videoconferencing. H.320 is the international standard for ISDN-based videoconferencing and H.323 is the standard for IP-based videoconferencing. PictureTel products also support T.120, the international standard for data collaboration. PictureTel has been a staunch supporter of and contributor to worldwide videoconferencing standards. PictureTel co-authored the H.323 standard and has contributed portions of the H.320 and T.120 standards as well. PictureTel authored the new G.722.1 audio compression algorithm and has licensed this technology to Microsoft, Nortel and others. PictureTel's commitment to industry standards gives its customers the peace of mind that their PictureTel systems will interoperate with any other manufacturer's standards-based systems. In a PictureTel-to-PictureTel operating environment, users can take advantage of proprietary PictureTel technology to get the highest available video and audio performance prior to industry standardization of such capabilities.

Intel Relationship

In January 1999, PictureTel entered into a distribution and joint product development agreement to accelerate growth of videoconferencing worldwide. Under terms of the distribution and development agreement, Intel provided PictureTel with distribution rights to sell the Intel® ProShare® Video System 500, and exclusive worldwide distribution rights to sell and support the Intel® TeamStation™ System. In addition to its expertise in videoconferencing distribution, sales and marketing, PictureTel provides its complete line of professional, managed and maintenance support services for both products. Intel TeamStation System is a conference room workstation that combines videoconferencing, Internet access, corporate network access and PC applications in one convenient system. Based on the Intel Pentium® line of processors, the Intel TeamStation is a turnkey, high-performance system that brings increased productivity to conference rooms. Intel ProShare Video System 500 is an add-in kit for desktop PCs. It operates over both ISDN and LAN networks and offers fully integrated data-sharing capabilities. These Intel products augment PictureTel's existing product line of group, desktop/personal and network server systems.

Intel and PictureTel also agreed to begin joint development of videoconferencing and collaboration products based on a common PC-based technology platform. The common platform will be the foundation for future products that will feature communication and multimedia capabilities such as collaboration over LANs, streaming audio and video, and real-time conferencing. The first products resulting from this joint development agreement, the PictureTel 900 Series, were delivered in August 2000. These products, which will operate over multiple networks, including IP, ISDN and asynchronous transfer mode (ATM), have replaced PictureTel's existing product line and are marketed under the PictureTel brand name.

Sharp Relationship

In August 2000, the Company entered into a joint design and manufacturing partnership with Sharp to develop iPower™ -based visual and audio collaboration tools. The new products will be based on the PictureTel iPower architecture, which was jointly developed by PictureTel and Intel. They will run the Microsoft Windows 2000 Professional operating system and will incorporate Windows NetMeeting and Internet Explorer. The PictureTel/Sharp joint development relationship will leverage the scalable iPower core technology, which serves as the common ITU-standards-based platform for the products. The first of the products jointly developed with Sharp are expected to be introduced in the second quarter of 2001.

Videoconferencing Services

PictureTel assists customers in implementing and managing their visual collaboration technology on a global enterprise-wide basis through a comprehensive portfolio of maintenance and professional services, which together address each phase of the product life cycle. Professional services include conferencing, consulting, education, design and project management services. Consulting services provide planning and needs analysis to customers. Design services, such as room design and custom solutions, provide customized videoconferencing solutions to meet each customer's unique requirements. Project management, installation and training provide customers with effective implementation of videoconferencing systems. For the on-going operation of customers' videoconferencing environments, PictureTel provides conference services and maintenance services. Conference services facilitate the customer's use of the videoconferencing technology by providing conference room scheduling, call launching, bridging and end-to-end problem resolution during conferences. These services are delivered for point-to-point, as well as multipoint conferences on a global basis. All services are sold both directly to customers and through PictureTel's distributors. Service programs for local and international distributors range from reselling PictureTel's service offerings to providing back-end support for servicing end-users.

All maintenance services are delivered on a worldwide basis from several integrated global support centers located in the United States, United Kingdom, Singapore and Japan. Spare parts are stocked around the world to meet response time commitments to customers and distributors. PictureTel utilizes direct field service staff as well as distributors and third party service providers to perform installation and on-site repairs. Conference services are delivered from geographically distributed Network Operations Centers. Major centers are in the United States, United Kingdom, and Singapore. PictureTel delivers professional services and training through conferencing engineers, consultants, project managers and instructors. In addition, PictureTel offers electronic support via the World Wide Web.

PictureTel believes that the quality and reliability of its systems and services are important to customer satisfaction. Accordingly, PictureTel's videoconferencing services are ISO9002 registered and PictureTel expects to continue to maintain its certification. PictureTel also regularly measures customer satisfaction and strives to implement corrective actions to improve the quality of its service. The delivery of service is backed by PictureTel's certification program, which tests and certifies the technical abilities of all support personnel dealing with videoconferencing products. PictureTel provides warranty support for parts and software media on the majority of its products. The warranty period is generally one year for hardware, ninety days for software media, and ninety days for repaired parts.

Current Strategy

In 2000, the Company adopted and is now pursuing a three-pronged approach to meeting the anticipated needs of the developing multimedia collaboration marketplace. First, in conjunction with Intel and Sharp, it developed, and continues to develop, its next generation endpoint conferencing products for video, voice and data collaboration. Second, it expanded its enterprise-wide solutions services beyond management of multipoint videoconferences to include streaming video services, custom integration, and outsourced management of enterprise conferencing. The last prong is the development of Internet-based, multimedia application services.

Research and Development

PictureTel continues to invest a significant percentage of its annual revenue in its research and development activities. A strong investment in research and development since the Company's inception has enabled PictureTel to become the world leader in videoconferencing and is the basis for the Company's new visual collaboration strategy. PictureTel's historic investments in research and development have earned the Company more than thirty patents for its video and audio technologies.

Sales

The Company and its subsidiaries currently distribute PictureTel products worldwide by direct sales and indirect channels of distribution. In 2000, the Company derived approximately 11% of its worldwide product revenues from direct selling activities, and 89% from indirect channels.

Direct Sales Organization. The Company directly markets its videoconferencing products and videoconferencing services principally to large companies, which typically have multiple locations in the United States as well as internationally and specify a single vendor to supply equipment on a worldwide basis. The Company believes that it is important to maintain a close working relationship with these customers in order to meet their demands for sales and support on a multinational basis.

Within the United States, the Company maintains seven regional sales and support offices, as well as seven demonstration centers. Sales offices typically include demonstration equipment as well as a number of customer and technical sales representatives and field support personnel.

Indirect Channels. To provide a large competitive presence, the Company uses indirect channels to expand its market presence. The Company utilizes telecommunication equipment distributors, value-added resellers ("VARs") and dedicated dealers who sell the Company's videoconferencing products and videoconferencing services.

International Distribution. Outside of the United States, the Company relies on a network of foreign market distributors and its own international subsidiaries. Agreements with the Company's foreign market distributors generally provide for pricing, volume discounts, order lead times, a specific geographic territory and other terms and conditions and are typically for terms of one to three years with options to extend such terms by mutual agreement.

Competition

In its established businesses of group systems and desktop systems, the Company competes with a number of larger corporations, which have greater financial and marketing resources than the Company. In the developing businesses of network-based videoconferencing systems and compact systems, a number of corporations have begun to offer competitive products. In addition, partnerships between corporations that compete with the Company and corporations that develop and market network products, as well as mergers among competitors, are intensifying competition in the marketplace. This increased competition, together with a slowdown in the growth of the general market for videoconferencing products, has led, and may continue to lead, to decreases in average selling prices and margins in both group and desktop videoconferencing systems, a lower segment market share by the Company for products and services in the emerging area of network-based visual collaboration, and to increases in the defection or dilution of the Company's distribution channel partners to competitors.

The Company competes primarily on the basis of video and audio quality and data collaboration, as well as on favorable features, support services and the pricing of those systems and services. The Company believes that its products and services are competitive in each of these areas. Moreover, in response to this competitive environment, the Company is investing in perceived growth areas such as visual, audio and data collaboration applications; web-based scheduling and call-launching tools; integration services; and other value-added offerings. The Company believes that these investments, combined with the launch of its new-generation products, will competitively position the Company in this landscape.

Additional risks with regard to competition may be found in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under Risk Factors Which May Affect Future Results.

Manufacturing

The Company has developed a supply chain that encompasses the Company's subassemblies and products supplied by vendors to the delivery of finished goods to the customer. This effort has resulted in a cost effective and timely delivery of products to the Company's customers. This strategy allows the Company to reduce costly investment in manufacturing capital and to leverage the expertise of its vendors.

The Company's manufacturing operation consists of final assembly and testing of complete systems. Subassemblies of large systems, including tested printed circuit boards, are assembled into complete systems. These final systems are tested to ensure they meet all functional requirements.

Desktop/personal hardware products are purchased in final form from various vendors. The products have been subjected to PictureTel's quality testing at the vendor site. These products are placed into inventory, and are shipped according to demand.

The Company utilizes a European Distribution Center (EDC) in Holland to centralize videoconferencing product shipments to its customer base in Europe. PictureTel has sourced components from local vendors in Europe to support proper stocking levels in Holland and maintain timely customer shipments. The EDC incorporates the same working relationships and policies with vendors in Europe as the Company currently does in the United States.

Patents

The Company's principal technology consists primarily of certain advances in video and audio compression algorithms, echo cancellation and audio signal processing, camera positioning, and automatic speaker location technology, implemented in software and hardware configurations for use in PictureTel products and unique product designs. The Company has been issued a number of United States patents relating to the above-described technology, which expire at various dates from 2004 to 2017. The Company has a number of additional patent applications issued and pending in various countries including the United States, Canada, Europe and Japan, and will continue to file additional applications. However, there can be no assurance that its current patents (or any additional patents that may be issued in the future) provide broad protection from the development of similar product technology by competitors of the Company. In the absence of broad patent protection, and despite the Company's reliance upon its proprietary confidential information, competitors of the Company may be able to use algorithms similar to those used by the Company to design and manufacture products that are directly competitive with the Company's products.

Employees

At December 31, 2000, the Company had 820 full-time employees, of whom 474 were employed in sales, marketing and customer support, 140 in product development and engineering, 51 in manufacturing and 155 in administration and finance. The Company had 257 employees in foreign countries at December 31, 2000.

The Company's future success will depend in part on its ability to attract and retain highly skilled and motivated personnel who are currently in great demand throughout the industry.

None of the Company's employees are represented by a labor union. The Company believes its relations with its employees to be good.

Item 2. ***Properties***

The Company has substantially reduced its real estate footprint over the past three years. PictureTel's corporate offices and research, development and manufacturing facilities are currently located in one leased facility in Andover, Massachusetts and one leased facility in Chelmsford, Massachusetts, aggregating approximately 321,000 and 69,940 square feet, respectively. The lease at 100 Minuteman Road in Andover, Massachusetts expires in 2014. The lease for the product distribution facility in Chelmsford, Massachusetts expires in August 2003.

In June 1998, the Company subleased its property at 50 Minuteman Road for a period of ten years. This lease was accounted for as a capital lease until December 2000, at which time the Company, pursuant to an option agreement with the landlord, renegotiated its lease term on the 50 Minuteman facility. The lease on the 50 Minuteman facility expires in June 2008 and is currently classified as an operating lease.

Effective July 1999, the Company's property at 6 Riverside Drive in Andover was subleased for a period of five years. The Company's lease on this facility expires in July, 2007. Additionally, the Company did not renew the lease at 100 Brickstone Square in Andover when it expired in August 1999.

In September 2000, pursuant to an option agreement with the landlord of its facility located at 200 Minuteman Road in Andover, Massachusetts, the Company vacated certain space in the 200 Minuteman facility in exchange for termination of the lease. Additionally, the Company continues to lease its facility in Mountain View, California where offices for its former Starlight division were located until disposition of the division in October 2000. This lease is scheduled to expire in 2003.

PictureTel also leases office space for its regional and branch sales and support offices in the United States and for similar offices of its subsidiary and branch operations worldwide.

Item 3. ***Legal Proceedings***

A. SEC Investigation

In May 1999, the Company was informed that the Securities and Exchange Commission (SEC) had initiated a formal investigation of matters related to the Company's 1997 restatement of its earnings. The Company has been cooperating with the SEC and will continue to do so. The Company expresses no opinion as to the likely outcome. While no assurances can be provided, the Company does not believe that the investigation will have a material adverse effect on its business, financial condition, results of operations or cash flows.

B. RevNet, Inc.

On June 2, 1998, the Company was served with a complaint from a former distribution channel customer, RevNet, Inc., which has ceased operations. (*RevNet, Inc., v. PictureTel Corporation*. Civil Action 98092039, filed April 2, 1998, in the Circuit Court for Baltimore City, Maryland.) The complaint alleged that the Company breached an oral contract. RevNet was seeking $200 million in damages. On September 13, 1999, the Company filed a related action in the Circuit Court for Baltimore City, Maryland against RevNet, Inc., Vuecom, Inc. (an entity related to RevNet, Inc.), George Harris IV, George Sandmann and Lou Brown, (*PictureTel Corporation v. RevNet, Inc., et al.* Civil Action 24-C99-004406) alleging among other things Breach of Contract, Fraudulent Inducement and Securities Fraud. This issue was scheduled to go to trial on May 14, 2001. On October 30, 2000, the parties agreed to a settlement of this matter. Under the terms of the settlement, the Company will pay to the RevNet group $700 thousand over the course of the year 2001. In return, all parties have dismissed all claims and have released the others of all related causes of actions. This closes this matter.

In addition to the above, the Company has also been and is from time to time subject to claims, such as potential patent infringements, and suits incidental to the conduct of business. There can be no assurance that the Company's insurance will be adequate to cover all liabilities that may arise out of such claims. Further, although the Company intends to defend itself vigorously against all such claims, the ultimate outcome of the claims cannot be accurately predicted. The Company does not believe that any claim of which it is aware, other than the claims listed above, could result in an outcome that will have a material adverse effect to its business, financial condition, results of operations or cash flows.

Item 4. ***Submission of Votes***

There were no items submitted to the shareholders during the fiscal year 2000.

PART II

Item 5. ***Market for Registrant's Common Equity and related Stockholder Matters***

PRICE RANGE OF COMMON STOCK

The following table sets forth the high and low sale prices for the Company's Common Stock for the periods indicated as reported by NASDAQ under the symbol PCTL.

	High	Low
1999		
First Quarter	$11.000	$5.875
Second Quarter	$11.000	$4.313
Third Quarter	$ 8.125	$3.625
Fourth Quarter	$ 6.500	$3.250
2000		
First Quarter	$15.219	$4.250
Second Quarter	$ 9.000	$1.875
Third Quarter	$ 9.940	$2.813
Fourth Quarter	$ 8.000	$2.190
2001		
First Quarter (through March 9, 2001)	$ 4.190	$2.060

As of March 9, 2001 there were approximately 1,626 holders of record of the Company's Common Stock.

DIVIDEND POLICY

The Company has not paid any dividends on its Common Stock since its inception. The Board of Directors does not anticipate declaring any cash dividends in the foreseeable future.

