LANTRONIX INC
Form 10-Q
February 08, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2006

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to ___________.

Commission file number: 1-16027

LANTRONIX, INC.
(Exact name of registrant as specified in its charter)

Delaware	**33-0362767**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

15353 Barranca Parkway, Irvine, California
(Address of principal executive offices)

92618
(Zip Code)

(949) 453-3990
(Registrant’s telephone number, including area code)

Former name, former address and former fiscal year, if changed since last report: N/A

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o   Accelerated filer o   Non-accelerated filer x.

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

As of February 6, 2007, 59,605,957 shares of the Registrant's common stock were outstanding.

LANTRONIX, INC.

FORM 10-Q
FOR THE FISCAL QUARTER ENDED
December 31, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	December 31, 2006	June 30, 2006
	(In thousands)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 7,744	$ 7,729
Marketable securities	96	88
Accounts receivable, net	3,468	3,087
Inventories, net	8,528	8,113
Contract manufacturers' receivable	1,033	1,049
Settlements recovery	13,943	15,325
Prepaid expenses and other current assets	606	577
Total current assets	35,418	35,968
Property and equipment, net	1,787	1,589
Goodwill	9,488	9,488
Purchased intangible assets, net	568	610
Officer loans	126	122
Other assets	40	38
Total assets	$ 47,427	$ 47,815
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 9,136	$ 7,865
Accrued payroll and related expenses	1,905	1,596
Warranty reserve	474	693
Accrued settlements	15,075	16,767
Other current liabilities	3,130	3,675
Total current liabilities	29,720	30,596
Long-term liabilities	270	230
Long-term capital lease obligations	146	211
Commitments and contingencies		
Stockholders' equity:		
Common stock	6	6
Additional paid-in capital	183,887	182,857
Accumulated deficit	(167,014)	(166,450)
Accumulated other comprehensive income	412	365
Total stockholders' equity	17,291	16,778
Total liabilities and stockholders' equity	$ 47,427	$ 47,815

See accompanying notes.

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LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
	(In thousands, except per share data)			
Net revenues (1)	$ 14,829	$ 12,955	$ 27,343	$ 25,195
Cost of revenues (2)	7,429	6,357	13,336	12,477
Gross profit	7,400	6,598	14,007	12,718
Operating expenses:				
Selling, general and administrative	6,057	6,218	11,555	12,290
Research and development	1,882	1,310	3,600	2,713
Litigation settlement costs	75	2,600	90	2,600
Amortization of purchased intangible assets	18	-	36	2
Restructuring recovery	-	-	-	(29)
Total operating expenses	8,032	10,128	15,281	17,576
Loss from operations	(632)	(3,530)	(1,274)	(4,858)
Interest income, net	1	18	7	21
Other income (expense), net	730	(49)	727	(59)
Income (loss) before income taxes	99	(3,561)	(540)	(4,896)
Provision for income taxes	12	10	24	16
Net income (loss)	$ 87	$ (3,571)	$ (564)	$ (4,912)
Basic - net income (loss) per share	$ 0.00	$ (0.06)	$ (0.01)	$ (0.08)
Diluted - net income (loss) per share	$ 0.00	$ (0.06)	$ (0.01)	$ (0.08)
Basic - weighted average shares	59,562	58,670	59,413	58,582
Diluted - weighted average shares	60,196	58,670	59,413	58,582
(1) Includes net revenues from related party	$ 302	$ 306	$ 581	$ 606
(2) Includes amortization of purchased intangible assets	$ 4	$ 223	$ 6	$ 520

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended December 31,	
	2006	2005
	(In thousands)	
Cash flows from operating activities:		
Net loss	$ (564)	$ (4,912)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Share-based compensation	635	474
Depreciation	194	220
Amortization of purchased intangible assets	42	520
Provision (recovery) for doubtful accounts	20	(35)
Litigation settlement costs	90	2,600
Provision for inventories	(70)	(109)
Gain on disposal of fixed assets	-	(2)
Restructuring recovery	-	(29)
Foreign currency transaction loss	-	77
Changes in operating assets and liabilities:		
Accounts receivable	(401)	153
Inventories	(345)	313
Contract manufacturers' receivable	16	(188)
Prepaid expenses and other current assets	(25)	(287)
Other assets	(6)	28
Accounts payable	1,272	1,099
Accrued payroll and related expenses	304	163
Accrued settlements	(400)	-
Warranty reserve	(219)	(276)
Other liabilities	(617)	819
Net cash (used in) provided by operating activities	(74)	628
Cash flows from investing activities:		
Purchases of property and equipment, net	(271)	(132)
Net cash used in investing activities	(271)	(132)
Cash flows from financing activities:		
Net proceeds from issuances of common stock	395	200
Payment of capital lease obligations	(78)	(79)
Net cash provided by financing activities	317	121
Effect of foreign exchange rate changes on cash	43	(113)
Increase in cash and cash equivalents	15	504
Cash and cash equivalents at beginning of period	7,729	6,690
Cash and cash equivalents at end of period	$ 7,744	$ 7,194

See accompanying notes.

