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**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

**Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934**

(Mark One)

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

For the quarterly period ended March 31, 2001

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

For the Quarter ended March 31, 2001

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)

**978-292-5000**  
Registrant's telephone number

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 the number of shares outstanding of each of the issuer's classes of common stock as of the latest practical date.

As of May 4, 2001, there were outstanding 45,098,941 shares of common stock of the registrant.

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**PICTURETEL CORPORATION**

**FORM 10-Q**

**INDEX**

**PART I. CONSOLIDATED FINANCIAL INFORMATION**

**Item 1. Consolidated Financial Statements:**

Consolidated Balance Sheets March 31, 2001 and December 31, 2000 .....	2
Consolidated Statements of Operations Three Months Ended March 31, 2001 and April 1, 2000.....	3
Consolidated Statements of Cash Flows Three Months Ended March 31, 2001 and April 1, 2000.....	4
Notes to Consolidated Financial Statements .....	5-8

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations .....	9-16
--	------

Item 3. Quantitative and Qualitative Disclosures about Market Risk .....	16
--	----

**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings .....	16
---------------------------------	----

Item 2. Changes in Securities .....	Not Applicable
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Item 3. Defaults Upon Senior Securities .....	Not Applicable
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Item 4. Submission of Matters to a Vote of Security Holders .....	Not Applicable
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Item 5. Other Information .....	Not Applicable
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Item 6. Exhibits and Reports on Form 8-K.....	16
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Signature .....	17
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# **PART I. CONSOLIDATED FINANCIAL INFORMATION**

## **Item 1. CONSOLIDATED FINANCIAL STATEMENTS**

### **PICTURETEL CORPORATION**

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

	<u>March 31, 2001</u>	<u>December 31, 2000</u>
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents . . . . .	\$ 34,302	\$ 43,441
Restricted cash and cash equivalents . . . . .	8,400	5,775
Accounts receivable, less allowances for doubtful accounts of \$2,723 and \$4,100 at March 31, 2001 and December 31, 2000, respectively . . . . .	32,427	39,897
Inventories . . . . .	27,871	27,020
Other current assets . . . . .	<u>10,412</u>	<u>9,716</u>
Total current assets . . . . .	113,412	125,849
Property and equipment, net . . . . .	16,701	18,310
Other assets . . . . .	<u>1,956</u>	<u>2,861</u>
Total assets . . . . .	<u>\$ 132,069</u>	<u>\$147,020</u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Short-term borrowings . . . . .	\$ 566	\$ 1,487
Accounts payable . . . . .	17,558	20,575
Accrued compensation and benefits . . . . .	5,000	7,280
Accrued expenses . . . . .	30,305	32,896
Deferred revenue . . . . .	<u>19,202</u>	<u>18,216</u>
Total current liabilities . . . . .	72,631	80,454
Non-current liabilities . . . . .	<u>2,126</u>	<u>2,101</u>
Total liabilities . . . . .	<u>74,757</u>	<u>82,555</u>
Commitments and contingencies (Notes 5 and 8)		
Redeemable convertible preferred stock, \$.01 par value 13,500,000 shares authorized; 9,416,708 shares issued and outstanding at March 31, 2001 and December 31, 2000 . . . . .	<u>42,845</u>	<u>42,845</u>
Stockholders' equity:		
Preferred stock, \$.01 par value 1,500,000 shares authorized; 0 issued and outstanding at March 31, 2001 and December 31, 2000 . . . . .		
Common stock, \$.01 par value; 80,000,000 shares authorized; 45,191,006 and 45,049,032 shares issued and outstanding at March 31, 2001 and December 31, 2000 . . . . .	452	450
Additional paid-in capital . . . . .	245,816	245,399
Accumulated deficit . . . . .	(229,180)	(221,751)
Accumulated other comprehensive loss . . . . .	(2,065)	(1,922)
Treasury stock, 92,065 shares, at cost . . . . .	<u>(556)</u>	<u>(556)</u>
Total stockholders' equity . . . . .	<u>14,467</u>	<u>21,620</u>
Total liabilities, redeemable convertible preferred stock and stockholders' equity . . . . .	<u>\$ 132,069</u>	<u>\$147,020</u>