Item 6. ***Selected Financial Data***

SELECTED FINANCIAL DATA
(Dollars in thousands, except per share amounts)

	Year Ended December 31,				
	2000	1999	1998	1997	1996
Statement of Operations Data:					
Revenue(1)	$ 245,149	$323,995	$407,143	$466,425	$490,225
Net income (loss)(2)	$(106,971)	$(84,526)	$(55,679)	$(39,398)	$ 32,172
Net income (loss) applicable to Common shareholders(2)(3)	$(113,871)	$(90,138)	$(55,679)	$(39,398)	$ 32,172
Net income (loss) per common share — basic(2)(3)(4)	$ (2.73)	$ (2.23)	$ (1.45)	$ (1.04)	$ 0.89
Net income (loss) per common share — diluted(2)(3)(4)	$ (2.73)	$ (2.23)	$ (1.45)	$ (1.04)	$ 0.81
Weighted average shares Outstanding — basic(4)	41,739	40,376	38,527	37,760	36,097
Weighted average shares Outstanding — diluted(4)	41,739	40,376	38,527	37,760	39,598

	As of December 31,				
	2000	1999	1998	1997	1996
Balance Sheet Data:					
Working capital	$ 45,395	$ 82,994	$112,322	$152,973	$202,063
Total assets	$ 147,020	$294,870	$352,994	$355,051	$386,254
Total short-term debt	$ 1,487	$ 1,978	$ 4,418	$ 3,612	$ 3,942
Total long-term debt	$ —	$ 54,584	$ 56,411	$ 22,000	$ 14,202
Redeemable preferred stock	$ 42,845	$ 30,500	$ —	$ —	$ —
Stockholders' equity	$ 21,620	$109,266	$190,242	$227,965	$264,846

(1) Effective in the fourth quarter of 2000, the Company adopted the FASB's Emerging Issues Task Force (EITF) Issue No. 00-10, "Accounting for Shipping and Handling Fees and Costs." Consistent with this Issue, amounts billed to customers for shipping and handling have been reclassified as revenue from cost of revenue in the Company's financial statements. Amounts reclassified for the first three quarters of 2000, and for the years 1999 and 1998 were $546, $716 and $991, respectively. Reclassification for years prior to 1998 was determined to be impracticable.

(2) Includes other charges totaling $42,313, $9,752, $10,564 and $42,664 before income tax benefit in 2000, 1999, 1998 and 1997, respectively. Also includes a $15,245 gain on the sale of MultiLink, Inc. and a gain of $104 on the sale of Starlight Networks, Inc. in 2000, an $8,495 gain on the sale of RealNetworks stock in 1999, a $4,442 charge in 1998 for in-process technology acquired in connection with the 1998 Starlight Networks purchase, and tax expense of $35,141 in 1998 to record a full valuation allowance against deferred tax assets. See Notes 3, 10, 15 and 16 of "Notes to Consolidated Financial Statements."

(3) Includes beneficial conversion feature adjustments of $6,900 and $5,612 in 2000 and 1999, respectively, related to issuance of convertible preferred stock. See Note 9 of "Notes to Consolidated Financial Statements."

(4) The Company has not paid dividends on its common stock since its inception. The Board of Directors does not anticipate declaring any cash dividends in the foreseeable future.

Item 7. ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Dollars in thousands, unless otherwise indicated)

The following table sets forth, for the periods indicated, the percentages of revenue for certain items in the Company's Statement of Operations for each period. The table and the following discussion reflect the other charges described in Note 15 of the Notes to Consolidated Financial Statements:

	Year Ended December 31,		
	2000	1999	1998
Revenue	100.0%	100.0%	100.0%
Cost of revenue	76.8	68.5	57.5
Gross margin	23.2	31.5	42.5
Selling, general and administrative	52.8	39.0	32.1
Research and development	19.1	20.4	16.2
Total operating expense	71.9	59.4	48.3
Loss from operations	(48.7)	(27.9)	(5.8)
Interest income (expense), net	(0.9)	(0.1)	0.5
Other income, net	6.4	3.3	0.4
Loss before income tax expense	(43.2)	(24.7)	(4.9)
Income tax expense	(0.5)	(1.4)	(8.8)
Net loss	(43.7)	(26.1)	(13.7)
Preferred stock beneficial conversion feature	(2.8)	(1.7)	—
Net loss applicable to common shareholders	(46.5)	(27.8)	(13.7)

Forward-Looking Statements

This document includes forward-looking statements about the Company's business, revenue and expenses, effective tax rate, operating and capital requirements, liquidity and management's plans to introduce new products and seek additional equity investment. Forward-looking statements made or incorporated by reference herein are not guarantees of future performance. In addition, forward-looking statements may be included in various other PictureTel documents to be issued in the future and in various oral statements by PictureTel representatives to security analysts and investors from time to time. Any forward-looking statements are subject to risks that could cause the actual results to vary materially. Such risks are discussed in "Risk Factors Which May Affect Future Results" and in other related portions of this document.

Business Developments

In early 2000, the Company adopted and is now pursuing a three-pronged approach to meeting the anticipated needs of the developing multimedia collaboration marketplace. First, in conjunction with Intel, it is developing its next generation endpoint conferencing products for video, voice and data collaboration. Second, it is expanding its enterprise-wide solutions services beyond management of multipoint videoconferences to include streaming video services, custom integration, and outsourced management of enterprise conferencing. The last prong is the development of Internet-based, multimedia application services built around a network-neutral collaboration hub. As part of this approach, PictureTel entered into a distribution and joint product development agreement with Intel, Inc. PictureTel and Intel agreed to jointly develop videoconferencing and collaboration products based on a common PC-based technology platform. These joint development efforts resulted in the new iPower™ architecture. Use of this single architecture improves ease of use and functionality, while reducing both product and associated support costs. The Company has focused its development and engineering resources on new products evolving around the iPower™ architecture. The first products developed, the PictureTel 900 Series, were introduced in August 2000. Additional new product series are planned for introduction in 2001, with the earliest being scheduled for release in the second quarter of 2001.

In addition to meeting marketplace needs, the Company has focused its business plan on improving liquidity, disposition of non-core business assets, consolidation opportunities and process improvement.

The Company took several steps during 2000 to improve the Company's liquidity. On July 24, 2000, the Company consummated a preferred stock transaction resulting in funding of $21,845 through issuance of Series B redeemable convertible preferred shares. In addition to the stock transaction, in August 2000, the Company obtained an asset-based secured revolving line of credit with a limit of up to $35,000.

With regard to disposition of non-core business assets, the Company sold its Starlight division, in exchange for a $300 note receivable, on October 12, 2000, resulting in estimated expense reductions of approximately $1,800 and on November 27, 2000, the Company sold its audioconferencing subsidiary, MultiLink, Inc., for $25,900 in cash. These dispositions have strengthened the Company's liquidity position by reducing future anticipated cash outflows.

Real estate consolidation opportunities were negotiated with the landlord of the Company's various facilities located on Minuteman Road in Andover, Massachusetts. During the third quarter of 2000, the lease at 200 Minuteman Road was terminated. Related lease termination charges amounted to $15,142 and restricted cash and deposits, amounting to approximately $4,000, were returned to the Company as available funds. Anticipated annualized reductions in rent and related costs associated with the 200 Minuteman facility are approximately $4,500. At the end of the fourth quarter, lease options held by the landlord on 50 and 100 Minuteman Road facilities were exercised and resulted in a one-time net charge of $7,654 and restricted cash of approximately $6,850 became unrestricted.

Management has reduced operating expense quarter over quarter during the year ended December 31, 2000, as follows:

	Quarter Ended				
	April 1, 2000	**July 1, 2000**	**September 30, 2000**	**December 31, 2000**	**Total**
Operating expense, as reported	$40,762	$43,673	$56,858	$35,085	$176,378
Significant/other charges	—	4,139(a)	23,615(b)	7,654(c)	35,408
Operating expense, as adjusted	$40,762	$39,534	$33,243	$27,431	$140,970

(a) Impairment charge relating to intangible assets.

(b) Lease termination charge of $15,142, $1,205 write-off of capitalized costs related to Web development, $6,207 for costs associated with the beneficial conversion feature of the preferred stock issuance and $1,061 for severance and other.

(c) Lease termination charge, net.

Operating expense, as adjusted, for the quarter ended December 31, 2000 compared to the quarter ended July 1, 2000 was $27,431 compared to $39,534, a reduction of $12,103, or 31%. The reduction was principally due to the effects of plans implemented by management and result from real estate consolidation, disposition of non-core business assets, noted above, as well as staff reductions and other initiatives. Management is continuing the review process and plans to further reduce operating expense and improve working capital measures.

In early 2000, the Company announced the formation of 1414c, Inc., a wholly-owned subsidiary established to provide application service providers (ASPs) access to a broad range of IP-based interactive communication solutions. These solutions will enable ASPs to provide rapid Web access to streaming, videoconferencing, Voice-over-IP, and other Web-enabled interactive solutions such as call scheduling and launching. The Company is currently exploring joint venture and other financing opportunities to develop this activity.

Year ended December 31, 2000 Compared to the Year ended December 31, 1999

Revenue. The Company reported revenue of $245,149 in the year ended December 31, 2000, compared to $323,995 in the previous year, a decrease of $78,846, or 24%. The overall decrease is principally attributable to declining sales of legacy group videoconferencing systems (Concorde 4500™ and Venue 2000™), which were not offset by sales of the new iPower™ PictureTel 900 Series, lower average selling prices on new system units, and changes in product sales mix. In addition, as a result of changes during 2000 associated with a change in the Company's management of certain channel partners, the Company deferred sales of approximately $8,000 as of December 31, 2000, due to changes over the last year in our product portfolio, the expansion of our global distribution and the credit risk associated with these geographies.

Revenue from sales to foreign markets was approximately 44% and 46% of total revenue in 2000 and 1999, respectively. The Company expects that international revenue will continue to account for a significant portion of total revenue. Revenue from 2000 sales to foreign markets was principally comprised of sales originating in the United States of $20,019, the United Kingdom of $51,129 and Japan of $20,305. Revenue from sales to foreign markets in 1999 were principally comprised of sales originating in the United States of $27,822, the United Kingdom of $65,654 and Japan of $27,055.

Gross Margin. Overall gross margin dollars decreased $45,184, or 44%, to $56,952 in 2000 versus 1999. This decrease is principally attributed to lower dollar volume and significant charges, including a $4,721 charge necessary to reduce legacy PC-based inventory to net realizable value and an impairment charge of $6,905 to write-down purchased software, associated with the Starlight division. Gross margin as a percentage of revenue was 23% in 2000 compared to 32% in 1999. In addition to the significant charges, under-absorption of manufacturing variances on lower revenue, lower selling prices resulting from competitive pricing pressures on legacy product offerings and an inability to reduce costs related to products approaching end-of-life contributed to the decreased margin percentage.

Operating Expense. Selling, general and administrative expense of $129,595 increased $3,305, or 3%, from 1999 and increased as a percentage of revenue to 53% from 39%. Research and development expense, inclusive of all engineering costs, of $46,783 decreased $19,347, or 29%, during 2000 as compared to prior year. As a percentage of revenue, research and development expense was nearly consistent year over year at 19% and 20% in 2000 and 1999, respectively. The Company did not capitalize any software costs in either 2000 or 1999, as these costs were deemed immaterial. Total operating expense of $176,378 for 2000 was 8% lower than total operating expense in the prior year. Significant charges totaling $35,408 were included in operating expense for the year ended December 31, 2000. These charges included $22,796 in lease termination costs associated with the Company's 200 and 50 Minuteman Road facilities, a $1,205 write-off of capitalized website development costs, $917 of severance charges related to headcount reduction, $6,207 for costs associated with the beneficial conversion feature of the Series B preferred stock issuance and $4,283 of impairment charges related to the write-down of tradename and assembled workforce for a division of the Company's videoconferencing products segment. Without these charges, operating expense for the year ended December 31, 2000 declined $38,838, or 23%, as compared to operating expense, exclusive of significant charges totaling $9,261, for the year ended December 31, 1999.

Videoconferencing Products. The videoconferencing products segment develops, manufactures, and markets a full range of videoconferencing and advanced collaboration solutions. Videoconferencing products scale from personal/desktop systems to large conference room solutions. Additionally, the segment markets a wide range of network infrastructure products and peripheral devices. Videoconferencing product revenue decreased 32% to $159,160 in 2000 from $233,249 in 1999. The decrease in revenue is primarily due to declining sales in legacy product systems, which were not offset by increases in new product sales. In the third quarter of 2000, the Company introduced a new line of advanced collaboration solutions based on PictureTel's iPower™ architecture developed jointly by PictureTel and Intel®. The PictureTel 900 Series delivers superior audio and video capabilities and advanced information sharing in a flexible open-PC platform. The decrease in year over year revenue is further attributed to lower average selling prices on new system units, increased competition and changes in product sales mix. In addition, as a result of changes during 2000 associated with a change in the Company's management of certain channel partners, the Company deferred sales of approximately $8,000 as of December 31, 2000, due to changes over the last year in our product portfolio, the expansion of our global distribution and the credit risk associated with these geographies.

The videoconferencing products segment generated an operating loss of $74,161 in 2000 compared with a $68,409 operating loss in 1999, an increase of 8%. Significant effort and investment went into the development and launch of the PictureTel 900 Series products. Product development, selling and marketing efforts were all focused on product introduction activities. These efforts only began to yield corresponding revenue in the second half of 2000. Significant charges of $12,599 and $4,062 are included in the 2000 and 1999 operating losses, respectively. Of these charges, $6,905 impacted gross margin in 2000 and $329 impacted gross margin in 1999. The 2000 charges reflect impairment charges totaling $11,188 related to the write-down of certain intangible assets, $1,205 write-off of capitalized website development costs and $206 in severance charges related to headcount reduction. Excluding the significant charges, the operating loss in 2000 would have been $61,562 compared to $64,347 in 1999, a 4% improvement.

Gross margin for the videoconferencing products segment in 2000 was 23% as compared to 34% in 1999. Excluding significant charges in both years, gross margin was 27% and 34% in 2000 and 1999, respectively. Margin declined, in part, due to increased competitive pricing pressures on legacy product offerings and an inability to reduce costs related to products approaching end-of-life. In addition, margins were unfavorably impacted by a charge to reduce legacy PC-based inventory to net realizable value and under-absorption of fixed manufacturing costs on lower revenue.

Videoconferencing Services. The videoconferencing services segment provides maintenance as well as professional consulting and management services for videoconferencing products sold by the Company and its competitors. Segment revenue decreased 1% from $70,304 in 1999 to $69,741 in 2000. Maintenance revenue was 4% lower than the prior year while professional services increased 5%. The professional services growth came largely from managing multipoint videoconferences for customers.

Operating profits were $9,585 in 2000, which represents a 222% increase from the prior year's $2,976 figure. The increase is largely due to the absence in 2000 of excessive charges incurred in 1999 for spare parts obsolescence, higher selling expenses and development costs associated with new service offerings.

Year ended December 31, 1999 Compared to the Year ended December 31, 1998

Revenue. Total 1999 revenue of $323,995 decreased $83,148, or 20%, from prior year levels. Lower average selling prices and changes in the videoconferencing products sales mix to more products at the lower end of the product line principally account for the decline. The Company's revenue from sales to foreign markets was approximately 46% and 43% of total revenue in 1999 and 1998, respectively. The Company expects that international revenue will continue to account for a significant portion of total revenue. Revenue from 1999 sales to foreign markets was principally comprised of sales originating in the United States of $27,822, the United Kingdom of $65,654 and Japan of $27,055. Revenue from sales to foreign markets in 1998 were principally comprised of sales originating in the United States of $35,618, the United Kingdom of $79,396 and Japan of $24,747.

Gross Margin. Overall gross margin decreased $70,930, or 41%, to $102,136 in 1999 versus 1998. Gross margin as a percentage of revenue was 32% in 1999 compared to 43% in 1998. Both declines were primarily caused by lower average selling prices coupled with increased relative sales of lower margin products in the videoconferencing products segment. Higher videoconferencing services costs also contributed to the lower gross margin performance.

Operating Expense. Selling, general and administrative expense decreased $4,372, or 3%, from 1998 but increased as a percentage of revenue to 39% from 32%. A 25% headcount decrease, partially offset by $2,554 of severance and related expense, $2,550 settlement cost of shareholder litigation, and $2,481 related to subleasing excess real estate, is responsible for the lower dollar expenses. Research and development expense of $66,130 was essentially the same as in 1998 and represented 20% and 16% of revenue for 1999 and 1998, respectively. Research and development expenditures, prior to the capitalization of software costs, were $73,500 in 1998, or 18% of revenue. The Company capitalized software costs of $7,446 in 1998, excluding completed technology purchased as part of the Starlight acquisition. No such costs were capitalized in 1999, as no current projects in progress had achieved technological feasibility.