LANTRONIX, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006

1. Basis of Presentation

The condensed consolidated financial statements included herein are unaudited. They contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of Lantronix, Inc. and its subsidiaries (collectively, the "Company") at December 31, 2006, and the consolidated results of its operations for the three and six months ended December 31, 2006 and 2005, and its cash flows for the six months ended December 31, 2006 and 2005. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three and six months ended December 31, 2006 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

These financial statements do not include certain footnotes and financial presentations normally required under generally accepted accounting principles. Therefore, they should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2006, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on September 12, 2006.

2. Computation of Net Income (Loss) per Share

Basic and diluted net income (loss) per share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the year.

The following table presents the computation of net income (loss) per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
	(In thousands, except per share data)			
Numerator:				
Net income (loss)	$ 87	$ (3,571)	$ (564)	$ (4,912)
Denominator:				
Weighted-average shares outstanding	59,562	59,002	59,413	58,914
Less: Unvested common shares outstanding	-	(332)	-	(332)
Basic - weighted average shares	59,562	58,670	59,413	58,582
Effect of dilutive shares:				
Stock options	634	-	-	-
Diluted - weighted average shares	60,196	58,670	59,413	58,582
Basic - net income (loss) per share	$ 0.00	$ (0.06)	$ (0.01)	$ (0.08)
Diluted - net income (loss) per share	$ 0.00	$ (0.06)	$ (0.01)	$ (0.08)

The following table presents the common stock equivalents excluded from the diluted net income (loss) per share calculation, because they were anti-dilutive as of such dates. These excluded common stock equivalents could be dilutive in the future.

	Three Months Ended December 31,		**Six Months Ended December 31,**	
	2006	**2005**	**2006**	**2005**
Common stock equivalents	1,682,991	1,403,127	2,500,146	1,255,727

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3. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and consist of the following:

	December 31, 2006	June 30, 2006
	(In thousands)	
Raw materials	$ 3,266	$ 3,863
Finished goods	6,136	6,518
Inventory at distributors	1,552	1,690
Large scale integration chips *	964	731
	11,918	12,802
Reserve for excess and obsolete inventories	(3,390)	(4,689)
	$ 8,528	$ 8,113

* This item is both sold individually and embedded into the Company's products.

4. Warranty

Upon shipment to its customers, the Company provides for the estimated cost to repair or replace products to be returned under warranty. The Company's products typically carry a one- to two-year warranty. In addition, certain products that were sold prior to August 2003 carry a five-year warranty. Although the Company engages in extensive product quality programs and processes, its warranty obligation is affected by product failure rates, use of materials or service delivery costs that differ from our estimates. As a result, additional warranty reserves could be required, which could reduce gross margins. Additionally, the Company sells extended warranty services, which extend the warranty period for an additional one- to three-years depending upon the product.

The following table is a reconciliation of the changes to the product warranty liability for the periods presented:

	Six Months Ended December 31, 2006	Year Ended June 30, 2006
	(In thousands)	
Beginning balance	$ 693	$ 1,248
Recovered to cost of revenues	(49)	(35)
Usage	(170)	(520)
Ending balance	$ 474	$ 693

5. Bank Line of Credit and Debt

In May 2006, the Company entered into a two-year secured revolving Loan and Security Agreement ("Line of Credit") with a bank, which provides for borrowings up to $5.0 million. The borrowing capacity is limited to eligible accounts receivable as defined under the Line of Credit. Borrowings under the Line of Credit bear interest at the prime rate plus 1.75% per annum. The Company is required to pay an unused line fee of 0.50% on the unused portion of the Line of Credit. In addition, the Company paid a fully earned, non-refundable commitment fee of $54,000 and is required to pay an additional $54,000 on the first anniversary of the Effective Date.

The Company's obligations under the Line of Credit are secured by substantially all of the Company's assets, including its intellectual property.