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

**PICTURETEL CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands, except share data)  
(Unaudited)

	<u>Three Months Ended</u>	
	<u>March 31, 2001</u>	<u>April 1, 2000</u>
Revenue .....	\$49,605	\$ 65,203
Cost of revenue .....	<u>31,827</u>	<u>47,484</u>
Gross margin .....	<u>17,778</u>	<u>17,719</u>
Operating expense:		
Selling, general and administrative .....	18,117	27,309
Research and development .....	<u>7,184</u>	<u>13,453</u>
Total operating expense .....	<u>25,301</u>	<u>40,762</u>
Loss from operations .....	(7,523)	(23,043)
Interest income (expense), net .....	571	(292)
Other income (expense), net .....	<u>(68)</u>	<u>327</u>
Loss before income tax expense .....	(7,020)	(23,008)
Income tax expense .....	<u>410</u>	<u>834</u>
Net loss .....	<u><u>\$(7,430)</u></u>	<u><u>\$(23,842)</u></u>
Net loss per common share — basic and diluted .....	<u><u>\$ (0.17)</u></u>	<u><u>\$ (0.59)</u></u>
Weighted average shares outstanding — basic and diluted .....	<u><u>44,984</u></u>	<u><u>40,630</u></u>

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

**PICTURETEL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Dollars in thousands)**  
**(Unaudited)**

	<u>Three Months Ended</u>	
	<u>March 31, 2001</u>	<u>April 1, 2000</u>
Cash flows from operating activities:		
Net loss .....	\$(7,430)	\$(23,842)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization .....	2,182	6,938
Provision for doubtful accounts .....	404	553
Provision for inventory obsolescence .....	456	2,649
Other non-cash items .....	130	(17)
Changes in operating assets and liabilities:		
Accounts receivable .....	6,173	16,687
Inventories .....	(1,581)	(9,419)
Other current assets .....	(210)	4,631
Accounts payable .....	(2,786)	237
Accrued compensation and benefits and accrued expenses .....	(4,558)	(6,818)
Deferred revenue .....	1,380	(950)
Net cash used in operating activities .....	<u>(5,840)</u>	<u>(9,351)</u>
Cash flows from investing activities:		
Purchase of marketable securities .....	—	(23,126)
Proceeds from sale of marketable securities .....	—	33,022
Purchases of property and equipment .....	(791)	(2,284)
Proceeds from sale of fixed assets .....	4	10
Net cash provided by (used in) investing activities .....	<u>(787)</u>	<u>7,622</u>
Cash flows from financing activities:		
Restricted cash and cash equivalents .....	(2,625)	1,050
Payments on short-term/long-term borrowings .....	(848)	(188)
Principal payments under capital lease obligations .....	—	(433)
Proceeds from exercise of stock options .....	—	2,460
Proceeds from employee stock purchase plan .....	418	520
Net cash provided by (used in) financing activities .....	<u>(3,055)</u>	<u>3,409</u>
Effect of exchange rate changes on cash .....	543	229
Net increase (decrease) in cash and cash equivalents .....	(9,139)	1,909
Cash and cash equivalents at beginning of period .....	43,441	21,915
Cash and cash equivalents at end of period .....	<u>\$34,302</u>	<u>\$ 23,824</u>

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

**PICTURETEL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Amounts in thousands, except share data)**

**1. Management's Representation**

As permitted by the rules of the Securities and Exchange Commission applicable to Quarterly Reports on Form 10-Q, these notes are condensed and do not contain all the disclosures required by generally accepted accounting principles. Reference should be made to the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000, as filed with the Securities and Exchange Commission on April 17, 2001.

In the opinion of the management of PictureTel Corporation, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the Company's financial position at March 31, 2001 and December 31, 2000, results of operations for the three months ended March 31, 2001 and April 1, 2000 and changes in cash flow for the three months ended March 31, 2001 and April 1, 2000.

The results disclosed in the Consolidated Balance Sheet at March 31, 2001, the Consolidated Statement of Operations for the three months ended March 31, 2001 and the Consolidated Statement of Cash Flows for the three months ended March 31, 2001 are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. These estimates affect the reported amounts of assets and liabilities, 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. The financial statements include significant estimates of the net realizable value of accounts receivable, inventory and the amount of certain contingent liabilities. Actual results could differ from those estimates.