Videoconferencing Products. The videoconferencing products segment develops, manufactures and markets visual communications systems and collaboration software. Videoconferencing products scale from personal/desktop systems to large conference room solutions. Additionally, the segment markets a wide range of network infrastructure products and peripheral devices. Videoconferencing product revenue decreased 28% to $233,249 in 1999 from $324,478 in 1998. The decrease can be attributed to lower average selling prices and significant changes in product sales mix. Trends toward lower average selling prices are expected to continue in response to increased competition. Shifts in sales mix from large room systems such as the Concorde and Venue product lines to compact class room systems, such as SwiftSite II and Intel® TeamStation™ System, continued in 1999. Traditional large room systems represented 36% of total room system sales in 1999 compared with 62% in 1998. Overall unit sales grew only 2% versus the prior year with room systems increasing 13% and personal systems decreasing 6%. Revenue was further impacted by a delay in releasing SwiftSite II, a next generation compact room system, until the second quarter of 1999, and lower investment in legacy product features and functionality. Significant resources have been redirected to next generation products being jointly developed with Intel Corporation that are scheduled for release starting in the second quarter of 2000.

The videoconferencing products segment generated an operating loss of $68,409 in 1999 compared to a $16,049 operating loss in 1998. Significant charges of $4,062 and $11,250 are included in the 1999 and 1998 losses, respectively. Severance and other workforce reduction related costs account for the 1999 charges. The 1998 charges included $4,442 for incomplete technology acquired in connection with the November 1998 acquisition of Starlight Networks plus $6,808 related to the write-down of inventory and capitalized software to their net realizable value plus other costs associated with discontinuance of a video network server product line.

Absent these charges the videoconferencing product segment operating losses would have been $64,347 in 1999 versus $4,799 in 1998. Lower revenue, decreased software development cost capitalization, capitalized software amortization related to SwiftSite II, and amortization of goodwill and completed technology purchased as part of the Starlight acquisition were the primary contributors to the earnings decline. Ongoing operating expenses excluding capitalized software decreased approximately 12% versus 1998 as segment headcount was reduced by nearly 40% during the year in response to lower revenue expectations. Gross margin was 34% in 1999 excluding charges compared with a 1998 figure of 46%.

Videoconferencing Services. The videoconferencing services segment provides maintenance as well as professional consulting and management services for videoconferencing products sold by the Company and its competitors. Segment revenue increased 18% from $59,760 in 1998 to $70,304 in 1999. Maintenance revenue was 10% higher than the prior year while professional services increased 35%. The professional services growth came largely from managing multipoint videoconferences for customers and from custom product integration sales and services.

Operating profits were $2,976 in 1999, which represents a 59% decrease from the prior year's $7,191 figure. Higher average costs for contracted services, increased provision for spare parts obsolescence, higher selling expenses, and development costs associated with new service offerings are responsible.

Other

Net Interest Income (Expense). The Company had net interest expense of $2,082 in 2000 compared with net interest expense of $375 in 1999 and $1,948 of net interest income in 1998. The decreasing trend from 1998 to 2000 resulted primarily from reduced interest income on lower invested cash balances, which has offset interest expense associated with capital leases and short-term borrowings.

Other Income (Expense). Other income of $15,707 in 2000 includes a $15,245 gain on the sale of MultiLink, Inc., a $104 gain on the sale of Starlight Networks and net gains on foreign currency transactions. Other income of $10,517 in 1999 consists principally of net gains on foreign currency transactions and a $8,495 gain from the third quarter sale of RealNetworks shares acquired through an investment in a company later acquired by RealNetworks. Net gains on foreign currency transactions are also the primary component of 1998's other income of $1,804.

Income Taxes. The Company's effective tax rate for 2000, 1999, and 1998 was 1%, 6%, and 180%, respectively. The 2000, 1999 and 1998 rates differ from the federal statutory rate due to state and foreign taxes and an increase in the valuation allowance for deferred taxes. Due to uncertainty surrounding the Company's ability to fully realize deferred tax assets, PictureTel established a full valuation allowance against its deferred tax assets in 1998 and recognized no deferred tax benefits in 1998, 1999 or 2000.

Liquidity and Capital Resources

At December 31, 2000 the Company had $43,441 in unrestricted cash and cash equivalents. Operating activities used $57,913 of cash during 2000 and used $65,369 of cash during 1999. The primary operating use of cash during 2000 was to fund operating losses in excess of non-cash expense. The Company paid $2,371 of accrued severance and restructuring charges during 2000 and had a remaining accrual in the amount of $1,430 for such items as of December 31, 2000 that will be paid over the next twelve months.

Investing activities provided $57,489 of cash in 2000 compared with a $3,465 usage during the previous year. Maturation and conversion of marketable securities into cash generated a primary source of cash in both 2000 and 1999. Proceeds of $25,900 from the sale of MultiLink provided an additional source of cash in 2000.

Financing activities generated $21,409 of cash in 2000 compared with $27,736 provided in 1999. The principal source of cash from financing activities was from the issuance of convertible preferred stock in both 2000 and 1999. Proceeds from issuance of convertible preferred stock amounted to $21,845 and $30,500 in 2000 and 1999, respectively. An increase in restricted cash balances and principal payments on capital leases constituted major uses of cash in both 2000 and 1999, though lease payments in 2000 were reduced due to the termination of capital leases.

Liquidity is a major priority for the Company. The Company entered into a new asset-based secured revolving credit agreement dated August 21, 2000, which will expire on August 21, 2003. The new credit facility provides a revolving credit line of up to $35,000 with Congress Financial Corporation (New England) (the "Lender"). The availability for borrowings under the new credit facility are variable based on eligible receivables and is subject to a $10,000 minimum reserve, which is available at the Lender's discretion. The Company is required to maintain cash collateral equal to 105% in an account held at the Lender of the outstanding obligations or an equal dollar amount of eligible receivables. At December 31, 2000, availability based on receivables and net of the $10,000 discretionary reserve was $4,448. Interest for loans under this facility is payable at 1% above the Lender's prime rate. There were no borrowings outstanding against the calculated receivable availability at December 31, 2000. The Company has $5,500 of outstanding standby letters of credit issued under this agreement as of December 31, 2000. The letters of credit have been collateralized 105% and are in an account held at the Lender. Cash subject to the cash collateral requirement amounts to $5,775 and is classified as current on the Company's balance sheet at December 31, 2000. Fees for letters of credit outstanding against this facility are payable at 225 basis points per annum of the face amount. The secured letters of credit expire between September 2001 and December 2001. This credit agreement also contains certain financial covenants, including minimum net worth and working capital requirements. This new credit facility replaces the amended facility entered into in May 2000. A term loan provided by the amended credit facility in the amount $8,500 was paid in full in July 2000 from a portion of the proceeds of the Series B Preferred Stock issued in the third quarter of 2000. (See also Note 9.)

Local lines of credit are available for short-term advances of up to $1,487 to certain of the Company's foreign subsidiaries. The agreements require interest payable up to one and three-quarter percent, per annum. Borrowings totaling $1,487 were outstanding against these local lines of credit at December 31, 2000.

In 2000, management disposed of non-core assets, raised equity and implemented expense reductions which are expected to reduce 2001 quarterly operating expenses substantially compared to the amounts incurred in 2000. Margins are expected to improve from levels experienced in 2000, since significant charges related to asset impairment and necessary provisions for inventory losses are not expected to recur in 2001. Additionally, management has implemented plans for further operating expense reductions as well as margin improvement.

Working capital management is expected to improve due to hiring a new credit manager and strengthening of procedures with respect to sales and collections. Management is in the process of challenging terms with vendors to more closely align those terms with other working capital measures.

Management expects to introduce the next generation of its product line in the second quarter of 2001. These products rely on the same iPower™ architecture as the PictureTel 900 Series which was introduced in 2000. Reliance on this architecture reduces development time and cost, as well as the technological risk associated with a new product introduction. Further, the expected price points will be competitive and features are expected to exceed offerings in the industry.

The Company has engaged Robertson Stephens, an investment banking firm, to advise management with respect to enhancing shareholders' value under various types of alternatives.

In March 2000, the Company received a report from our independent accountants containing an explanatory paragraph stating that our recurring losses and requirement for additional financing raise substantial doubt about our ability to continue as a going concern. Management's plans to continue as a going concern rely heavily on forecasted revenue from new products being jointly developed with Sharp and Intel Corporation, including recently introduced new products utilizing the new iPower™ architecture, new multimedia applications services, and enhanced compact videoconferencing systems and on continued implementation of cost reductions. There can be no guarantee that either such revenue increase will occur or, if it does occur, will be sufficient to meet the Company's needs or that cost reduction measures will be sufficient to maintain liquidity.

The Company has operating leases for various rented properties. The Company signed an agreement to sublease MultiLink's former facility at 6 Riverside Drive in Andover, Massachusetts in May 1999 as part of its space consolidation efforts. As of December 31, 2000, the remaining obligation under this operating lease was $7,125. After giving effect to expected sublease income, this obligation is $4,748. In addition, in June 1998, the Company subleased its property at 50 Minuteman Road for a ten-year term. As of December 31, 2000, the remaining obligation under this operating lease was $19,220. After giving effect to expected sublease income, the remaining obligation under the operating lease was $1,209.

In October 1998, the Board of Directors authorized a plan to repurchase up to 1,000,000 shares of the Company's Common Stock in open market, privately negotiated or other transactions. No shares were repurchased during 2000. The Company repurchased 70,000 shares during 1999 at a cost of $556 (approximately $7.94 per share). In addition, 22,065 shares were returned to the Company from shares held in escrow related to the MultiLink acquisition. There are no definitive plans to repurchase the additional shares under the plan.

Recently Issued Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." This statement, as amended, was originally effective for all fiscal years beginning after June 15, 1999. In June 1999, the FASB issued Statement 137, which delayed the effective date of Statement 133 by one year. Statement 133 will be effective for PictureTel's fiscal year beginning January 1, 2001. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The Company is currently evaluating the effects of this change but anticipates that the adoption of SFAS 133 will not have a significant effect on the Company's financial position or results of operations.

Risk Factors Which May Affect Future Results

The following risk factors relating to the business of PictureTel and certain forward-looking statements contained herein should be considered by current and prospective investors of PictureTel stock. These factors should be considered in conjunction with other information contained in this document.

New Products, Cost Reductions, Technological Change, and Evolving Markets. The Company is engaged in an industry that is still emerging as a result of extensive research and development efforts and which continues to bring to market new, more technologically advanced products introduced on an accelerated basis. Simultaneously, the larger telecommunications market is in a heightened competitive state due to deregulation throughout the world. In order to maintain its market share in this fast-paced emerging market, the Company must continue to introduce, through internal development or by acquisition, joint venture or other collaborative arrangements, significant innovative, technologically leading and cost-competitive products. There can be no assurance that such new products will be introduced by the Company, or if introduced, will be accepted by the market and its customers. In January 1999, the Company entered into a distribution and joint product development agreement with Intel Corporation. The Company announced that it began shipping the resulting product (known as the 900 Series) in mid August 2000. However, there can be no assurance that the products produced by this partnership will be accretive to the Company's results of operations and financial condition, or if accretive will, by themselves return the Company to profitability. In addition to offering products that operate in an integrated service digital network (ISDN) environment, the Company and its competitors are exploring new technologies and networks, such as the Internet and corporate intranets or LANs, for delivering videoconferencing and data collaboration services. The industry standards for such new technologies and networks, however, are still in the early stages of development, which the Company believes has led to customer uncertainty and, accordingly, a slowdown in the growth of the general market for videoconferencing products. As a result of customer preferences, the Company continues to experience a shift in its sales model to videoconferencing systems with lower average selling prices. There can be no assurance that the Company will be successful in implementing cost reductions for all of its products or in developing and marketing suitable new products and related services with attractive margins for these new technologies and networks. The possible transition, migration and/or convergence of technologies is difficult to predict and could have profound implications for the industry and the business of the Company. Further, there is significant risk that existing products could be rendered obsolete due to changing technology. The Company's failure to develop and market new products on a timely basis or to enhance its existing products or to respond effectively to technological changes, new industry standards or product announcements by competitors could have a material adverse effect on the Company's business, financial condition and results of operations.

Competition. This increased competition resulting from such partnerships and acquisitions, together with mergers among competitors and a slowdown in the growth of the general market for visual collaboration products, has led and may continue to lead to increases in the defection or dilution of PictureTel's distribution channel partners to competitors, decreases in average selling prices and margins in both group and desktop visual collaboration systems, and a lower segment market share by PictureTel for products and services in the emerging area of network-based visual collaboration. In some cases, PictureTel competes with its channel partners for various services, which increases the complexity of channel management. In addition, competitors may offer network-based visual collaboration software solutions or incorporate standard algorithms into processor chips free of additional charge, which may reduce the value PictureTel technology provides to the market, especially in its lower end visual collaboration products. In addition, the prices which PictureTel is able to charge for its visual collaboration products and services may continue to decrease as a result of new product introductions by competitors, price competition, technological advances, or otherwise. Any of these factors could have a material adverse effect on PictureTel's business, financial condition and results of operations.

Manufacturing. Certain key subassemblies and products are currently available only from one vendor. In addition, several vendors are corporations with limited financial resources that could in the future prove to be inadequate. In some cases components are sourced from only one vendor, even where multiple sources are available, to maintain quality control and enhance the working relationship with the vendor. In addition, the Company from time to time enters into development arrangements with third parties to develop and incorporate new features and functions into the Company's products. Failure of these third parties to fulfill their respective obligations under these development arrangements could have a material adverse effect on the Company's business, financial condition and results of operations. The Company's business could also be adversely affected by delays or interruptions in delivery, and poor quality of supplies, subassemblies or products from key vendors. In addition, the Company designs and procures certain circuits, components and subassemblies from non-videoconferencing divisions of its competitors, such as Sharp, Sony and Panasonic Corporation. The failure to obtain adequate supplies or the requirement to redesign and source supplies from another manufacturer may take substantial time and result in significant expense, each of which could adversely impact product shipments and materially and adversely affect the Company's business, financial condition or results of operations.

Recent History of Losses; Liquidity Risks. The Company's revenue decreased 24% during 2000 as compared to 1999 and decreased 20% between 1999 and 1998. Losses from operations were $119,426, $90,284, and $23,650 in 2000, 1999, and 1998, respectively. Liquidity is a major priority for the Company. The Company's negative operating results have adversely impacted the Company's relationship with customers, vendors and employees, as well as its liquidity. Further negative operating results could effect the Company's ability to remain in compliance with covenants under its revolving credit agreement and further diminish its liquidity. In March 2000, the Company received a report from our independent accountants containing an explanatory paragraph stating that our recurring losses and requirement for additional financing raise substantial doubt about our ability to continue as a going concern. Management's plans to continue as a going concern rely heavily on forecasted revenue from new products being jointly developed with Sharp and Intel Corporation, including recently introduced new products utilizing the new iPower™ architecture, new multimedia applications services, and enhanced compact videoconferencing systems and on continued implementation of cost reductions. There can be no guarantee that either such revenue increase will occur or, if it does occur, will be sufficient to meet the Company's needs or that cost reduction measures will be sufficient to maintain liquidity.

Product Protection and Intellectual Property. The Company's success depends in part on its proprietary technology. The Company attempts to protect its proprietary technology through patents, copyrights, trademarks, trade secrets and license agreements. In absence of broad patent protection, which is not likely, and despite the Company's reliance upon its proprietary confidential information, competitors of the Company have been able to use algorithms, or other features similar to those used by the Company, to design and manufacture products that are directly competitive with the Company's products. The Company believes that due to the rapid pace of technological change in the visual collaboration industry, legal protection for its products is less significant than factors such as the Company's use, implementation and enhancement of standards-based open architecture and the Company's ongoing efforts in product innovation.