The Company is subject to a number of covenants under the Line of Credit, pursuant to which, among other things, the Company has agreed that it will not, without the Bank's prior written consent: (a) sell, lease, transfer or otherwise dispose, any of the Company's business or property, provided, however, that the Company may sell inventory in the ordinary course of business consistent with the provisions of the Line of Credit; (b) change the Company's business structure, liquidate or dissolve, or permit a change in beneficial ownership of more than 20% of the outstanding shares; (c) acquire, merge or consolidate with or into any other business organization; (d) incur any debts outside the ordinary course of the Company's business, except for permitted indebtedness, or grant any security interests in or permit a lien, claim or encumbrance upon all or any portion of the Company's assets, except in favor of or agreed to by the bank; (f) make any investments other than permitted investments; (g) make or permit any payments on any subordinated debt, except under the terms of existing subordinated debt or on terms acceptable to the bank, or amend any provision in any document related to the subordinated debt that would increase the amount thereof, or (h) become an "investment company" as such term is defined under the Investment Company Act of 1940. The Line of Credit also contains a number of affirmative covenants, including, among other things, covenants regarding the delivery of financial statements and notice requirements, accounts receivable, payment of taxes, access to collateral and books and records, maintenance of properties and insurance policies, and litigation by third parties.

The Line of Credit includes events of default that include, among other things, non-payment of principal, interest or fees, violation of affirmative and negative covenants, cross default to certain other indebtedness, material adverse change, material judgments, bankruptcy and insolvency events.

As of December 31, 2006, the Company had no borrowings against the Line of Credit.

6. Share-Based Compensation

The following table presents a summary of option activity under the Company's stock option plans:

	Number of Shares
Balance at June 30, 2006	5,467,753
Options granted	685,000
Options forfeited	(328,490)
Options expired	(28,638)
Options exercised	(227,597)
Balance at December 31, 2006	5,568,028

The following table presents information related to stock option grants:

	Three Months Ended December 31,				Six Months Ended December 31,			
	2006		2005		2006		2005	
Weighted-average grant date fair value	$	1.18	$	1.17	$	1.22	$	1.16
Weighted-average grant date exercise price	$	1.54	$	1.49	$	1.57	$	1.47

The following table presents a summary of share-based compensation by functional line item:

	Three Months Ended December 31,				Six Months Ended December 31,			
	2006		2005		2006		2005	
	(In thousands)				(In thousands)			
Cost of revenues	$	24	$	21	$	36	$	41
Selling, general and administrative		202		161		411		328
Research and development		96		53		188		105
	$	322	$	235	$	635	$	474

7. Other Income (Expense), net

In June 2006, the Company entered into an agreement to sell its ownership interest in Xanboo for aggregate cash consideration of $2.0 million. On June 13, 2006, the Company sold 65% of its interest in Xanboo for cash consideration of $1.3 million. The Company recorded the $1.3 million cash payment received during June 2006 as other income in the consolidated statements of operations for the fiscal year ended June 30, 2006. On October 19, 2006, the Company sold its remaining interest in Xanboo for cash consideration of $700,000. The Company recorded the $700,000 cash payment as other income in the consolidated statements of operations for the fiscal quarter ended December 31, 2006.

8. Income Taxes

The Company utilizes the liability method of accounting for income taxes. The following table presents the Company's effective tax rates based upon the income tax provision for the periods shown:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	**2005**	**2006**	**2005**
Effective tax rate	12%	0%	4%	0%

The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from the effect of our domestic losses recorded without a tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate.

9. Comprehensive Loss

The components of comprehensive loss are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	**2005**	**2006**	**2005**
	(In thousands)		**(In thousands)**	
Net income (loss)	$ 87	$ (3,571)	$ (564)	$ (4,912)
Other comprehensive income (loss):				
Change in net unrealized gain on investment, net of taxes of $0	2	5	8	12
Change in translation adjustments, net of taxes of $0	53	(30)	39	(35)
Total comprehensive loss	$ 142	$ (3,596)	$ (517)	$ (4,935)

10. Litigation Settlements

Securities Litigation Settlements

Securities Class Action Lawsuits ("Class Action")

Beginning on May 15, 2002, a number of securities class actions were filed against the Company and certain of its current and former directors and former officers alleging violations of the federal securities laws. These actions were consolidated into a single action pending in the United States District Court for the Central District of California and entitled: In *re Lantronix, Inc*. Securities Litigation, Case No. CV 02-3899 GPS (JTLx). After the Court appointed a lead plaintiff, amended complaints were filed by the plaintiff, and the defendants filed various motions to dismiss directed at particular allegations. Through that process, certain of the allegations were dismissed by the Court.