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 products which were released in the third quarter of 2000 and in April 2001. In addition, management is currently seeking additional financing. 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. Inventories**

Inventories consist of the following:

	<b>March 31, 2001</b>	<b>December 31, 2000</b>
Purchased Parts .....	\$ 3,706	\$ 4,018
Work in Process .....	140	234
Finished Goods .....	<u>24,025</u>	<u>22,768</u>
	<u><u>\$27,871</u></u>	<u><u>\$27,020</u></u>

**PICTURETEL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**3. Earnings Per Share**

The following table reconciles the numerator and the denominator of the basic and diluted EPS computations shown on the Consolidated Statements of Operations:

	<u>Three Months Ended</u>	
	<u>March 31, 2001</u>	<u>April 1, 2000</u>
Basic and Diluted EPS Computation		
Numerator:		
Net loss .....	<u>\$ (7,430)</u>	<u>\$ (23,842)</u>
Denominator:		
Weighted average common shares outstanding .....	<u>44,984</u>	<u>40,630</u>
Basic and diluted EPS .....	<u>\$ (0.17)</u>	<u>\$ (0.59)</u>

Options to purchase shares of the Company's common stock of 5,839,952 and 7,007,732 were outstanding at March 31, 2001 and April 1, 2000, respectively, but were not included in the computation of diluted EPS because they were antidilutive due to the net losses sustained in 2001 and in 2000. Warrants for 2,723 shares of the Company's Common Stock and Convertible Redeemable Preferred Stock of 9,416,708 shares were outstanding at March 31, 2001, but were not included in the computation of diluted EPS because they were antidilutive due to the loss sustained in 2001.

**4. Comprehensive Loss**

The Company adopted SFAS No. 130, "Reporting Comprehensive Income," in fiscal year 1998. The calculation of comprehensive income includes the loss as reported in the Consolidated Statements of Operations, the gains and losses on foreign currency translation adjustments and unrealized gains and losses on marketable securities.

	<u>Three Months Ended</u>	
	<u>March 31, 2001</u>	<u>April 1, 2000</u>
Net loss .....	\$ (7,430)	\$ (23,842)
Foreign currency translations, net .....	(143)	(248)
Unrealized losses on marketable securities, net .....	—	(17)
Comprehensive loss .....	<u>\$ (7,573)</u>	<u>\$ (24,107)</u>

**5. Debt**

The Company entered into an asset-based secured revolving credit agreement dated August 21, 2000, which will expire on August 21, 2003. This 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 this 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 March 31, 2001, availability based on receivables and net of the \$10,000 discretionary reserve, was \$3,328. Interest for loans under this facility is payable at 1% above the Lender's prime rate. There were no borrowings outstanding against the availability at March 31, 2001. The Company has \$8,000 of outstanding standby letters of credit issued under this agreement as of March 31, 2001. The letters of credit have been collateralized 105% and are in an account held at the Lender. Cash subject to the cash collateral requirement

# **PICTURETEL CORPORATION**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

amounts to \$8,400 and is classified as current on the Company's balance sheet at March 31, 2001. 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.

Local lines of credit of up to \$1,374 are available to certain of the Company's foreign subsidiaries for short-term advances. The agreements require interest payable up to one and three-quarter percent per annum. Borrowings totaling \$566 were outstanding against these local lines of credit at March 31, 2001.

The Company has operating leases for various rented properties. The Company signed an agreement to sublease its former MultiLink subsidiary's facility at 6 Riverside Drive in Andover, Massachusetts in May 1999, as part of its space consolidation efforts. As of March 31, 2001, the remaining obligation under this operating lease was \$6,868. After giving effect to expected sublease income, this obligation is \$4,659. In addition, in June 1998, the Company subleased its property at 50 Minuteman Road for a ten-year term. After giving effect to expected sublease income, the remaining obligation under this operating lease was \$1,198 at March 31, 2001.

### **6. Commitments**

In conjunction with a joint development agreement with Sharp Corporation, the Company has outstanding commitments as of March 31, 2001 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 were released in April 2001.

### **7. Segment Information**

The Company has determined that its reportable segments are 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 videoconferencing products.

	<u>Video- conferencing Products</u>	<u>Video- conferencing Services</u>	<u>Other</u>	<u>Total</u>
Quarter ended March 31, 2001:				
Revenue from external customers .....	\$ 33,856	\$15,708	\$ 41	\$ 49,605
Operating income (loss) .....	\$ (6,468)	\$ 3,979	\$(5,034)	\$ (7,523)
Quarter ended April 1, 2000:				
Revenue from external customers .....	\$ 44,775	\$18,198	\$ 2,230	\$ 65,203
Operating income (loss) .....	\$(15,662)	\$ 1,461	\$(8,842)	\$(23,043)

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 is no material intersegment revenue. 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.