Although the Company does not believe that its products infringe the proprietary rights of any third parties, third parties have asserted infringement and other claims against the Company from time to time. There can be no assurance that third parties will not assert such claims against the Company in the future or that such claims will not be successful. The Company could incur substantial costs and diversion of management resources with respect to the defense of any claims relating to proprietary rights, which in turn could have a material adverse effect on the Company's business, financial condition and result of operations.

Potential Fluctuations of Quarterly Operating Results. The majority of the Company's revenues in each quarter result from orders booked in that quarter, and a substantial portion of the Company's orders and shipments typically occur during the last weeks of each quarter such that forecasting of revenue and product mix is both complex and difficult. Unanticipated variations in the timing of receipt of customer orders in any quarter may produce significant fluctuations in quarterly revenues. As a result, a shortfall in revenue compared to internal expectations may not evidence itself until late in the quarter and any resulting impact on earnings may not be determinable until several weeks after the end of the quarter. The Company's ability to maintain or increase net revenues depends upon its ability to increase unit volume sales; the Company has not been successful in increasing unit volume sales during the year 2000. There can be no assurance that the Company will be able to increase or to maintain the current level of unit volume sales in the year 2001. Other factors which may cause period-to-period fluctuations in operational results include the timing of new product announcements and introductions by the Company and its competitors, market acceptance of new or enhanced versions of the Company's products, changes in the product mix of sales, changes in the relative proportions of sales among distribution channels or among customers within each distribution channel, changes in manufacturing costs, and general economic factors.

International Operations. Revenue related to international operations of the Company totaled approximately 44%, 46%, and 43% of total revenues for the three years ended December 31, 2000, 1999, and 1998, respectively. Management of the Company expects international revenues to continue to constitute a significant portion of total revenues in future periods. However, there can be no assurance that the Company will be able to maintain or increase international market demand for its products and, to the extent the Company is unable to do so, its business, financial condition, results of operations or cash flows could be materially adversely affected. The Company's sales to international distributors are denominated in U.S. dollars in order to minimize risks associated with fluctuating foreign currency rates. An increase in the value of the U.S. dollar relative to other currencies, however, could make the Company's product more expensive and, therefore, potentially less competitive in foreign markets. Sales by the Company's foreign subsidiaries are generally made in the foreign subsidiary's local currency, in which case fluctuations in the value of the U.S. dollar relative to such other currencies could have a material adverse effect on the operating results of the Company. Currently, the Company employs various currency hedging strategies to reduce these risks. In addition, a significant portion of the Company's revenue is derived from Asian markets. Given the current general weakness in the Asian markets, there can be no assurance that the Company will be able to sustain current revenue levels or growth in such markets. There can be no assurance that the above factors will not have a material adverse effect on the Company's future international sales and, consequently, on its business, financial condition, results of operations or cash flows.

Volatility of Stock Price. As is frequently the case with the stocks of high technology corporations, the market price of PictureTel Common Stock has been, and may continue to be, volatile. Factors such as quarterly fluctuations in results of operations, increased competition, the introduction of new products by the Company and by its competitors, changes in the mix of products and sales channels, the timing of significant customer orders, and macroeconomic conditions generally, may have a significant adverse effect on the market price of the Company's stock in any given period. In addition, the stock market has, from time to time, experienced extreme price and volume fluctuations, which have particularly affected the market price for many high technology corporations and which, on occasion, have appeared to be unrelated to the operating performance of such corporations. Past financial performance should not be considered a reliable indicator of future performance and investors should not use historical trends to anticipate results or trends in future periods. Any shortfall in revenue or earnings from the levels anticipated by securities analysts could have an immediate and significant adverse effect on the market price of PictureTel Common Stock in any given period.

Dependence on Key Personnel. On August 31, 1999, the Company announced that Dr. Norman Gaut had succeeded Bruce R. Bond as Chairman of the Board, CEO and President of the Company. In February 1998, Mr. Bond succeeded Dr. Gaut as Chief Executive Officer and President and had been elected Chairman of the Board in June 1998. At that time, Dr. Gaut had retired as an active employee while remaining a member of the Board of Directors. Dr. Gaut accepted this 1999 position at a difficult time for the Company. On June 19, 2000, Mr. Lewis Jaffe became President and Chief Operating Officer of the Company, while Dr. Gaut remained Chairman and Chief Executive Officer. The Company appointed Mr. Ralph Takala, a principal of Altman and Associates as its interim Chief Financial Officer on June 15, 2000, following the resignation of its previous Chief Financial Officer. On January 9, 2001 the Company announced that Mr. Dalton Edgecomb would become its Chief Financial Officer. The Company depends on a limited number of key senior management personnel, including Norman Gaut; Lewis Jaffe; Dalton Edgecomb; Jonathan Kosheff, Vice President, Operations; Edward Semonite, Vice President, Marketing; Amit Akkad, Vice President, Services; David Snow, Vice President, Worldwide Sales; and W. Robert Kellegrew, Jr., Vice President, General Counsel and Treasurer. There has been, and continues to be, considerable turnover in the Company's senior management team over the past several years, and the loss of the services of one or more of the Company's senior management team or the inability to attract, retain, motivate and manage additional key personnel could have a material adverse effect on the business, financial condition or operating results of the Company. In addition, the Company has made redundant a number of positions and continues to experience significant voluntary employee attrition from engineering and other departments. There is no assurance, given the competitive nature of the current job market, that the Company will be able to adequately fill the open positions.

Euro. On January 1, 1999, eleven of the fifteen member countries of the European Union established fixed conversion rates between their existing sovereign currencies and established the euro, making the euro their common legal currency on that date. Based on a recent assessment, the euro conversion is not anticipated to have a material impact on the Company's business.

Item 7a. *Quantitative and Qualitative Disclosures About Market Risk*

The Company and its subsidiaries face exposures to financial market risks, including adverse movements in foreign currency exchange rates and changes in interest rates. The Company's primary currency exposure has been related to foreign currency denominated receivables and receivables denominated in a currency other than the functional currency. Historically, the Company has hedged currency exposures associated with foreign currency denominated receivables by entering into foreign currency forward contracts as a hedge against the foreign currency receivable transaction. Forward contracts generally have a maturity date within four to six months of the contract date. The goal of the Company's hedging activity is to minimize the exposures inherent in these transactions. The Company's hedging activities minimize the Company's exchange rate risk because the gains and losses on these contracts offset the losses and gains on the transactions being hedged.

The following table represents hypothetical changes in fair value in the Company's foreign currency forward contracts. The modeling technique measures the fair value of the forward contract by currency type arising from potential changes in foreign currency rates. Movements in foreign currency rates of plus or minus 3% and 6% reflect hypothetical shifts in fair value of these forward contracts. "No change in currency rates" represents the market value of each market-rate sensitive currency as of December 31, 2000. All values are represented in U.S. dollar equivalents:

Forward contract currency type	Valuation of forward given a currency rate increase of 3%	Valuation of forward given a currency rate increase of 6%	No change in currency rates	Valuation of forward given a currency rate decrease of (3%)	Valuation of forward given a currency rate decrease of (6%)
Functional Currency — USD					
British Pound	$2,195	$2,258	$2,131	$2,067	$2,003
Japanese Yen	2,045	2,105	1,986	1,926	1,867
German Deutschemark	753	775	731	709	687
Australian Dollar	1,235	1,271	1,199	1,163	1,127
Functional Currency — Germany					
U.S. Dollar	$ 144	$ 148	$ 140	$ 136	$ 132

The Company's cash is primarily held in high investment grade quality mutual funds. Cash can be accessed daily to meet the Company's operational needs. As a result, the Company does not have any market risk due to the liquidity of the Company's cash.

Item 8. ***Financial Statements and Supplementary Data***

PICTURETEL CORPORATION

INDEX TO FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders and Board of Directors of
PICTURETEL CORPORATION:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of PictureTel Corporation and its subsidiaries at December 31, 2000 and December 31, 1999, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has incurred recurring losses from operations and requires additional financing. These factors raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

PricewaterhouseCoopers LLP

Boston, Massachusetts
February 21, 2001

PICTURETEL CORPORATION

CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share data)

	December 31, 2000	December 31, 1999
ASSETS		
Current assets:		
Cash and cash equivalents	$ 43,441	$ 21,915
Restricted cash and cash equivalents	5,775	1,200
Marketable securities	—	37,787
Accounts receivable, less allowances for doubtful accounts of $4,100 and $5,642 at December 31, 2000 and 1999, respectively	39,897	73,483
Inventories	27,020	32,930
Other current assets	9,716	12,562
Total current assets	125,849	179,877
Property and equipment, net	18,310	86,219
Capitalized software costs, net	—	11,341
Goodwill, net	—	4,242
Other assets	2,861	9,554
Total assets	$ 147,020	$ 291,233
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	$ 1,487	$ 196
Accounts payable	20,575	21,681
Accrued compensation and benefits	7,280	10,517
Accrued expenses	31,610	32,166
Accrued income taxes	1,286	5,352
Current portion of capital lease obligations	—	1,782
Deferred revenue	18,216	25,189
Total current liabilities	80,454	96,883
Other non-current liabilities	2,101	—
Capital lease obligations, net of current portion	—	54,584
Total liabilities	82,555	151,467
Commitments and contingencies		
Redeemable convertible preferred stock, $.01 par value	42,845	30,500
Stockholders' equity:		
Preferred stock, $.01 par value 1,500,000 shares authorized; 0 issued and outstanding at December 31, 2000 and December 31, 1999		
Common stock, $.01 par value; 80,000,000 shares authorized; 45,049,032 and 40,617,634 shares issued and outstanding at December 31, 2000 and 1999, respectively	450	406
Additional paid-in capital	245,399	225,513
Accumulated deficit	(221,751)	(114,780)
Accumulated other comprehensive loss	(1,922)	(1,317)
Treasury stock, 92,065 shares, at cost	(556)	(556)
Total stockholders' equity	21,620	109,266
Total liabilities, redeemable preferred stock and stockholders' equity	$ 147,020	$ 291,233

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

PICTURETEL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in thousands, except per share amounts)

	Year Ended December 31, 2000	1999	1998
Revenue:			
Product revenue	$ 174,071	$251,914	$346,067
Service revenue	71,078	72,081	61,076
Total revenue	245,149	323,995	407,143
Cost of revenue:			
Product cost of revenue	128,252	159,005	185,725
Service cost of revenue	59,945	62,854	48,352
Total cost of revenue	188,197	221,859	234,077
Gross margin	56,952	102,136	173,066
Operating expense:			
Selling, general and administrative	129,595	126,290	130,662
Research and development	46,783	66,130	66,054
Total operating expense	176,378	192,420	196,716
Loss from operations	(119,426)	(90,284)	(23,650)
Interest income	2,886	4,261	4,857
Interest expense	4,968	4,636	2,909
Other income, net	15,707	10,517	1,804
Loss before income tax expense	(105,801)	(80,142)	(19,898)
Income tax expense	(1,170)	(4,384)	(35,781)
Net loss	(106,971)	(84,526)	(55,679)
Preferred stock beneficial conversion feature	(6,900)	(5,612)	—
Net loss applicable to common shareholders	$(113,871)	$(90,138)	$(55,679)
Net loss per common share — basic and diluted	$ (2.73)	$ (2.23)	$ (1.45)
Weighted average common shares outstanding — basic and diluted	41,739	40,376	38,527

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

PICTURETEL CORPORATION

CONSOLIDATED STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2000, 1999 and 1998
(Dollars in thousands, except share amounts)

	Redeemable Convertible Preferred Stock		Common Stock		Addt'l Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Treasury Stock		Total Stockholders' Equity
	Shares	Amount	Shares	Par Value					Shares	Cost	
Balance, December 31, 1997	—	—	38,040,363	$380	$204,242	$ 25,425	$(2,082)		—	—	$ 227,965
Exercise of employee stock options	—	—	232,068	2	979	—	—		—	—	981
Employee stock purchase plan shares	—	—	286,074	3	2,345	—	—		—	—	2,348
Issuance of shares — Starlight acquisition	—	—	1,509,266	15	14,664	—	—		—	—	14,679
Net loss	—	—	—	—	—	(55,679)	—	$ (55,679)	—	—	(55,679)
Other comprehensive income (loss)											
Foreign currency translation adjustment	—	—	—	—	—	—	—	(63)	—	—	(63)
Unrealized gain on marketable securities	—	—	—	—	—	—	—	11	—	—	11
Other comprehensive loss	—	—	—	—	—	—	(52)	(52)	—	—	—
Comprehensive loss	—	—	—	—	—	—	—	$ (55,731)	—	—	—
Balance, December 31, 1998	—	—	40,067,771	400	222,230	(30,254)	(2,134)		—	—	190,242
Exercise of employee stock options	—	—	254,043	3	1,841	—	—		—	—	1,844
Employee stock purchase plan shares	—	—	295,820	3	1,442	—	—		—	—	1,445
Treasury stock transactions	—	—	—	—	—	—	—		92,065	$(556)	(556)
Issuance of preferred shares — Series A	4,478,708	$30,500	—	—	—	—	—		—	—	—
Net loss	—	—	—	—	—	(84,526)		$ (84,526)	—	—	(84,526)
Other comprehensive income (loss)											
Foreign currency translation adjustments	—	—	—	—	—	—	—	823	—	—	823
Unrealized loss on marketable securities	—	—	—	—	—	—	—	(6)	—	—	(6)
Other comprehensive income	—	—	—	—	—	—	817	817	—	—	—
Comprehensive loss	—	—	—	—	—	—	—	$ (83,709)	—	—	—
Balance, December 31, 1999	4,478,708	30,500	40,617,634	406	225,513	(114,780)	(1,317)		92,065	(556)	109,266
Exercise of employee stock options	—	—	438,659	4	3,187	—	—		—	—	3,191
Employee stock purchase plan shares	—	—	192,739	2	1,030	—	—		—	—	1,032
Treasury stock transactions	—	—	—	—	—		—		—	—	—
Issuance of preferred shares — Series B	8,738,000	21,845	—	—	—	—	—		—	—	—
Conversion of preferred shares to common stock	(3,800,000)	(9,500)	3,800,000	38	9,462	—	—		—	—	9,500
Beneficial conversion feature adjustment	—	—	—	—	6,207	—	—		—	—	6,207
Net loss	—	—	—	—	—	(106,971)	—	$(106,971)	—	—	(106,971)
Other comprehensive income (loss)											
Foreign currency translation adjustments	—	—	—	—	—	—	—	(605)	—	—	(605)
Other comprehensive loss	—	—	—	—	—	—	(605)	(605)	—	—	—
Comprehensive loss	—	—	—	—	—	—	—	$(107,576)	—	—	—
Balance, December 31, 2000	9,416,708	$42,845	45,049,032	$450	$245,399	$(221,751)	$(1,922)		92,065	$(556)	$ 21,620