On October 18, 2004, the plaintiff filed the third amended complaint, which is now the operative complaint in the action. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933, as amended (the "Securities Act") and violations of Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Securities Act claims are brought on behalf of all persons who purchased common stock of Lantronix pursuant or traceable to the Company's August 4, 2000 initial public offering ("IPO"). The Exchange Act claims are based on alleged misstatements related to the Company's financial results that were contained in the

Registration Statement and Prospectus for the IPO. The claims brought under the Exchange Act are brought on behalf of all persons and entities that purchased or acquired Lantronix securities from November 1, 2000 through May 30, 2002 (the “Class Period”). The complaint alleges that defendants issued false and misleading statements concerning the business and financial condition in order to allegedly inflate the value of the Company’s securities during the Class Period. The complaint alleges that during the Class Period, Lantronix overstated financial results through improper revenue recognition and failure to comply with Generally Accepted Accounting Principles (“GAAP”). Defendants have filed an answer to the complaint and the case is now in discovery. While the complaint does not specify the damages plaintiff may seek on behalf of the purported classes of stockholders, a recovery by the plaintiff and the plaintiff classes could have a material adverse impact on the Company. The proceeds from certain insurance policies have funded and continue to fund much of the Company’s defense to the Class Action lawsuit.

The Company reached an agreement with plaintiffs to settle the Class Action lawsuit. The Company also reached agreements with its relevant insurance carriers with respect to the funding of the cash portions of the settlement with plaintiffs, and the cash funding of the settlement has been completed. Under the terms of the agreement with the Class Action plaintiffs, the Company will not be required to contribute any cash to the Class Action settlement, as all cash contributed would be from the Company's insurance carriers. However, as part of the agreement with the plaintiffs in the Class Action lawsuit, the Company has agreed to issue certain Lantronix securities to the plaintiffs. As a result of the anticipated issuance of such securities, and in connection with the issuance of securities for the settlement of the Synergetic action described below, the Company recorded a charge of $1.2 million in the consolidated statement of operations for the fiscal year ended June 30, 2006. As of December 31, 2006, the Company had an accrued settlement of $15.1 million of which the Company's insurance carriers agreed to fund $13.9 million. On December 11, 2006, the United States District Court for the Central District of California gave its final approval to the settlement and issued a final order and judgment in the matter. The Company expects to issue the Lantronix securities with a fair value of $1.1 million to the class plaintiffs as final consideration for the settlement by February 9, 2007.

Securities Claims Brought by Former Stockholders of Synergetic Micro Systems, Inc. ("Synergetic")

On October 17, 2002, Richard Goldstein and several other former stockholders of Synergetic filed a complaint entitled *Goldstein, et al. v. Lantronix, Inc., et al*. in the Superior Court of the State of California, County of Orange, against the Company and certain of its former officers and directors. Plaintiffs filed an amended complaint on January 7, 2003. The amended complaint alleges fraud, negligent misrepresentation, breach of warranties and covenants, breach of contract and negligence, all stemming from its acquisition of Synergetic. The complaint seeks an unspecified amount of damages, interest, attorneys' fees, costs, expenses, and an unspecified amount of punitive damages. On May 5, 2003, the Company answered the complaint and generally denied the allegations in the complaint.

In May 2006, the Company entered into a definitive settlement agreement with the plaintiffs in the Synergetic action. Pursuant to the settlement agreement, in June 2006, the Company issued 84,053 common shares with a fair value of $175,000 as partial consideration for its settlement of the Synergetic claims, and the Company's insurance carriers paid $750,000 to the plaintiffs. In connection with the settlement, the plaintiffs filed a request for dismissal with prejudice of all claims against all parties with the Court on July 7, 2006, and this litigation is now concluded.

Government Investigation

During June 2006, the Company reached an agreement in principle with the regional staff of the SEC regarding the terms of a settlement that the regional staff has agreed to recommend to the SEC. On September 27, 2006, the Commission formally approved of the proposed settlement. The settlement, under which the Company has not admitted or denied any wrongdoing, fully resolves all claims against the Company relating to the formal investigation that the SEC commenced in July 2002 relating to the Company's restatement of its financial results announced in May and June 2002. The settlement includes the following principal terms:

- The Company agreed to a cease and desist order from future violations of securities laws;
- The Company was not required to pay any monetary penalties; and
- The Company has agreed to cooperate with the Commission on any further proceedings in connection with its investigation.

Accrued Settlements and Settlements Recovery

The following table presents details of the Company's accrued settlements and settlements recovery:

	December 31, 2006	June 30, 2006
	(In thousands)	
Accrued settlements:		
Class Action and Synergetic	$ 15,075	$ 15,167
Derivative	-	1,200
Patent infringement	-	400
	15,075	16,767
Settlements recovery:		
Class Action and Synergetic	13,943	14,125
Derivative	-	1,200
	13,943	15,325
Direct settlement obligations of the Company	$ 1,132	$ 1,442

11. Litigation

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. Except as discussed in Note 10, the Company is currently not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on its business, prospects, financial position, operating results or cash flows.