**PICTURETEL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

*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:

	<u>United States</u>	<u>United Kingdom</u>	<u>Japan</u>	<u>All Other</u>	<u>Total</u>
Three months ended March 31, 2001:					
Revenue from external customers . . . . .	\$ 31,261	\$10,467	\$4,301	\$3,576	\$ 49,605
Long-lived assets . . . . .	\$ 15,527	\$ 2,097	\$ 853	\$ 180	\$ 18,657
Three months ended April 1, 2000:					
Revenue from external customers . . . . .	\$ 36,827	\$16,677	\$7,249	\$4,450	\$ 65,203
Long-lived assets . . . . .	\$101,039	\$ 3,577	\$2,079	\$ 231	\$106,926

**8. Litigation**

*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 affect to its business, financial condition, results of operations or cash flows.

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

### Forward-Looking Statements

This document includes forward-looking statements about the Company's business, revenues and expenses, effective tax rate, operating and capital requirements, liquidity and management's plans to introduce new products and seek additional financing. 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 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 Corporation, it developed its new 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. On April 30, 2001, the Company began shipping the first of these new products, the PictureTel 600 Series. The PictureTel 600 Series is the world's first PC-based videoconferencing solution in a compact package. This solution is the second product series in the iPower family.

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.

### Results of Operations

The following table sets forth, for the periods indicated, the percentage of revenue for certain items in the Company's Statement of Operations for each period:

	<b>Three Months Ended</b>	
	<b>March 31, 2001</b>	<b>April 1, 2000</b>
Revenue .....	100.0%	100.0%
Cost of revenue .....	64.2	72.8
Gross margin .....	35.8	27.2
Selling, general and administrative .....	36.5	42.0
Research and development .....	14.5	20.6
Total operating expense .....	51.0	62.6
Loss from operations .....	(15.2)	(35.4)
Interest income (expense), net .....	1.2	(0.4)
Other income (expense), net .....	(0.2)	0.5
Loss before income tax expense .....	(14.2)	(35.3)
Income tax expense .....	0.8	1.3
Net loss .....	(15.0)	(36.6)

*Three Months Ended March 31, 2001 Compared to Three Months Ended April 1, 2000*

**Revenue.** The Company reported revenue of \$49,605 for the three months ended March 31, 2001 compared to \$65,203 for the first three months of the prior year ended April 1, 2000, representing a decrease of \$15,598, or 24%. The decrease in revenue is primarily attributed to a decrease in unit sales of legacy systems, which was not offset by an increase in new system product sales. In addition, revenue for the first quarter of 2000 includes \$2,248 of revenue from MultiLink, the Company's audioconferencing subsidiary, and the Company's Starlight division, which were sold in the fourth quarter of 2000.

**Gross Margin.** Overall gross margin for the first quarter of 2001 was relatively flat at \$17,778 compared to \$17,719 for the first quarter of 2000. However, as a percentage of revenue, gross margin was 36% for the first quarter of 2001 compared to 27% for the first quarter of 2000. The increase in gross margin percentage is attributable to sales of products with higher margin percentages, along with the elimination of lower margins generated by the Company's audioconferencing segment, MultiLink, Inc., which was sold in the fourth quarter of 2000.

**Operating Expense.** First quarter 2001 operating expense of \$25,301 declined \$15,461, or 38%, from comparable prior year levels of \$40,762. As a percent of revenue, first quarter 2001 operating expense represented 51% of revenue while first quarter 2000 operating expense represented 63% of revenue. Selling, general and administrative expense decreased \$9,192, or 34%, to \$18,117 for the first quarter of 2001 compared to \$27,309 for the first quarter of 2000. Research and development decreased \$6,269, or 47%, to \$7,184 for the first quarter of 2001 compared to \$13,453 for the first quarter of 2000. The decline in operating expense is the result of on-going efforts, including headcount reductions, to reduce operating expense, along with the elimination of expenses associated with the Company's Starlight division and audioconferencing segment, MultiLink, Inc., which were sold in the fourth quarter of 2000.

**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 was \$33,856 for the first three months of 2001. This represents a decrease of \$10,919, or 24%, compared with the first three months of 2000, but represents a \$1,946, or 6%, increase versus the fourth quarter of 2000. Despite difficult economic conditions, including the freezing of telecommunications capital spending by many large companies, PictureTel was able to record sequential quarterly product sales growth. The revenue decrease from the first quarter of 2000 is due primarily to decreases in legacy product sales not entirely offset by sales of PictureTel's new 900 Series product offerings.