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

PICTURETEL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Year Ended December 31,		
	2000	1999	1998
Cash flows from operating activities:			
Net loss	$(106,971)	$ (84,526)	$ (55,679)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	23,520	34,576	28,183
Provision for doubtful accounts	596	2,474	4,160
Provision for inventory obsolescence	14,695	3,834	6,004
Write-down of capitalized software	—	—	1,088
Write-down of long-lived assets	11,603	—	3,149
Loss on disposal of fixed assets	5,270	687	—
Provision for deferred taxes	—	—	31,721
Gain on sales of securities	—	(8,495)	—
Reduction in obligation of terminated capital lease	(3,870)	—	—
Operating charge related to preferred stock issuance	6,207	—	—
Write-off of incomplete technology	—	—	4,442
Gain on sale of MultiLink and Starlight	(15,349)	—	—
Other non-cash items	—	(6)	896
Changes in operating assets and liabilities, net of effects of purchased business:			
Accounts receivable	27,508	136	29,376
Inventories	(14,776)	(6,298)	8,812
Other current assets	5,762	(4,619)	(1,086)
Accounts payable	(369)	(10,938)	2,468
Accrued compensation and benefits, accrued expenses, and accrued income taxes	(3,763)	2,306	(4,035)
Deferred revenue	(7,976)	5,500	(3,949)
Net cash provided by (used in) operating activities	(57,913)	(65,369)	55,550
Cash flows from investing activities:			
Purchase of marketable securities	(31,262)	(120,012)	(126,262)
Proceeds from sale of marketable securities	69,049	128,796	120,336
Purchases of property and equipment	(6,207)	(12,591)	(19,421)
Proceeds from sales of fixed assets	9	342	506
Proceeds from sale of MultiLink, Inc.	25,900	—	—
Capitalized software costs	—	—	(7,446)
Cash paid to acquire business, less cash acquired	—	—	(3,964)
Purchase of other assets	—	—	(2,851)
Net cash provided by (used in) investing activities	57,489	(3,465)	(39,102)
Cash flows from financing activities:			
Restricted cash and cash equivalents	(4,575)	(1,200)	—
Proceeds (payments) on short-term/long-term borrowings	1,395	(706)	(2,955)
Principal payments under capital lease obligations	(1,479)	(3,591)	(3,471)
Purchase of treasury stock	—	(556)	—
Proceeds from preferred stock issuance	21,845	30,500	—
Proceeds from exercise of stock options	3,191	1,844	981
Proceeds from employee stock purchase plan	1,032	1,445	1,718
Net cash provided by (used in) financing activities	21,409	27,736	(3,727)
Effect of exchange rate changes on cash	541	371	62
Net increase (decrease) in cash and cash equivalents	21,526	(40,727)	12,783
Cash and cash equivalents at beginning of year	21,915	62,642	49,859
Cash and cash equivalents at end of year	$ 43,441	$ 21,915	$ 62,642

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

PICTURETEL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share amounts)

1. Nature of the Business:

PictureTel Corporation (the "Company") develops, manufactures and markets a full range of visual and audio collaboration equipment and services. These products and services enable businesses, schools, medical facilities, government and other organizations to eliminate the barrier of distance so they can work together more effectively. The Company sells its products internationally through both direct and indirect channels.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. The Company has incurred recurring losses from operations and requires additional financing. These factors raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Management's plans to continue as a going concern rely heavily on forecasted revenue from new products which were released in the third quarter of 2000. In addition, management is currently seeking additional equity investment. Management is also continuing to identify and implement internal actions to improve the Company's liquidity. While there can be no assurances that these plans will be successful, management believes these actions will provide sufficient financial resources for the next twelve months.

2. Summary of Significant Accounting Policies:

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Foreign Currency

The financial statements of the Company's foreign operations, where the local currency is the functional currency, are translated using exchange rates in effect at the end of the year for assets and liabilities and average exchange rates during the year for results of operations. Related translation adjustments are reported in accumulated other comprehensive income. Transaction gains and losses are recognized in the statement of operations.

For the financial statements of the Company's foreign operations, where the U.S. dollar is the functional currency, monetary assets and liabilities of the operations are translated into U.S. dollars at the exchange rate in effect at period end and nonmonetary assets and liabilities are remeasured at historic exchange rates. Income and expense are remeasured at the average exchange rate for the period. Translation gains and losses are reflected in other income in the consolidated statement of operations.

Foreign Exchange Contracts

The Company and its subsidiaries have entered into foreign currency forward contracts as a hedge against specific intercompany and foreign currency receivable transactions. Forward contracts involve agreements to purchase or sell foreign currencies at specific rates at future dates. The Company does not hold or issue derivative financial instruments for trading purposes. The Company enters into derivatives only with counterparties which are financial institutions having credit ratings of single A to minimize credit risk. The Company's hedging activities do not subject the Company to exchange rate risk because the gains and losses on these contracts offset the losses and gains on the assets, liabilities, and transactions being hedged. The carrying amount of the forward contracts is the fair value, which is determined by obtaining market prices. Gains and losses on forward contracts are recognized each reporting period and are offset against the gain or loss on the hedged item in the same period that the underlying transactions are settled. At December 31, 2000 and 1999, the Company had contracts maturing through April 3, 2001 and April 3, 2000 to purchase $6,126 and $10,473, respectively, in foreign currency (British pounds, French francs, German marks, Japanese yen, and Australian dollars).

Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Those instruments with maturities between three months and twelve months are considered to be short-term marketable securities and investments with maturities of greater than one year are classified as long-term marketable securities. At December 31, 1999, marketable securities primarily consist of corporate obligations. The Company had no marketable securities at December 31, 2000.

The Company classifies all marketable securities as available for sale. They are carried at their fair value, based on quoted market prices, with the unrealized gains and losses; net of tax, reported in accumulated other comprehensive income. The cost of marketable securities is adjusted for the amortization of premiums and accretion of discounts over the life of the security. Such amortization and interest are included in interest income. For the purpose of determining gain or loss, the specific identification of securities method is used. Realized gains and losses are included in other income.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined on the first-in, first-out basis.

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization are provided using the straight-line method over the following estimated useful lives:

Buildings under capital lease	18 years
Equipment	2-5 years
Equipment and furniture under capital leases	3-5 years
Furniture and fixtures	3-5 years
Leasehold improvements	Estimated useful life or term of the lease, if shorter

Maintenance and repairs are charged to expense as incurred. Significant improvements and costs incurred during the application development stage of software developed for internal use, including website development, are capitalized and depreciated. Upon retirement or sale, the cost of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of net income.

Research and Development and Capitalized Software Costs

Costs incurred prior to the establishment of technological feasibility are charged to research and development expense. Software production costs incurred subsequent to the establishment of technological feasibility are capitalized until the product is available for general release to customers.

During the years ended December 31, 1998 and 1997, the Company capitalized approximately $7,446 and $7,252, respectively, of software production costs. No such costs were capitalized during the years ended

December 31, 2000 and 1999, as these costs were deemed immaterial. Capitalized software for the year ended December 31, 1998 also included completed technology of $12,781 acquired through the purchase of Starlight. Amortization is based on the straight-line method over the remaining estimated life of the product or on the ratio of current revenue to total projected product revenue, whichever is greater. During the years ended December 31, 2000, 1999 and 1998 the Company amortized approximately $4,436, $9,143 and $1,023, respectively, of software costs.

Other Assets

Included in other assets are intangible assets, consisting primarily of intellectual property rights and non-compete agreements, which are amortized over their estimated useful life, ranging from eighteen to thirty-six months. Accumulated amortization on intangible assets was $3,698, $3,144 and $279, at December 31, 2000, 1999 and 1998, respectively. Also included in other assets are prepaid royalties and investments accounted for under the cost method. The Company reviews other long-term assets for any impairment in accordance with the Statement of Financial Accounting Standard No. 121 "Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" (SFAS 121), whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value of the asset. If an impairment is indicated, the asset is written down to its estimated fair value on a discounted cash flow basis.

Revenue Recognition

The Company considers revenue recognized when it has persuasive evidence of an arrangement, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectibility is reasonably assured.

Revenue from product sales is recognized when the product is shipped to the customer and there are either no unfulfilled company obligations or any obligations will not affect the customer's final acceptance of the arrangement. Revenue from professional service is recognized as the services are provided. Revenue from maintenance contracts is recognized ratably over the term of the contract. Allowances for estimated future product returns and price protection under the Company's agreements with its distributors and resellers are provided for in the same period as the related revenue. In addition, revenue related to sales to certain resellers who stock the Company's products and for which a right of return exists, is recognized only when the reseller sells its stock through to its customers. Revenue under arrangements where products and services are sold together is allocated to each element based on their relative fair values.

Warranty

The Company provides a warranty for parts and labor on its products. Hardware warranty periods are generally one year from installation date on sales to end-users and one year from delivery date on sales to distributors. In addition, warranty periods for certain software products, repairs, and upgraded parts are 90 days upon receipt. Estimated warranty costs are recorded at the time of revenue recognition.

Income Taxes

The Company provides for the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The measurement of deferred tax assets is reduced by a valuation allowance if, based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

Earnings Per Share

Basic earnings per share ("EPS") excludes the effect of any dilutive options, warrants or convertible securities and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were issued, exercised or converted into common stock. Common share equivalents are not included in the per share calculations where the effect of their inclusion would be anti-dilutive. Dilutive common share equivalents consist of stock options and warrants calculated using the treasury stock method. The following table reconciles the numerator and the denominators of the basic and diluted EPS computations shown on the Consolidated Statements of Operations:

	Year Ended December 31,		
	2000	1999	1998
Basic and Diluted EPS Computation			
Numerator:			
Net loss applicable to common shareholders	$(113,871)	$(90,138)	$(55,679)
Denominator:			
Weighted average common shares outstanding	41,739	40,376	38,527
Basic and diluted EPS	$ (2.73)	$ (2.23)	$ (1.45)

Options to purchase shares of the Company's Common Stock of 5,819,086, 6,912,081 and 6,686,832 were outstanding at December 31, 2000, 1999 and 1998, respectively, but were not included in the computation of diluted EPS because they were antidilutive due to the net losses sustained in 2000, 1999 and 1998. Warrants for 2,723 shares of the Company's Common Stock and Convertible Preferred Stock of 9,461,708 shares were outstanding at December 31, 2000, but were not included in the computation of diluted EPS because they were antidilutive due to the loss sustained in 2000.

Concentrations

Credit Risk

Financial instruments, which potentially subject the Company to concentration of credit risk, include cash, cash equivalents, foreign currency forward contracts and trade receivables. With respect to its cash and cash equivalents, the Company invests its excess cash primarily in deposits with a commercial bank and corporate obligations and has established guidelines relative to credit ratings, diversification and maturities that maintain safety and liquidity. The Company sells its products to a variety of customers, including end users, dealers and distributors, in a variety of different industries and geographic regions. The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses.

Suppliers

Certain components and parts used in the Company's products are procured from a single source. The Company obtains parts from one vendor only, even where multiple sources are available, to maintain quality control and enhance the working relationship with suppliers. These purchases are made under existing contracts or purchase orders. The failure of a supplier, including a subcontractor, to deliver on schedule could delay or interrupt the Company's delivery of products and thereby adversely affect the Company's revenues and profits.

Newly Issued Accounting Standards

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." This statement, as amended, was originally effective for all fiscal years beginning after June 15, 1999. In June 1999, the FASB issued Statement 137, which delayed the effective date of Statement 133 by one year. Statement 133 will be effective for PictureTel's fiscal year beginning January 1, 2001. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The Company is currently evaluating the effects of this change but anticipates that the adoption of SFAS 133 will not have a significant effect on the Company's financial position or results of operations.

Reclassifications

The presentation of certain prior year information has been reclassified to conform with the current year presentation. These reclassifications had no effect on net income or stockholders' equity.

Effective in the fourth quarter of 2000, the Company adopted the FASB's Emerging Issues Task Force (EITF) Issue No. 00-10, "Accounting for Shipping and Handling Fees and Costs." Consistent with this issue, amounts billed to customers for shipping and handling have been reclassified as revenue from cost of revenue in the Company's financial statements. Amounts reclassified for the first three quarters of 2000, and for the years 1999 and 1998 were $546, $716 and $991, respectively.

3. Impairment of Long-lived Assets:

Based on continuing operating losses and a change in product strategy for a division of the Company's videoconferencing products segment, the Company performed a review of its intangible assets including purchased software, tradename, assembled workforce and goodwill. In connection with this review, the Company determined that the carrying value of the goodwill and other intangible assets exceeded its fair value based on Company projections of the discounted future net cash flows from use, considering zero residual value for these assets. Accordingly, the Company recorded an impairment charge of $11,188 during 2000, of which $6,905 is included in cost of revenue and $4,283 is included in selling, general and administrative expense in the Company's Consolidated Statements of Operations, all of which impacted the Company's videoconferencing products segment.

4. Inventories:

Inventories consist of the following:

	December 31,	
	2000	**1999**
Purchased parts	$ 4,018	$ 3,184
Work-in-process	234	1,157
Finished goods	22,768	28,589
	$27,020	$32,930

During 2000, the Company recorded a $4,721 charge to reduce legacy PC-based inventory to its net realizable value. The charge primarily reflects a reduction in the carrying value of the inventory to its estimated fair market value, based on estimated selling prices, less costs to sell. The inventory write-down is associated with lower than expected sales of PC-based videoconferencing systems, exacerbated by the Company's transition to its next generation product line, PictureTel Series 900.

5. Marketable Securities:

The Company has no marketable securities at December 31, 2000. At December 31, 1999, marketable securities, including $8,708 reported in cash equivalents, were as follows:

	December 31, 1999	
	Amortized Cost	Fair Value
U.S. Government and its agencies	$ 3,726	$ 3,726
Corporate obligations	42,769	42,769
Total debt securities	$46,495	$46,495

During the third quarter of 1999, the Company recorded an $8,495 gain on the sale of RealNetworks stock. This stock was acquired through a 1996 investment in Vivo Software, Inc., which was subsequently acquired by RealNetworks. This gain is included in other income.

6. Property and Equipment:

Property and equipment consist of the following:

	December 31,	
	2000	1999
Property and equipment, excluding assets under capital leases:		
Equipment	$107,750	$113,572
Furniture and fixtures	15,875	18,071
Leasehold improvements	16,634	20,777
	140,259	152,420
Less: Accumulated depreciation	121,949	119,918
	18,310	32,502
Assets under capital leases:		
Buildings	—	38,000
Buildings held for sublease	—	20,938
Equipment and furniture	—	2,774
	—	61,712
Less: Accumulated depreciation	—	7,995
	—	53,717
Property and equipment, net	$ 18,310	$ 86,219

At December 31, 2000 and 1999, accumulated depreciation amounted to $0 and $5,353 on buildings under capital leases and $0 and $2,642 on equipment and furniture under capital leases, respectively. Depreciation expense for the years ended December 31, 2000 and 1999 was $16,538 and $20,926, respectively. Annual depreciation expense for the years 2000 and 1999 of $1,163, related to the buildings under capital lease held for sublease and the related sublease income of $2,353, was included in other income.

7. Debt:

The Company entered into a new asset-based secured revolving credit agreement dated August 21, 2000, which will expire on August 21, 2003. The new credit facility provides a revolving credit line of up to $35,000 with Congress Financial Corporation (New England) (the "Lender"). The availability for borrowings under the new credit facility are variable based on eligible receivables and is subject to a $10,000 minimum reserve, which is available at the Lender's discretion. The Company is required to maintain cash collateral equal to 105% in an account held at the Lender of the outstanding obligations or an equal dollar amount of eligible receivables. At December 31, 2000, availability based on receivables and net of the $10,000 discretionary reserve was $4,448. Interest for loans under this facility is payable at 1% above the Lender's prime rate. There were no borrowings outstanding against the calculated receivable availability at December 31, 2000. The Company has $5,000 of outstanding standby letters of credit issued under this agreement as of December 31, 2000. The letters of credit have been collateralized 105% and are in an account held at the Lender. Cash subject to the cash collateral requirement amounts to $5,775 and is classified as current on the Company's balance sheet at December 31, 2000. Fees for letters of credit outstanding against this facility are payable at 225 basis points per annum of the face amount. The secured letters of credit expire between September 2001 and December 2001. This credit agreement also contains certain financial covenants, including minimum net worth and working capital requirements. This new credit facility replaces the amended facility entered into in May 2000. A term loan provided by the amended credit facility in the amount $8,500 was paid in full in July 2000 from a portion of the proceeds of the Series B Preferred Stock issued in the third quarter of 2000. (See also Note 9.)

Local lines of credit are available for short-term advances of up to $1,487 to certain of the Company's foreign subsidiaries. The agreements require interest payable up to one and three-quarter percent, per annum. Borrowings totaling $1,487 were outstanding against these local lines of credit at December 31, 2000.