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

Cautionary Statement

You should read the following discussion and analysis in conjunction with our Unaudited Condensed Consolidated Financial Statements and the related notes thereto contained elsewhere in this Quarterly Report on Form 10-Q. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the fiscal year ended June 30, 2006 and subsequent reports on our Current Reports on Form 8-K, which discuss our business in greater detail.

The section entitled "Risk Factors" set forth in Part II, Item 1A, and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this Quarterly Report on Form 10-Q and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.

This report contains forward-looking statements which include, but are not limited to, statements concerning projected net revenues, expenses, gross profit and net income (loss), the need for additional capital, market acceptance of our products, our ability to achieve further product integration, the status of evolving technologies and their growth potential and our production capacity. Among these forward-looking statements are statements regarding a potential decline in net revenue from non-core product lines, potential variances in quarterly operating expenses, the adequacy of existing resources to meet cash needs, some reduction in the average selling prices and gross margins of products, need to incorporate software from third-party vendors and open source software in our future products and the potential impact of an increase in interest rates or fluctuations in foreign exchange rates on our financial condition or results of operations. These forward-looking statements are based on our current expectations, estimates and

projections about our industry, our beliefs and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are inte to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, including but not limited to those identified under the heading "Risk Factors" set forth in Part II, Item 1A. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

Lantronix, Inc. ("Lantronix" or "the Company") designs, develops and markets devices that make it possible to access, manage, control and configure electronic products over the Internet or other networks. We are a leader in providing innovative networking solutions. We were initially formed as "Lantronix," a California corporation, in June 1989. We reincorporated as "Lantronix, Inc.," a Delaware corporation, in May 2000.

We have a history of providing devices that enable information technology ("IT") equipment to network using standard protocols for connectivity, including Ethernet and wireless. Our first device was a terminal server that allowed "dumb" terminals to connect to a network. Building on the success of our terminal servers, in 1991 we introduced a complete line of print servers that enabled users to inexpensively share printers over a network. Since then, we have continually refined our core technology and have developed additional innovative networking solutions that expand upon the business of providing our customers network connectivity. With the expansion of networking and the Internet, our technology focus has been increasingly broader and has expanded beyond IT equipment, so that our device solutions provide a product manufacturer with the ability to network its products within the industrial, service and commercial markets.

During the fiscal quarter ended September 30, 2006, we renamed our product lines to reflect our single focus on device networking and our broadening product portfolio and entry into new adjacent applications. The Company will report its two core product lines as "device enablement" (formerly "device networking"), and "device management" (formerly "IT management"). The non-core category, representing older legacy products, will include terminal servers formerly categorized as a part of "IT management".

The following describes our core product lines:

- *Device Enablement* - We offer an array of embedded and external device enablement solutions that enable integrators and manufacturers of electronic and electro-mechanical products to add network connectivity, manageability and control. Our customers' products originate from a wide variety of applications within the machine-to-machine ("M2M") market, from blood analyzers that relay critical patient information directly to a hospital's information system, to simple devices such as time clocks, allowing the user to obtain information from these devices and to improve how they are managed and controlled. We also offer products such as multi-port servers that enable devices outside the data center to cost effectively share the network connection and convert various protocols to industry-standard interfaces such as Ethernet and the Internet.

- *Device Management* -We offer off-the-shelf appliances such as console servers, remote KVM servers, and power control products that enable IT professionals to remotely connect, monitor and control network infrastructure equipment and large groups of servers using highly secure out-of-band management technology. In addition, we offer off-the-shelf appliances that enable IT professionals to reliably, remotely and simply monitor, configure and manage multiple devices from a single point of control.

The following describes our non-core product line:

- *Non-core Products* - Over the years, we have innovated or acquired various product lines that are no longer part of our primary, core markets described above. In general, these non-core businesses represent decreasing markets and we minimize research and development in these product lines. Included in this category are terminal servers, visualization solutions, legacy print servers, software and other miscellaneous products.

Financial Highlights and Other Information for the Fiscal Quarter Ended December 31, 2006

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended December 31, 2006:

- Net revenues of $14.8 million for the fiscal quarter ended December 31, 2006 increased by $1.9 million or 14.5% as compared to $13.0 million reported during the fiscal quarter ended December 31, 2005. The increase in net revenues is due to an increase of $2.4 million in our core product lines as a result of a $1.9 million increase in our device enablement product line and a $588,000 increase in our device management product line. Our non-core product line decreased by $572,000.