Videoconferencing system units sold during the first quarter of 2001 were 47% less than the comparable quarter in the prior year. However, units sold of larger group systems increased by 78% from the prior year first quarter primarily due to sales of the new PictureTel 900 Series units. Total Group system volume decreased by 17 due to lower compact system sales, while lower-end desktop/personal system volume decreased by 68%. The large decrease in desktop/personal systems was primarily the result of the Intel ProShare end of life, offset in part by increased PictureTel 550 sales. PictureTel 900 Series unit sales increased 14% versus the fourth quarter of 2000, continuing sequential quarterly growth since its introduction in August 2000.

The videoconferencing products segment generated an operating loss of \$6,468 in the first quarter of 2001 compared to a \$15,662 operating loss during the first quarter of 2000. Despite lower gross margin, the decrease in operating loss is in part attributed to lower engineering costs resulting from completion of the iPower architecture development. In addition, a reduction in selling, general and administrative expense, resulting from on-going efforts to reduce expenses on a worldwide basis, along with the elimination of operating expense related to the Company's Starlight division sold in the fourth quarter of 2000, also contributed to the decrease in operating loss.

**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 14% from \$18,198 in the first quarter of 2000 to \$15,708 in the first

quarter of 2001. The decrease in service revenue is primarily attributed to lower videoconferencing system unit sales, along with lower pricing on maintenance contracts. Maintenance revenue, including sales of spare parts, was 21% lower than the prior year, while professional services increased 2%.

Operating profits were \$3,979 in the first quarter of 2001, which represent a 172% increase from the prior year of \$1,461. The increase is largely due to decreased costs in all areas.

*Income Taxes.* The Company's effective income tax rate was 6% in the first quarter of 2001 compared to 4% in the first quarter of 2000. The tax rate in both periods relates to state and/or foreign taxes.

#### *Comparison of First Quarter 2001 with Fourth Quarter 2000.*

First quarter 2001 revenue of \$49,605 represented an increase of \$1,253, or 3%, when compared with \$48,352 revenue for the fourth quarter of 2000. Net loss from operations for first quarter 2001 was \$7,523 compared to \$15,604 (normalized, after removing a \$7,654 one-time special charge for lease termination) for fourth quarter 2000, an improvement of \$8,081 at the operating line. Resulting gross margin for first quarter 2001 improved by 11.3 percentage points over gross margin for fourth quarter 2000.

#### **Liquidity and Capital Resources**

At April 1, 2001, the Company had \$34,302 in cash and cash equivalents. Operating activities used \$5,840 of cash during the first quarter of 2001 compared with a \$9,351 use in the comparable 2000 quarter. The primary operating use of cash during both quarters was to fund operating losses in excess of non-cash expense. The Company generated a \$1,582 usage of cash from working capital during 2001's first quarter compared to generating \$4,368 of cash for working capital in the first quarter of 2000. The Company paid \$627 of accrued severance and restructuring charges during the first quarter of 2001 and had a remaining accrual in the amount of \$922 for such items as of April 1, 2001 that will be paid over the next nine months.

Investing activities used \$787 of cash in the first quarter of 2001 compared with \$7,622 provided in the first quarter of 2000. The usage in the first quarter of 2001 is principally attributable to the purchase of property and equipment. This usage is approximately 65% less than the comparable 2000 figure, as the Company has sharply curtailed spending on property and equipment. Changes in marketable securities balances were the principal source of cash provided by investing activities in the first quarter of 2000. During the first quarter of 2001, the Company held no marketable securities.

Financing activities used \$3,055 of cash in the first quarter of 2001 compared with \$3,409 provided in the first quarter of 2000. The usage in the first quarter of 2001 was primarily the result of an increase in restricted cash balances. Cash provided by financing activities in the first quarter of 2000 was principally the result of employee stock option exercises and a reduction in restricted cash balances.

Liquidity is a major priority for the Company. The Company entered into an asset-based secured revolving credit agreement dated August 21, 2000, which will expire on August 21, 2003. This 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 this 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 March 31, 2001, availability based on receivables and net of the \$10,000 discretionary reserve, was \$3,328. Interest for loans under this facility is payable at 1% above the Lender's prime rate. There were no borrowings outstanding against the availability at March 31, 2001. The Company has \$8,000 of outstanding standby letters of credit issued under this agreement as of March 31, 2001. 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 \$8,400 and is classified as current on the Company's balance sheet at March 31, 2001. 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.