The Company has operating leases for various rented properties. The Company signed an agreement to sublease MultiLink's former facility at 6 Riverside Drive in Andover, Massachusetts in May 1999, as part of its space consolidation efforts. As of December 31, 2000, the remaining obligation under this operating lease was $7,125. After giving effect to expected sublease income, this obligation is $4,748. In addition, in June 1998, the Company subleased its property at 50 Minuteman Road for a ten-year term. As of December 31, 2000, the remaining obligation under this operating lease was $19,220. After giving effect to expected sublease income, the remaining obligation under this operating lease was $1,209.

Pursuant to an option agreement with the landlord of its facility located at 200 Minuteman Road in Andover, Massachusetts, the Company vacated certain space in the 200 Minuteman facility during the third quarter in exchange for termination of the lease. Under the terms of this agreement, termination charges amounted to $15,142, net of a $1,806 gain on the elimination of the capitalized lease and related liability of $35,760 and $37,566, respectively. The $15,142 net charges included a $3,756 loss on leasehold improvements, $340 real estate commission, $1,419 incremental rent charge, cash payment of $11,433, and the above mentioned $1,806 gain. In December 2000, pursuant to an option agreement exercisable only by the landlord, with respect to other properties in the Minuteman Park on Minuteman Road in Andover, Massachusetts, the Company renegotiated its lease term on the 50 Minuteman facility. In connection therewith, termination charges amounted to $7,654, net of a $2,064 gain on the elimination of the capitalized lease and related liability of $17,061 and $19,125, respectively. The $7,654 net charges included a $718 incremental rent charge, a cash payment of $9,000 and the gain of $2,064 mentioned above.

8. Commitments:

The Company has commitments under non-cancelable operating leases for office and manufacturing space. The facility leases are for terms ranging from one to fourteen years. The leases generally contain provisions that allow for expansion, extension and termination. In December 2000, the Company renegotiated the 1997 eighteen year lease agreement for the building at 50 Minuteman Road in Andover, Massachusetts, shortening the lease term by seven years, now expiring in 2008. In June 1998, the property was subleased for a period of ten years. As of December 31, 2000, the lease is accounted for as an operating lease. Effective July 1999, the Company subleased the property at 6 Riverside Drive in Andover for a period of 5 years. This operating lease expires in 2007. Additionally, the Company continues to lease its facility in Mountain View, California where offices for its former Starlight division were located until disposition of the division in October 2000. This lease is scheduled to expire in 2003.

Future minimum lease payments under operating leases with initial or remaining terms of one year or more are:

	Operating Leases
2001	$10,981
2002	10,467
2003	9,732
2004	9,170
2005	9,147
Thereafter	42,392
Total future minimum lease payments	$91,889

Total future minimum lease payments have not been reduced by future minimum sublease payments under non-cancelable sublease agreements. Income from future minimum sublease agreements with initial or remaining terms of one year or more are:

	Operating Leases
2001	$ 3,209
2002	3,188
2003	3,106
2004	2,765
2005	2,414
Thereafter	6,034
Total future minimum sublease payments	$20,716

Net rental expense for operating leases was $10,165, $10,783 and $11,692 for 2000, 1999 and 1998, respectively.

In conjunction with a joint development agreement with Sharp Corporation, the Company has agreed to pay up to a maximum amount of $900 for tooling costs in 2001. This amount has been included in accrued expenses on the Company's balance sheet as of December 31, 2000. In addition, the Company has outstanding commitments as of December 31, 2000 to purchase approximately $20,000 of inventory over a twelve month period, scheduled to begin with the release of the new products being jointly developed. The first products are scheduled for release in the second quarter of 2001.

9. Capital Stock and Redeemable Preferred Stock:

Redeemable Convertible Preferred Stock

The Company's redeemable preferred stock is comprised of the following:

	December 31, 2000	December 31, 1999
Redeemable Convertible Preferred Stock:		
Series A:		
4,500,000 shares authorized, 4,478,708 shares, issued and outstanding at December 31, 2000 and December 31, 1999	$30,500	$30,500
Series B:		
9,000,000 shares authorized, 4,983,000 and 0 shares issued and outstanding at December 31, 2000 and December 31, 1999	12,345	—
Total Redeemable Convertible Preferred Stock	$42,845	$30,500

On July 13, 2000 the Company announced it had agreements with investors to purchase $21,845 (8,738,000 shares at $2.50 per share) of new convertible shares of Series B Preferred Stock. In conjunction with the purchase of convertible Series B Preferred Stock, each investor also received a specified small minority interest in the Company's subsidiary, 1414c, Inc. The Company determined that the fair value of shares received in the Company's subsidiary, 1414c, by the investors was insignificant. In addition, in accordance with the convertible Series B Preferred Stock agreement, the Company also entered into a joint venture and hosting agreement with one of the investors. These transactions were completed and the funds became available on July 24, 2000. In October 2000, one of the investors converted its 3,800,000 shares of the Series B Preferred Stock to 3,800,000 shares of the Company's Common Stock.

The convertible Series B Preferred Stock is non-voting and preferred with respect to dividend rights and liquidation preference to the Company's Common Stock. When issued, each share of Series B Preferred Stock, was convertible into one share of common stock, which represents a discount from the fair value of common stock on the date of issuance of $1.50 per share. The value attributable to this conversion right represents an incremental yield, or a beneficial conversion feature. For investors that have a purely financial relationship with the Company, the discount resulting from the allocation of proceeds to the beneficial conversion feature is accreted, using the interest method, from the date of issuance through the date the Series B Preferred Stock is first convertible which is October 13, 2000. The Company has recorded accretion of $6,900 for the year ended December 31, 2000. This accretion represents a non-cash charge in determination of net loss attributable to common shareholders.

The investor that entered into a joint venture and hosting agreement with the Company as well as investors that are also employees or directors of the Company are considered to have a business relationship with the Company beyond that of a financial investor. As a result, their investments are considered to involve elements of compensation for goods or services. Therefore, the Company determined the fair value of the beneficial conversion feature associated with these shares to be $6,207, which has been recorded as selling, general and administrative expense during the year ended December 31, 2000.

On February 18, 1999, an investor acquired approximately 10% of the Company's equity when it invested $30,500 in convertible Series A Preferred Stock. The convertible preferred stock was issued to the investor at a price of $6.81 per share. The shares are convertible to common stock on a one for one basis, which represents a discount from the fair value of common stock on the date of issuance of $8.01 per share. The intrinsic value attributable to this conversion right represents a beneficial conversion feature that has been recorded as an increase to net loss in the consolidated statement of operations in the period ended December 31, 1999, and represents a non-cash charge in the determination of net loss attributable to common stockholders.

The Company's Board of Directors is empowered to fix the terms and rights of the Series A preference stock and issuance of the convertible Series A Preferred Stock limits the rights of the common stockholders. The Series A convertible Preferred Stock issued is non-voting and preferred with respect to dividend rights and liquidation preference to the Company's Common Stock. For the period through February 17, 2004, the holders of the convertible preferred stock are entitled to receive, out of funds legally available, noncumulative dividends on shares of common stock or preferred stock for each share of preferred stock held per year, when and if declared by the Board of Directors. The Series A convertible Preferred Stock is subject to redemption requirements that are outside of the control of the Company under certain limited circumstances, as defined in the Series A Certificate of Designation. Those circumstances include a merger or consolidation of the Company in which its stockholders do not retain a majority of the voting power in the surviving corporation. Under such circumstances, the holders of Series A convertible Preferred Stock are entitled to receive a payment equal to the purchase price originally paid for the Series A convertible Preferred Stock together with any declared but unpaid dividends, before any payment is made to holders of common stock.

Treasury Stock

In October 1998, the Board of Directors authorized a plan to repurchase up to 1,000,000 shares of the Company's Common Stock in open market, privately negotiated or other transactions. No shares were repurchased during 1998. The Company repurchased 70,000 shares during 1999 at a cost of $556 (approximately $7.94 per share). In addition, 22,065 shares were returned to the Company from shares held in escrow related to the MultiLink acquisition.

Warrants

As part of the acquisition of Starlight Networks, Inc. in 1998, the Company assumed warrants, issued by the acquired company. Provisions of the warrants include rights to purchase 2,723 shares of Common Stock and are exercisable at an average price of $27.83 per share and have expiration dates ranging from February 2002 through February 2007.

Stockholders' Rights Agreement

On March 25, 1992, the Board of Directors of the Company declared a dividend of one purchase right (a "Right") for every outstanding share of the Company's Common Stock. After giving effect to the split, each Right entitles the holder to purchase from the Company one two-hundredths of a share of Junior Preference Stock at a price of $90 per one two-hundredths of a share, subject to adjustment. The Rights will become exercisable on the fifteenth business day following the date of a public announcement that an acquiring person (as defined in the Rights Agreement, the definition of which provides for certain limited exclusions) has acquired, or obtained the right to acquire, beneficial ownership of 15% or more of the Company's outstanding Common Stock or on the fifteenth business day following the commencement of a tender offer or exchange offer that would result in an acquiring person owning 15% or more of the Company's outstanding Common Stock.

If the Company were acquired in a merger or other business combination, or more than 25% of its assets or earning power were sold, each holder of a Right would be entitled to exercise such Right and thereby receive common stock of the acquiring company with a market value of two times the exercise price of the Right. If an acquiring person has acquired or obtained the right to acquire 15% of the Company's Common Stock, each holder of a Right, other than the acquiring person, will be entitled to receive shares of the Company's Common Stock having a market value of two times the exercise price of the Right. At any time the Company may redeem the Rights at a redemption price of $0.005 per Right. The Rights expire March 25, 2002.

Stock-Based Compensation Plans

The Company has adopted the disclosure requirements of Statement of Financial Accounting Standard (SFAS) No. 123, "Accounting for Stock-Based Compensation." The Company continues to recognize compensation costs using the intrinsic value based method described in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." No compensation costs were recognized in 2000, 1999 and 1998.

Net loss and net loss per share as reported in these consolidated financial statements and on a pro forma basis, as if the fair value based method described in SFAS No. 123 had been adopted, are as follows:

	Year Ended December 31,		
	2000	1999	1998
Net loss applicable to common shareholders			
As reported	$(113,871)	$(90,138)	$(55,679)
Pro forma	(120,601)	(98,638)	(66,224)
Net loss per common share — basic and diluted			
As reported	$ (2.73)	$ (2.23)	$ (1.45)
Pro forma	(2.89)	(2.44)	(1.72)

Employee Stock Purchase Plan

Under terms of an Employee Stock Purchase Plan (the "ESPP") adopted in 1994 and amended in 1996, eligible employees are able to purchase shares of the Company's Common Stock at 85% of the average market value as of the start of each six month option period or the end of such period, whichever is lower. As of December 31, 2000, shareholders have authorized the purchase of up to 2,000,000 shares of Common Stock under the ESPP. Shares purchased under the ESPP in 2000, 1999 and 1998 totaled 165,896, 295,820 and 286,074, respectively.

On June 17, 1999, the Company's shareholders approved the 1999 Foreign Subsidiary Employee Stock Purchase Plan ("the Foreign Plan"). Under the Foreign Plan, eligible foreign subsidiary employees are able to purchase shares of the Company's Common Stock on terms substantially similar to those of the ESPP. Up to 500,000 shares are authorized under the Foreign Plan. There were 26,843 shares purchased under the Foreign Plan in 2000.

The weighted average grant date fair value of the shares purchased was $2.63, 2.15 and $2.64 in 2000, 1999 and 1998, respectively. At December 31, 2000, there were 1,336,529 shares available under these plans.

For the purpose of providing pro forma disclosures, the fair values of shares purchased were estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions used for purchases in 2000, 1999 and 1998, respectively: a risk-free interest rate of 6.01%, 4.97% and 5.11%, an expected life of 6 months, expected volatility of 78%, 69% and 65% and no expected dividends.

Stock Option Plans

On November 14, 1989, the Company's shareholders approved the PictureTel Equity Incentive Plan (the "EIP"). Pursuant to terms contained therein, the EIP terminated on November 14, 1999 and as of November 14, 1999, shareholders have authorized the issuance of up to 9,000,000 shares of post Stock Split Common Stock under the Plan. Following the Termination Date, no additional options were granted under the EIP, but earlier option grants made thereunder expire seven to ten years after the effective date of the grant. On June 17, 1999, the Company's shareholders approved the PictureTel 1999 Equity Plan (the "1999 Plan"). As of December 31, 2000, shareholders have authorized the issuance of up to 3,000,000 shares of Common Stock under the 1999 Plan. The 1999 Plan permits the granting of non-statutory and incentive stock options, a variety of stock and stock-based awards and related benefits, and cash performance awards, which are in addition to option grants under the EIP and the 1984 Amended and Restated Stock Option Plan, to employees and other persons who are in a position to make significant contributions to the success of the Company. Generally, grants issued under these plans become exercisable over a four year period and expire ten years (seven years for United Kingdom issued grants) after the effective date.

Effective October 23, 1992, the Board of Directors adopted the 1992 Non-Employee Directors' Stock Option Plan. As of December 31, 1998, shareholders have authorized the issuance of up to 430,000 shares of Common Stock under the Plan to eligible non-employee directors. Under this Plan, each non-employee director at October 23, 1992 and each non-employee director subsequently elected receives, at October 23, 1992 or the director's first election date, a non-statutory option to purchase 40,000 shares of post Stock Split Common Stock at an exercise price equal to the fair market value of the stock on the effective date of grant. The Plan was amended at the Annual Meeting on June 17, 1996 so as to increase the aggregate number of shares available for issuance under the Plan from 280,000 to 430,000, and to further provide, as of August 1, 1996, for the automatic grant of a non-statutory option to purchase 20,000 shares of Common Stock to directors who have been directors for more than two years on August 1, 1996, and on the later date of first election of any other director and thereafter, for the annual grant of stock options to purchase 5,000 shares of the Company's Common Stock on August first of each year, commencing on August 1, 1997, so long as such individual is serving as a director on the applicable August first date, provided that no such annual option for 5,000 shares shall be granted to a director who first became a director of the Company within six months prior to August first of said year. The Plan was further amended by the Board of Directors on February 27, 1998 to provide for non-automatic grants of non-statutory options not to exceed 60,000 shares in the aggregate for all directors. On June 17, 1999, because of anticipated accounting rule changes affecting the grant of stock options to outside directors, the Plan was amended by the Board of Directors to provide for the immediate vesting of all options granted after August 1, 1999. All options expire ten years after the effective date of grant; all options, except annual and non-automatic options, granted prior to August 1, 1999 become exercisable over a one-year period; and all options granted after August 1, 1999 become exercisable immediately at the date of grant. At December 31, 2000, there were 433,026 shares available for future grant under these plans.

Effective upon the consummation of the acquisition of MultiLink, Inc. on July 22, 1997, the Board of Directors voted to assume the 1984, 1986, 1987 and 1996 MultiLink, Inc. Stock Options Plans and renamed the 1984, 1986, 1987 and 1996 PictureTel (MultiLink) Option Plans (the "Plans"), as appropriate, and provided for the issuance of shares of Common Stock in replacement for MultiLink Common Stock upon the exercise thereof. The Compensation Committee of the Board of Directors administers the MultiLink Option Plans assumed (and renamed) by PictureTel. There is reserved for issuance under the Plans 655,419 shares of Common Stock of PictureTel Corporation to be issued upon exercise of the options outstanding under the Plans. No additional options will be issued under the Plans. All options expire ten years after the effective date of the grant, and such options become exercisable over a four-year period.