- Gross profit as a percentage of net revenues was 49.9% for the fiscal quarter ended December 31, 2006, decreasing 1.0 percentage point from the 50.9% reported in the fiscal quarter ended December 31, 2005. The decrease in gross margin percent is primarily attributable to a combination of sale incentive discounts and a change in product mix from higher margin non-care legacy products towards lower-margin device enablement products, offset by a decrease in the amortization of purchased intangible assets.

- Loss from operations as a percentage of net revenues was 4.3% for the fiscal quarter ended December 31, 2006 compared to a 27.2% loss from operations in the fiscal quarter ended December 31, 2005.

- Net income of $87,000 or $0.00 per basic and diluted share, in the fiscal quarter ended December 31, 2006, increased from a net loss of $3.6 million, or $0.06 per basic and diluted share, in the fiscal quarter ended December 31, 2005. Net income for the quarter ended December 31, 2006 was significantly impacted by the $700,000 of income recognized on the sale of our investment in Xanboo. Net loss for the quarter ended December 31, 2005 was significantly impacted by $2.6 million of litigation settlement costs.

- Cash, cash equivalents and marketable securities remained consistent at $7.8 million as of December 31, 2006 and June 30, 2006, respectively.

- Accounts receivable, net were $3.5 million as of December 31, 2006 as compared to $3.1 million at June 30, 2006. Annualized days sales outstanding ("DSO") in receivables as of December 31, 2006 increased to 20 days from 16 days as of June 30, 2006. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped to distributors).

- Inventories, net were $8.5 million as of December 31, 2006 as compared to $8.1 million as of June 30, 2006. Our annualized inventory turns increased with 3.6 annualized turns during the fiscal quarter ended December 31, 2006 compared to 3.4 annualized turns during the fiscal quarter ended June 30, 2006.

Critical Accounting Policies and Estimates

The accounting policies that have the greatest impact on our financial condition and results of operations and that require the most judgment are those relating to revenue recognition, warranty reserves, allowance for doubtful accounts, inventory valuation, valuation of deferred income taxes, goodwill and purchased intangible assets and legal settlement costs. These policies are described in further detail in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006. There have been no significant changes in our critical accounting policies and estimates during the fiscal quarter ended December 31, 2006 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

Recent Accounting Pronouncements

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Qualifying Misstatements in Current Year Financial Statements* ("SAB 108"), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 was issued to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements and related disclosures. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company is currently assessing the impact, if any, from the adoption of SAB 108.

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently assessing the impact, if any, from the adoption of SFAS 157.

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies

the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes," by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under FIN 48, the financial statement effects of a tax position should initially be recognized when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. A tax position that meets the more-likely-than-not recognition threshold should initially and subsequently be measured as the largest amount of tax benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement with a taxing authority. FIN 48 is effective for fiscal years beginning after December 15, 2006. The cumulative effect, if any, of applying the provisions of FIN 48 will be reported as an adjustment to the opening balance of retained earnings in the period adopted. The Company is currently evaluating the impact that the adoption of FIN 48 will have on the results of operations, financial position and liquidity.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not or are not believed by management to have a material impact on the Company’s present or future consolidated financial statements.

Consolidated Results of Operations

The following table sets forth, for the periods indicated, the percentage of net revenues represented by each item in our condensed consolidated statement of operations:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	**2005**	**2006**	**2005**
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	50.1%	49.1%	48.8%	49.5%
Gross profit	49.9%	50.9%	51.2%	50.5%
Operating expenses:				
Selling, general and administrative	40.8%	48.0%	42.3%	48.8%
Research and development	12.7%	10.1%	13.2%	10.8%
Litigation settlement costs	0.5%	20.1%	0.3%	10.3%
Amortization of purchased intangible assets	0.1%	0.0%	0.1%	0.0%
Restructuring recovery	0.0%	0.0%	0.0%	(0.1%)
Total operating expenses	54.2%	78.2%	55.9%	69.8%
Loss from operations	(4.3%)	(27.2%)	(4.7%)	(19.3%)
Interest income, net	0.0%	0.1%	0.0%	0.1%
Other income (expense), net	4.9%	(0.4%)	2.7%	(0.2%)
Income (loss) before income taxes	0.7%	(27.5%)	(2.0%)	(19.4%)
Provision for income taxes	0.1%	0.1%	0.1%	0.1%
Net income (loss)	0.6%	(27.6%)	(2.1%)	(19.5%)

Comparison of the Three and Six Months Ended December 31, 2006 and 2005

Net Revenues by Product Line

Our revenue is generated primarily by sales of our networking devices. Device enablement and device management represent our core product lines. The non-core product line represents legacy products that we are no longer investing in the development of. Net revenue is revenue less reductions for rebates and provisions for returns and allowances.