Local lines of credit of up to \$1,374 are available to certain of the Company's foreign subsidiaries for short-term advances. The agreements require interest payable up to one and three-quarter percent per annum. Borrowings totaling \$566 were outstanding against these local lines of credit at March 31, 2001.

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, along with on-going efforts to reduce operating expense, management implemented a headcount reduction plan in April 2001. Management anticipates an approximate \$1,200 quarterly reduction in operating expense, as a result of this plan.

Working capital management is expected to improve due to the hiring of a new credit manager during the fourth quarter of 2000 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 introduced its next product line series in April 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 February 2001, the Company received a report from its independent accountants containing an explanatory paragraph stating that its 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 multi-media 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 its former MultiLink subsidiary's facility at 6 Riverside Drive in Andover, Massachusetts in May 1999 as part of its space consolidation efforts. As of March 31, 2001, the remaining obligation under this operating lease was \$6,868. After giving effect to expected sublease income, this obligation is \$4,659. In addition, in June 1998, the Company subleased its property at 50 Minuteman Road for a ten-year term. After giving effect to expected sublease income, the remaining obligation under this operating lease was \$1,198 at March 31, 2001.

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. The Company repurchased 70,000 shares during the first quarter of 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.

### **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 begun shipping the resulting product (known as the PictureTel 900 Series) in mid August 2000. Also 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. Additional new product series are planned for introduction in 2001. On April 30, 2001, the Company began shipping the first of these new products, the PictureTel 600 Series. The PictureTel 600 Series is the world's first PC-based videoconferencing solution in a compact package. This solution is the second product series in the iPower family. There can, however, 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. The Company announced on May 8, 2001, its intention to license its PurePoint technology, which is owned by its 1414c subsidiary, to First Virtual Communications (FVC). In return, the Company will receive a technology license, which is anticipated to allow the Company to broaden its endpoint product line, and warrants in FVC. There can be no assurance that the transaction will close, that the technology from FVC will be accretive to PictureTel or that the warrants will have any value.

*Competition.* The increased competition resulting from partnerships and acquisitions by and with our competitors, 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 further decrease from historical levels 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 and several vendors are smaller corporations with limited financial resources that could 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 and Liquidity Risks.* While revenue for the first quarter of 2001 was above fourth quarter 2000, the Company reported a 24% decrease in revenue for the first quarter of 2001 as compared to the first quarter of 2000. Losses from operations were \$7,523 and \$23,043 for the first quarter of 2001 and 2000, respectively, representing a 67% decrease in losses from operations.

The Company's revenue decreased 24% during fiscal year 2000 as compared to fiscal year 1999 and decreased 20% between fiscal year 1999 and fiscal year 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 affect the Company's ability to remain in compliance with covenants under its revolving credit agreement and further diminish its liquidity. In February 2001, the Company received a report from its independent accountants for the year ended December 31, 2000 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 multi-media applications services, and enhanced compact videoconferencing systems and on continued implementation of cost reductions. There can be no guarantee that 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 revenue 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 revenue depends upon its ability to increase unit volume sales. There can be no assurance that the Company will be able to increase or to maintain the current level of unit volume sales. 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 such as currency fluctuations.

*International Operations.* Revenue related to international operations of the Company totaled approximately 46% and 53% of total revenue for the periods ended March 31, 2001 and April 1, 2000, respectively. Management of the Company expects international revenue to continue to constitute a significant portion of total revenue 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.

**Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

There were no material changes in the Company's exposure to market risk from December 31, 2000.

**PART II — OTHER INFORMATION**

**Item 1. *Legal Proceedings***

**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 affect on its business, financial condition, results of operations or cash flows.

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

**(a) *Exhibits***

None

**(b) *Reports on Form 8-K***

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.

## **SIGNATURE**

Pursuant to the Securities Exchange Act of 1934, the registrant has duly caused this report on Form 10-Q to be signed on its behalf by the undersigned thereunto duly authorized.

PICTURETEL CORPORATION

/s/ DALTON EDGECOMB  
Dalton Edgecomb  
Chief Financial Officer,  
(Principal Financial and Accounting Officer)  
May 15, 2001