Effective upon the consummation of the acquisition of Starlight Networks, Inc. on November 10, 1998, the Board of Directors voted to approve the 1998 Acquisition Stock Option Plan (the "Acquisition Plan"). The Acquisition Plan permits the grant of non-qualified options to purchase shares of Common Stock of PictureTel Corporation to Starlight employees who are in a position to make significant contributions to the success of the Company. The Board of Directors amended the Acquisition Plan on March 1, 2001 to further permit the grant of stock options to employees of the Company (excluding directors and officers of the Company), subsidiaries of the Company, and business acquired by the Company. The Compensation Committee of the Board of Directors administers the Acquisition Plan. There is reserved for issuance under the Plan 400,000 shares of Common Stock to be issued upon exercise of the options granted under the Plan. All options expire ten years after the effective date of the grant, and such options become exercisable over a four-year period. At December 31, 2000, there were 362,729 shares available for future grant under the Plan.

The following table summarizes the Company's stock option plans at December 31, 2000, 1999 and 1998 and changes during the years then ended:

	2000		1999		1998	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	6,912,081	$7.05	6,686,832	$ 9.16	4,728,190	$11.21
Granted at fair market value	2,855,004	4.80	4,790,305	5.35	3,627,100	7.01
Exercised	(438,659)	7.28	(254,043)	7.26	(232,068)	4.23
Forfeited	(3,509,340)	6.85	(4,311,013)	8.41	(1,436,390)	11.26
Outstanding at end of year	5,819,086	$6.06	6,912,081	$ 7.05	6,686,832	$ 9.16
Options exercisable at year-end	2,135,317	$7.97	1,921,405	$10.23	2,328,993	$11.52
Weighted-average grant date fair value of options granted during the year at fair market value		$3.62		$ 3.49		$ 4.38

The following table summarizes information about stock options outstanding at December 31, 2000:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted-Average Remaining Contractual Life (In years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$ 0.893 – $ 2.656	338,856	9.44	$ 2.598	37,556	$ 2.653
2.679 – 3.625	495,240	9.40	3.278	2,096	3.310
3.656 – 3.719	936,991	7.81	3.718	319,676	3.715
3.880 – 5.031	858,251	9.09	4.756	165,843	4.403
5.188 – 5.531	1,178,988	8.63	5.497	459,175	5.521
5.625 – 6.810	624,687	8.88	6.388	109,340	6.045
6.813 – 8.875	732,817	6.37	8.079	507,415	8.187
8.940 – 12.875	485,606	6.00	9.722	367,251	9.730
14.970 – 25.815	106,950	6.02	17.172	106,265	17.174
35.000 – 40.500	60,700	5.41	36.814	60,700	36.814
$ 0.893 – $40.500	5,819,086	8.12	6.06	2,135,317	7.97

For the purpose of providing pro forma disclosures, the fair values of options granted were estimated using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 2000, 1999 and 1998, respectively: a risk-free interest rate of 6.27%, 5.65% and 5.10%, an expected life of 6.0, 5.5 and 5.5 months, expected volatility of 85%, 71% and 67% and no expected dividends.

10. Income Taxes:

Significant items making up total net deferred tax assets are as follows:

	December 31, 2000	December 31, 1999
Net operating loss and tax credit carryforwards	$ 85,281	$ 66,723
Inventory reserves	6,398	3,387
Depreciation and amortization	6,263	(2,816)
Other temporary differences	21,152	15,985
Valuation allowance	(119,094)	(83,279)
Total net deferred tax assets	$ —	$ —

Other temporary differences principally represent bad debt and warranty reserves, deferred research and development, deferred revenue, vacation and other payroll related differences. Management believes the Company is unlikely to fully realize the deferred tax assets and accordingly has established a full valuation allowance on the deferred tax assets. Approximately $7,959 of the gross deferred tax assets at December 31, 2000 relates to the benefit of deductions from the exercise of stock options. The benefit will be recorded as a credit to additional paid in capital when realized.

The provision (benefit) for income taxes consisted of the following:

	Year Ended December 31,		
	2000	1999	1998
Federal income taxes:			
Currently payable	$ —	$ —	$ 253
Deferred	—	—	24,634
State income taxes:			
Currently payable	450	204	75
Deferred	—	—	7,011
Foreign taxes:			
Currently payable	720	4,180	3,732
Deferred	—	—	76
Total	$1,170	$4,384	$35,781

The differences between the statutory federal income tax rate and the Company's effective income tax rate were as follows:

	Year Ended December 31,		
	2000	1999	1998
Statutory federal income tax rate	(35.0)%	(35.0)%	(35.0)%
State income tax, net of federal tax benefit	(3.8)	(4.4)	0.2
Federal credits from research and development	0.6	(0.7)	—
Difference between foreign and US tax rates	1.7	4.4	3.1
Change in deferred asset valuation allowance	33.2	39.6	207.6
Other	4.4	1.6	3.9
Effective tax rate	1.1%	5.5%	179.8%

At December 31, 2000, the Company had remaining net operating loss ("NOL") carryforwards available of approximately $195,000 to offset future federal taxable income. The Company also has unused federal research and development tax credits of approximately $5,151. The NOL and tax credit carryforwards both expire at various dates through the year 2020. As a result of prior equity issuances, the Company's use of NOL carryforwards incurred prior to July 1988 is subject to certain annual limitations. At December 31, 2000, approximately $3,975 of the available NOL carryforwards have an annual limitation amount of approximately $662 that may be used to reduce the Company's taxable income in the future. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of the carryforwards which can be utilized.

11. Employee Benefit Plans:

The Company has a defined contribution profit sharing plan incorporating features under Section 401(k) of the Internal Revenue Code designed to provide retirement benefits to its employees. The Plan covers substantially all employees of the Company, and eligible participants may contribute up to 15% of their pay on a pretax basis subject to annual dollar limits established by the Internal Revenue Code and plan limitations. The Plan document states that the Company will provide at least 33.3% matching contribution up to the first 3% of each participant's eligible compensation. For the years ended December 31, 2000, 1999 and 1998, the Company's matching contribution was 50%, 50% and 50%, respectively or $400, $600 and $780, respectively.

The Company assumed the MultiLink, Inc. 401K Plan as a result of the acquisition in July 1997. The Company filed a Plan termination with the Internal Revenue Service and received a favorable determination. The Plan was terminated effective September 30, 1997. No company contributions were made to the MultiLink Plan in 1997.

The Company assumed the Starlight, Inc. 401K Plan as a result of the acquisition in November 1998. The Company filed a Plan termination with the Internal Revenue Service and received a favorable determination. The Plan was terminated effective December 31, 1998. No company contributions were made to the Starlight Plan in 1998.

12. Segment Information:

The Company has determined that its reportable segments are those that are based on the Company's method of internal reporting, which aggregates its business into two reportable operating segments: videoconferencing products and videoconferencing services. The videoconferencing products segment develops, manufactures and markets visual communications systems and collaboration software. The videoconferencing services segment provides services for the videoconferencing products.

In 2000, 1999 and 1998, no customer accounted for 10% or more of total revenue. One supplier accounted for 32%, 33% and 32% of the Company's purchases from outside vendors in 2000, 1999 and 1998, respectively. Another supplier accounted for 18% of the Company's purchases from outside vendors in 1999 and a third supplier accounted for 10% of the Company's purchases from outside vendors in 1998.

	Video-conferencing Products	Video-conferencing Services	Other	Total
Year ended December 31, 2000				
Revenue from external customers	$159,160	$69,741	$ 16,248	$ 245,149
Operating income (loss)	$(74,161)	$ 9,585	$(54,850)	$(119,426)
Year ended December 31, 1999				
Revenue from external customers	$233,249	$70,304	$ 20,442	$ 323,995
Operating income (loss)	$(68,409)	$ 2,976	$(24,851)	$ (90,284)
Year ended December 31, 1998				
Revenue from external customers	$324,478	$59,760	$ 22,905	$ 407,143
Operating income (loss)	$(16,049)	$ 7,191	$(14,792)	$ (23,650)

The classification "Other" consists of non-core business revenue and expense and corporate administrative functions, which are excluded from the videoconferencing products and videoconferencing services segments for management decision making.

The Company evaluates the performance of its segments based upon operating income. There are no material intersegment sales. Transfers of videoconferencing products to the videoconferencing services segment are recorded at standard cost and are not tracked for management reporting purposes. Asset information by reportable segment has not been disclosed since the Company does not produce such information internally.

Geographic Data

In addition to its direct and indirect sales channels in the United States, the Company has subsidiaries in various foreign countries which, through direct and indirect sales channels, sell and service the Company's products in their respective geographic area. Revenue from external customers represent sales made from those countries. The Company's revenue and long-lived asset financial information is detailed as follows:

	United States	United Kingdom	Japan	All Other	Total
Year ended December 31, 2000					
Revenue from external customers	$157,180	$51,129	$20,305	$16,535	$245,149
Long-lived assets	$ 17,366	$ 2,467	$ 1,112	$ 226	$ 21,171
Year ended December 31, 1999					
Revenue from external customers	$201,480	$65,654	$27,055	$29,806	$323,995
Long-lived assets	$104,109	$ 3,872	$ 2,225	$ 1,150	$111,356
Year ended December 31, 1998					
Revenue from external customers	$268,102	$79,396	$24,747	$34,898	$407,143
Long-lived assets	$125,997	$ 3,804	$ 2,295	$ 2,235	$134,331

Segment information for 1998 has been reclassified to reflect the new allocation method employed in 1999.

13. Unaudited Interim Financial Information:

Quarterly financial information is as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2000				
Revenue(1)	$ 65,203	$ 61,565	$ 70,029	$ 48,352
Gross margin	17,719	6,577	20,829	11,827
Net loss applicable to common shareholders	(23,842)	(37,973)	(43,619)	(8,437)
Net loss per common share — basic and diluted	$ (0.59)	$ (0.93)	$ (1.06)	$ (0.19)
1999				
Revenue(1)	$ 76,421	$ 86,146	$ 78,953	$ 82,475
Gross margin	24,222	27,025	24,930	25,959
Net loss applicable to common shareholders	(31,582)	(31,832)	(10,567)	(16,157)
Net loss per common share — basic and diluted	$ (0.79)	$ (0.79)	$ (0.26)	$ (0.40)

(1) Effective in the fourth quarter of 2000, the Company adopted the FASB's Emerging Issues Task Force (EITF) Issue No. 00-10, "Accounting for Shipping and Handling Fees and Costs." Consistent with this Issue, amounts billed to customers for shipping and handling have been reclassified as revenue from cost of revenue in the Company's financial statements. Amounts reclassified for the first, second and third quarters of 2000 were $136, $141 and $269, respectively. Amounts reclassified for the first, second, third and fourth quarters of 1999 were $227, $184, $140 and $165, respectively.

14. Supplemental Cash Flow Information:

	2000	1999	1998
Supplemental cash flow information:			
Interest paid	$5,056	$4,642	$ 2,903
Income taxes paid	$1,394	$1,845	$ 1,245
Supplemental disclosure of non-cash investing activity:			
Building acquired under capital lease	$ —	$ —	$38,000
Issuance of stock for acquisition	$ —	$ —	$14,679
Assumption of debt for acquisition	$ —	$ —	$ 3,544
Supplemental disclosure of non-cash financing activity:			
Preferred stock beneficial conversion feature	$6,900	$5,612	$ —

15. Sale of Business Assets:

On October 12, 2000, the Company completed the sale of its Starlight division to AxessPoint, Inc. Terms of the sale provided for a note receivable in the amount of $300 payable to PictureTel on April 9, 2001. The Company has recorded a gain of $104, net an impairment charge of $11,188 (Note 3), on this sale in 2000, which is included in other income on the Company's Consolidated Statements of Operations.

Also during 2000, the Company completed the sale of MultiLink, Inc. to Spectel Group Ltd. for $25,900 cash on November 27, 2000. As a result of this sale, the Company recorded a gain of $15,245 on the sale in 2000, which is included in other income on the Company's Consolidated Statements of Operations.

16. Other Charges:

During the year ended December 31, 2000, the Company recorded charges totaling $42,313. Of these charges, $6,905 were included in cost of revenue and $35,408 were included in operating expense for the year. These charges included $22,796 in lease termination costs associated with the Company's 200 and 50 Minuteman Road facilities, a $1,205 write-off of capitalized website development costs, $917 of severance charges related to headcount reduction, $6,207 for costs associated with the beneficial conversion feature of the preferred stock issuance and $11,188 of impairment charges related to the write-down of purchased software, tradename, assembled workforce and goodwill for a division of the Company's videoconferencing products segment.

The Company recorded charges of $9,752 during 1999. Cost of revenue includes $491 of expense associated with workforce reductions. Operating expense includes approximately $2,554 of workforce reduction and related costs, $2,550 for the settlement of shareholder litigation, and $2,481 associated with subleasing MultiLink's former facility at 6 Riverside Drive, Andover, Massachusetts.

During 1998, the Company recorded charges of $10,564. Charges of $6,808 reported in cost of revenue include $5,457 related to the write down of inventory and capitalized software to their net realizable value and other costs associated with the discontinuation of one of the Company's product lines and $1,351 to record inventory provisions for the write down of certain inventories to their net realizable value. Charges of $3,756 included in operating expenses relate to the write down of leasehold improvements at the 50 Minuteman Road facility in Andover and transaction costs associated with subleasing this facility, and certain executive severance charges. The Company subleased the 50 Minuteman Road facility in June 1998, and the sublessee did not utilize the leasehold improvements in the facility.

17. Related Party

During 2000, the Company was involved in a development and purchase agreement with a related party, who is a stockholder of Series A and B redeemable preferred stock issued by the Company. For the year ended December 31, 2000, purchases from this related party totaled approximately $8,325 and the amount owed to this related party as of December 31, 2000, was $204.

18. Litigation:

A. SEC Investigation

In May 1999, the Company was informed that the Securities and Exchange Commission (SEC) had initiated a formal investigation of matters related to the Company's 1997 restatement of its earnings. The Company has been cooperating with the SEC and will continue to do so. The Company expresses no opinion as to the likely outcome. While no assurances can be provided, the Company does not believe that the investigation will have a material adverse effect to its business, financial condition, results of operations or cash flows.

B. RevNet, Inc.

On June 2, 1998, the Company was served with a complaint from a former distribution channel customer, RevNet, Inc., which has ceased operations. (*RevNet, Inc., v. PictureTel Corporation*. Civil Action 98092039, filed April 2, 1998, in the Circuit Court for Baltimore City, Maryland.) The complaint alleged that the Company breached an oral contract. RevNet was seeking $200,000 in damages. On September 13, 1999, the Company filed a related action in the Circuit Court for Baltimore City, Maryland against RevNet, Inc., Vuecom, Inc. (an entity related to RevNet, Inc.), George Harris IV, George Sandmann and Lou Brown, (*PictureTel Corporation v. RevNet, Inc., et al.* Civil Action 24-C99-004406) alleging among other things Breach of Contract, Fraudulent Inducement and Securities Fraud. This issue was scheduled to go to trial on May 14, 2001. On October 30, 2000, the parties agreed to a settlement of this matter. Under the terms of the settlement, the Company will pay to the RevNet group $700 over the course of the year 2001. In return, all parties have dismissed all claims and have released the others of all related causes of actions. This closes this matter.

In addition to the above, the Company has also been and is from time to time subject to claims, such as potential patent infringements, and suits incidental to the conduct of business. There can be no assurance that the Company's insurance will be adequate to cover all liabilities that may arise out of such claims. Further, although the Company intends to defend itself vigorously against all such claims, the ultimate outcome of the claims cannot be accurately predicted. The Company does not believe that any claim of which it is aware, other than the claims listed above, could result in an outcome that will have a material adverse effect to its business, financial condition, results of operations or cash flows.