The following table presents net revenues by product line:

	Three Months Ended December 31,				Change	
	2006	**% of Net Revenues**	**2005**	**% of Net Revenues**	$	%
	(In thousands, except percentages)					
Device enablement	$ 10,833	73.1%	$ 8,975	69.3%	$ 1,858	20.7%
Device management	2,560	17.3%	1,972	15.2%	588	29.8%
Core	13,393	90.3%	10,947	84.5%	2,446	22.3%

Non-core	1,436	9.7%	2,008	15.5%	(572)	(28.5%)
	$ 14,829	100.0%	$ 12,955	100.0%	$ 1,874	14.5%

The increase in net revenues for the three months ended December 31, 2006 as compared to the same period one year ago was a result of an increase in net revenues from our device enablement and device management products, offset by a decrease in our non-core products. The increase in our device enablement product line is primarily due to an increase in volume in our embedded device enablement products, which includes our XPort and WiPort product families, slightly offset by a decline in our external device enablement products. We are no longer investing in the development of our non-core product lines and expect net revenues related to these products to continue to decline in the future as we focus our investment in our core product lines.

The following table presents net revenues by product line:

	Six Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenue	2005	Revenue	$	%
	(In thousands, except percentages)					
Device enablement	$ 19,836	72.5%	$ 17,232	68.4%	$ 2,604	15.1%
Device management	4,274	15.6%	3,838	15.2%	436	11.4%
Core	24,110	88.2%	21,070	83.6%	3,040	14.4%
Non-core	3,233	11.8%	4,125	16.4%	(892)	(21.6%)
	$ 27,343	100.0%	$ 25,195	100.0%	$ 2,148	8.5%

The increase in net revenues for the six months ended December 31, 2006 as compared to the same period one year ago was a result of an increase in net revenues from our device enablement and device management products, offset by a decrease in our non-core products. The increase in our device enablement product line is primarily due to an increase in volume in our embedded device enablement products, which includes our XPort and WiPort product families, slightly offset by a decline in our external device enablement products. We are no longer investing in the development of our non-core product lines and expect net revenues related to these products to continue to decline in the future as we focus our investment in our core product lines.

Net Revenues by Region

The following table presents net revenues by geographic region:

	Three Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Americas	$ 9,573	64.6%	$ 7,893	60.9%	$ 1,680	21.3%
EMEA	3,720	25.1%	3,609	27.9%	111	3.1%
Asia Pacific	1,536	10.3%	1,453	11.2%	83	5.7%
	$ 14,829	100.0%	$ 12,955	100.0%	$ 1,874	14.5%

The increase for the three months ended December 31, 2006 as compared to the same period one year ago is primarily a result of an increase in net revenues in the Americas. In order of significance, the increase in net revenues in the Americas is the result of increased sales of our embedded device enablement products and to a lesser extent, our device management products, slightly offset by a decrease in our non-core products.

The following table presents net revenues by geographic region:

	Six Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenue	2005	Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 17,229	63.0%	$ 16,072	63.8%	$ 1,157	7.2%
EMEA	6,711	24.5%	6,568	26.1%	143	2.2%
Asia Pacific	3,403	12.5%	2,555	10.1%	848	33.2%
	$ 27,343	100.0%	$ 25,195	100.0%	$ 2,148	8.5%

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The increase for the six months ended December 31, 2006 as compared to the same period one year ago is primarily a result of an increase in net revenues in the Americas. In order of significance, the increase in net revenues in the Americas is the result of increased sales of our embedded device enablement products and to a lesser extent, our device management products, slightly offset by a decrease in our non-core products.

Gross Profit

Gross profit represents net revenues less cost of revenues. Cost of revenues consists of the cost of raw material components, subcontract labor assembly from contract manufacturers, manufacturing overhead, amortization of purchased intangible assets, establishing or relieving inventory reserves for excess and obsolete products or raw materials, warranty costs, royalties and share-based compensation.

The following table presents gross profit:

	Three Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Gross profit	$ 7,400	49.9%	$ 6,598	50.9%	$ 802	12.2%

In order of significance, the decrease in gross profit as a percentage of net revenues for the three months ended December 31, 2006 as compared to the same period one year ago is in part due to the following factors: (i) an increase in discounts and allowances (ii) an increase in manufacturing overhead costs; offset by (iii) a decrease in the amortization of purchased intangible assets as a result of a majority of our purchased intangible assets becoming fully amortized.

The following table presents gross profit:

	Six Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenue	2005	Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 14,007	51.2%	$ 12,718	50.5%	$ 1,289	10.1%

The increase in gross profit as a percentage of net revenues for the six months ended December 31, 2006 as compared to the same period one year ago is primarily due to a decrease in the amortization of purchased intangible assets as a result of a majority of our purchased intangible assets becoming fully amortized.