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

REPORT OF INDEPENDENT ACCOUNTANTS ON FINANCIAL STATEMENT SCHEDULE

To the Stockholders and Board of Directors of
PICTURETEL CORPORATION:

Our audits of the consolidated financial statements referred to in our report dated February 21, 2001 appearing in this Form 10-K also included an audit of this financial statement schedule listed in Item 14(a)(2) of this Form 10-K. In our opinion, this financial statement schedule presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

PricewaterhouseCoopers LLP

Boston, Massachusetts
February 21, 2001

SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS

Description	Balance at Beginning of Year	Charge to Costs and Expenses	Deductions	Balance at End of Year
		(In thousands)		
Year Ended December 31, 1998				
Accounts receivable reserves	$ 3,890	$ 4,160	$2,658(a)	$ 5,392
Manufacturing, demonstration, and service inventory reserves	$15,140	$ 6,004	$8,130(b)	$13,014
Warranty reserves	$ 4,727	$ 7,410	$7,289(c)	$ 4,848
Year Ended December 31, 1999				
Accounts receivable reserves	$ 5,392	$ 2,474	$2,224(a)	$ 5,642
Manufacturing, demonstration, and service inventory reserves	$13,014	$ 3,834	$4,759(b)	$12,089
Warranty reserves	$ 4,848	$ 5,210	$6,915(c)	$ 3,143
Year Ended December 31, 2000				
Accounts receivable reserves	$ 5,642	$ 3,207	$4,749(a)	$ 4,100
Manufacturing, demonstration, and service inventory reserves	$12,089	$14,695	$7,190(b)	$19,594
Warranty reserves	$ 3,143	$ 6,279	$6,184(c)	$ 3,238

(a) Specific write-offs

(b) Specific dispositions

(c) Specific cost

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

Information with respect to this item is incorporated by reference herein to information contained under the heading "Item 1 — "Election of Directors", subheadings "Nominees for Election", "Executive Officers" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the definitive 2001 Proxy Statement.

Item 11. ***Executive Compensation***

Information with respect to this item is incorporated by reference herein to information contained under the heading "Item 1 — Election of Directors", subheadings "Directors Compensation", "Management Compensation" and "Employment, Severance and Other Agreements" in the definitive 2001 Proxy Statement. (Information in the 2001 Proxy Statement under "Report of the Compensation Committee" and "Performance Graph" is not incorporated by reference.)

Item 12. ***Security Ownership of Certain Beneficial Owners and Management***

Information with respect to this item is incorporated by reference herein to information contained under the heading "Security Ownership" in the definitive 2001 Proxy Statement.

Item 13. ***Certain Relationships and Related Transactions***

Information with respect to this item is incorporated by reference herein to information contained under the heading "Certain Relationships and Related Transactions" [there was no such heading in 1996] in the definitive 2001 Proxy Statement.

PART IV

Item 14. ***Exhibits, Financial Statement Schedules, and Reports on Form 8-K***

(a) **1. Financial Statements**

- Report of Independent Accountants
- Consolidated Balance Sheets as of December 31, 2000 and 1999
- Consolidated Statements of Operations for the years ended December 31, 2000, 1999 and 1998
- Consolidated Statements of Stockholders' Equity for the years ended December 31, 2000, 1999 and 1998
- Consolidated Statements of Cash Flows for the years ended December 31, 2000, 1999 and 1998
- Notes to Consolidated Financial Statements

2. Financial Statement Schedule

- Report of Independent Accountants
- Schedule II — Valuation and Qualifying Accounts
- Schedules other than those listed above have been omitted since they are either not required, not applicable, or the information is otherwise included.

(b) Reports on Form 8-K

1. On December 15, 2000, the Company filed a report on Form 8-K to announce the disposition of the assets formerly owned by the Company's MutliLink subsidiary.

2. On February 7, 2001, the Company filed a report on Form 8-K to announce the hiring of Dalton Edgecomb as the Company's Chief Financial Officer.

(c) Exhibits

Exhibit Number	Description
3.1	Third Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1.4 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 27, 1992).
3.1.1	Certificate of designation, preferences and other rights of the Series A Preferred Stock of PictureTel Corporation, consisting of an Amendment to the Certificate of Incorporation (incorporated by reference to Exhibit 3.1.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended April 4, 1999).
3.1.1.1	Certificate of Decrease of the Series A Preference Stock of PictureTel Corporation, filed herewith.
3.1.2	Certificate of designation, Preferences and Other Rights of Series B Preference Stock of PictureTel Corporation, consisting of an Amendment to the Certificate of Incorporation filed as Exhibit 2 to Report on Form 8-K, dated July 31, 2000 and hereby incorporated by reference.
3.2	Amended and Restated By-laws (incorporated by reference to Exhibit 1 to the Registrant's Current Report on Form 8-K filed September 14, 1994).
4.1	Form of Common Stock Certificate (incorporated by reference to Exhibit 4(b) to Registrant's Registration Statement on Form S-8, Registration Number 33-36315, effective August 10, 1990).
4.2	Shareholders' Rights Agreement between the Company and The First National Bank of Boston as Rights Agent, dated March 25, 1992 (incorporated by reference to Exhibit 1 to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated March 26, 1992).
4.2.1	Form of Certificate of Designation with respect to Junior Preference Stock (incorporated by reference to Exhibit 2 to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated March 26, 1992).
4.2.2	Form of Rights Certificate (incorporated by reference to Exhibit 3 to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated March 26, 1992).
4.2.3	Summary of Purchase Rights (incorporated by reference to Exhibit 4 to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated March 26, 1992).
4.2.4	Amendment dated January 13, 1995 to Shareholders' Rights Agreement (incorporated by reference to Exhibit 4.2.4 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1994).
4.2.5	Stock Purchase and Investors Rights Agreement dated as of July 24, 2000, filed as Exhibit 1 to Report on Form 8-K dated July 31, 2000 and hereby incorporated by reference.
4.2.6	Stock Purchase Agreement between the Company and Intel Corporation, dated January 18, 1999, filed as Exhibit 1 to Form SC 13D filed on January 29, 1999.
10.1*	1984 Amended and Restated Stock Option Plan as amended through December 13, 1988 (incorporated by reference to Exhibit 10.10 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1988).
10.1.1*	Amendment to 1984 Amended and Restated Stock Option Plan dated October 26, 1994 (incorporated by reference to Exhibit 10.10.1 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1994).

Exhibit Number	Description
10.2*	PictureTel Corporation Equity Incentive Plan as amended through October 26, 1994 (incorporated by reference to Exhibit 10.11 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1994).
10.2.1*	Amendment to PictureTel Corporation Equity Incentive Plan dated June 29, 1995 (incorporated by reference to Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 1, 1995).
10.2.2	Amendment to PictureTel Corporation Equity Incentive Plan dated October 18, 1996 (incorporated by reference to Exhibit 10.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 27, 1998).
10.3*	1992 Non-Employee Director Stock Option Plan as amended through April 10, 1996 (incorporated by reference to Exhibit 4(a) to Registrant's Registration Statement on Form S-8, Registration Number 333-10163, effective September 2, 1997).
10.3.1	1992 Non-Employee Director Stock Option Plan as amended through February 27, 1998 (incorporated by reference to Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 27, 1998).
10.3.2	1992 Non-Employee Directors Stock Option Plan as amended through June 17, 1999 (incorporated by reference to Exhibit 10.3.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 4, 1999).
10.4	PictureTel Corporation 1994 Employee Stock Purchase Plan (incorporated by reference to Exhibit 4 to Registrant's Registration Statement on Form S-8, Registration Number 33-81848, effective July 22, 1994).
10.4.1	Amendment to PictureTel Corporation's 1994 Employee Stock Purchase Plan increasing the number of shares of Common Stock which may be delivered under the plan from 1,000,000 to 2,000,000 (incorporated by reference to Exhibit 10.4.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 4, 1999).
10.5	401(k) Profit Sharing Retirement Plan as amended through July 1, 1994 (incorporated by reference to Exhibit 10.45 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1994).
10.6*	Employment Agreement between PictureTel Corporation and Norman E. Gaut dated July 29, 1988 (incorporated by reference to Exhibit 10.12 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1988).
10.6.1*	Amendment dated January 15, 1995 to the Employment Agreement between PictureTel Corporation and Norman E. Gaut (incorporated by reference to Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended April 1, 1995).
10.6.2*	Employment Agreement Letter by and between Norman Gaut and PictureTel Corporation dated August 31, 1999 (incorporated by reference to Exhibit 10.6.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended October 3, 1999).
10.6.3	Change in Control Agreement between PictureTel Corporation and Norman Gaut dated August 31, 1999, filed herewith.
10.7	Reserved
10.8	Reserved
10.9	Reserved
10.9.1*	Employment agreement between PictureTel Corporation and Lawrence Bornstein dated December 5, 1997 (incorporated by reference to Exhibit 10.9.1 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1997).
10.9.2	Reserved
10.9.3	Amendment to employment agreement between PictureTel Corporation and Lawrence Bornstein dated January 20, 1999 (incorporated by reference to Exhibit 10.10.1 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1998).
10.10	Reserved

Exhibit Number	Description
10.10.1	Reserved
10.10.2	Reserved
10.11	Reserved
10.11.1*	Employment agreement between PictureTel Corporation and David Grainger dated December 5, 1997 (incorporated by reference to Exhibit 10.11.1 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1997).
10.11.2	Reserved
10.12	Form of Indemnification Agreement for directors and officers (incorporated by reference to Exhibit 10.34 to Registrant's Registration Statement on Form S-1, Registration No. 33-6368, effective August 12, 1986).
10.13	Reserved
10.13.1	Reserved
10.14	Lease Agreement between PictureTel Corporation and 100 Minuteman Limited Partnership dated October 7, 1995 (incorporated by reference to Exhibit 10.47 to Annual Report on Form 10-K for the year ended December 31, 1995).
10.14.1	Amendment No. 1 To Lease for 100 Minuteman, dated July 10, 1996 (incorporated by reference to Exhibit 10.14.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 29, 1997).
10.14.2	Amendment No. 2. To Lease for 100 Minuteman, dated August 19, 1996 (incorporated by reference to Exhibit 10.14.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 29, 1997).
10.15	Reserved
10.15.1	Reserved
10.15.2	Reserved
10.16	Lease Agreement between PictureTel Corporation and 50 Minuteman Limited Partnership dated August 26, 1996 (incorporated by reference to Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 28, 1996).
10.16.1	Amendment No. 1 to 50 Minuteman Lease dated March 19, 1997 (incorporated by reference to Exhibit 10.16.2 on Form S-4 dated October 5, 1998).
10.16.2	Sublease Agreement between PictureTel Corporation and Cabletron Systems, Inc. dated June 4, 1998 (incorporated by reference to Exhibit 10.16.3 on Form S-4 dated October 5, 1998).
10.17	Lease Agreement between PictureTel Corporation and 200 Minuteman Limited Partnership dated March 19, 1997 (incorporated by reference to Exhibit 10.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended June 29, 1997).
10.17.1	Amendment No. 1 to 200 Minuteman Lease dated June 4, 1998 (incorporated by reference to Exhibit 10.17.2 on Form S-4 dated October 5, 1998).
10.18*	Employment Agreement by and between PictureTel Corporation and Bruce R. Bond dated March 1, 1998 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 29, 1998).
10.18.1	Reserved
10.18.2*	Options to Bruce R. Bond effective January 31, 1998 (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 29, 1998).
10.18.3*	Separation Agreement Letter by and between Bruce R. Bond and PictureTel Corporation dated August 31, 1999 (incorporated by reference to Exhibit 10.18.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended October 3, 1999).

Exhibit Number	Description
10.19	Reserved
10.19.1	Reserved
10.19.2	Reserved
10.19.3	$35 million Loan and Security Agreement dated August 22, 2000, by and between Congress Financial Corporation (New England), PictureTel Corporation and certain subsidiaries of PictureTel Corporation, filed as Exhibit 1 to report on form 8-K dated August 30, 2000 and hereby incorporated by reference.
10.20	Reserved
10.20.1	Reserved
10.20.2*	Separation Agreement Letter by and between Gary L. Bond and PictureTel Corporation dated September 10, 1999 (incorporated by reference to Exhibit 10.20.2 to Registrant's Quarterly Report on Form 10-Q for the quarter ended October 3, 1999).
10.21	Reserved
10.21.1	Reserved
10.22	Reserved
10.22.1	Reserved
10.23*	1999 Equity Plan authorizing 3,000,000 shares of Common Stock to be delivered from time to time (incorporated by reference to Exhibit 10.23 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 4, 1999).
10.24*	1999 Foreign Subsidiary Employee Stock Purchase Plan under which 500,000 shares of Common Stock may be delivered from time to time (incorporated by reference to Exhibit 10.24 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 4, 1999).
10.25*	Employment agreement between PictureTel Corporation and Robert Byrnes dated November 9, 1999 (incorporated by reference to Exhibit 10.25 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1999).
10.26*	Employment agreement between PictureTel Corporation and Catherine O'Rourke dated December 21, 1999 (incorporated by reference to Exhibit 10.26 to Registrant's Annual Report on Form 10-K for the year ended December 31, 1999).
10.27*	Consultant agreement between PictureTel Corporation and Enzo Torresi dated January 5, 1999 (incorporated by reference to Exhibit 10.3 to Registrant's Quarterly Report on Form 10-Q for the quarter ended April 4, 1999).
10.28*	Employment Agreement between PictureTel Corporation and Lewis Jaffe dated June 19, 2000, (incorporated by reference to Exhibit 10.28 to Registrant's Quarterly report on Form 10-Q for the quarter ended July 1, 2000).
10.28.1*	Change in Control Agreement between PictureTel Corporation and Lewis Jaffe dated June 19, 2000, (incorporated by reference to Exhibit 10.28.1 to Registrant's Quarterly Report on Form 10-Q for the quarter ended July 1, 2000).
10.29*	Employment Agreement between PictureTel Corporation and Edward Semonite, dated September 15, 2000, (incorporated by reference to Exhibit 10.29 to Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000).
10.29.1*	Change in Control Agreement between PictureTel Corporation and Edward Semonite dated September 18, 2000, filed herewith.
10.30*	Employment Agreement between PictureTel Corporation and Jonathan Kosheff, dated September 15, 2000, (incorporated by reference to Exhibit 10.30 to Registrant's Quarterly report on Form 10-Q for the quarter ended September 30, 2000).
10.30.1*	Change in Control Agreement between PictureTel Corporation and Jonathan Kosheff dated September 18, 2000, filed herewith.

Exhibit Number	Description
10.31*	Employment Agreement between PictureTel Corporation and David Snow, dated December 22, 2000, filed herewith.
10.31.1*	Change in Control Agreement between PictureTel Corporation and David Snow dated December 18, 2000, filed herewith.
10.32*	Employment Agreement between PictureTel Corporation and Dalton Edgecomb, dated December 20, 2000, filed herewith.
10.32.1*	Change in Control Agreement between PictureTel Corporation and Dalton Edgecomb dated January 10, 2001, filed herewith.
10.33*	Change in Control Agreement between PictureTel Corporation and W. Robert Kellegrew dated September 18, 2000, filed herewith.
23	Consent of PricewaterhouseCoopers LLP, filed herewith.

* Indicates management contract or compensatory plan, contract or arrangement.

(d) Financial Statement Schedule

The Company hereby files as part of this Annual Report on Form 10-K the financial statement schedule listed on Item 14(a)2 as set forth above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

PICTURETEL CORPORATION

By /s/ NORMAN E. GAUT
Norman E. Gaut
Chairman and Chief Executive Officer

Date April 17, 2001

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ NORMAN E. GAUT Norman E. Gaut	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	April 17, 2001
/s/ LEWIS JAFFE Lewis Jaffe	President and Chief Operating Officer	April 17, 2001
/s/ CARL LEDBETTER Carl Ledbetter	Director	April 17, 2001
/s/ DAVID B. LEVI David B. Levi	Director	April 17, 2001
/s/ ROBERT T. KNIGHT Robert T. Knight	Director	April 17, 2001
/s/ WERNER SCHMÜCKING Werner Schmücking	Director	April 17, 2001
/s/ ENZO TORRESI Enzo Torresi	Director	April 17, 2001
/s/ DALTON EDGECOMB Dalton Edgecomb	Vice President, Chief Financial Officer, (Principal Financial Officer & Principal Accounting Officer)	April 17, 2001