Selling, General and Administrative

Selling, general and administrative expenses consist of personnel-related expenses including salaries and commissions, share-based compensation, facility expenses, information technology, trade show expenses, advertising, and legal and accounting fees offset by reimbursement of legal fees from insurance proceeds.

The following table presents selling, general and administrative expenses:

	Three Months Ended December 31,					
	2006	% of Net Revenues	2005	% of Net Revenues	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 3,124		$ 2,820		$ 304	10.8%
Professional fees & outside services	845		1,483		(638)	(43.0%)
Advertising and marketing	737		705		32	4.5%
Facilities	477		456		21	4.6%
Share-based compensation	202		162		40	24.7%
Depreciation	66		79		(13)	(16.5%)
Bad debt expense (recovery)	3		(41)		44	(107.3%)
Other	603		554		49	8.8%
Selling, general and administrative	$ 6,057	40.8%	$ 6,218	48.0%	$ (161)	(2.6%)

In order of significance, the decrease in selling, general and administrative expense for the three months ended December 31, 2006 as compared to the same period one year ago is in part due to the following factors: (i) a decrease in legal and professional fees primarily as a result of the settlement of our outstanding litigation; offset by (ii) an increase in personnel-related expenses due to an increase in headcount.

The following table presents selling, general and administrative expenses:

	Six Months Ended December 31,					
	2006	% of Net Revenue	2005	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 5,925		$ 5,401		$ 524	9.7%
Professional fees & outside services	1,605		2,947		(1,342)	(45.5%)
Advertising and marketing	1,352		1,475		(123)	(8.3%)
Facilities	1,017		969		48	5.0%
Share-based compensation	411		330		81	24.5%
Depreciation	143		170		(27)	(15.9%)
Bad debt expense (recovery)	20		(35)		55	(157.1%)
Other	1,082		1,033		49	4.7%
Selling, general and administrative	$ 11,555	42.3%	$ 12,290	48.8%	$ (735)	(6.0%)

In order of significance, the decrease in selling, general and administrative expense for the six months ended December 31, 2006 as compared to the same period one year ago is in part due to the following factors: (i) a decrease in legal and professional fees primarily as a result of the settlement of our outstanding litigation and (ii) a decrease in

direct advertising and marketing expenses; offset by (iii) an increase in personnel-related expenses as a result of an increase in headcount.

Research and Development

Research and development expenses consist of personnel-related expenses, facility expenses and share-based compensation, as well as expenditures to third-party vendors for research and development activities.

The following table presents research and development expenses:

	Three Months Ended December 31,					
	2006	% of Net Revenues	2005	% of Net Revenues	Change $	Change %
	(In thousands, except percentages)					
Personnel-related expenses	$ 1,338		$ 1,019		$ 319	31.3%
Facilities	148		125		23	18.4%
Professional fees & outside services	137		32		105	328.1%
Share-based compensation	96		52		44	84.6%
Depreciation	11		12		(1)	(8.3%)
Other	152		70		82	117.1%
Research and development	$ 1,882	12.7%	$ 1,310	10.1%	$ 572	43.7%

The increase in research and development expenses for the three months ended December 31, 2006 as compared to the same period one year ago is primarily due to an increase in personnel-related expenses as a result of an increase in headcount and professional fees for outside consultants.

The following table presents research and development expenses:

	Six Months Ended December 31,					
	2006	% of Net Revenue	2005	% of Net Revenue	Change $	Change %
	(In thousands, except percentages)					
Personnel-related expenses	$ 2,609		$ 2,021		$ 588	29.1%
Facilities	314		271		43	15.9%
Professional fees & outside services	218		150		68	45.3%
Share-based compensation	188		105		83	79.0%
Depreciation	20		24		(4)	(16.7%)
Other	251		142		109	76.8%
Research and development	$ 3,600	13.2%	$ 2,713	10.8%	$ 887	32.7%

The increase in research and development expenses for the six months ended December 31, 2006 as compared to the same period one year ago is primarily due to an increase in personnel-related expenses as a result of an increase in headcount.

Provision for Income Taxes

The following table presents our effective tax rate based upon our income tax provision:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
Effective tax rate	12%	0%	4%	0%

We utilize the liability method of accounting for income taxes as set forth in SFAS No. 109, "Accounting for Income Taxes." The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from the effect of our domestic losses recorded without a tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. As a result of our cumulative losses, we provided a full valuation allowance against our net deferred tax assets for the three and six months ended December 31, 2006 and 2005.

Other Income (Expense), Net

Other income (expense), net consists of gains (losses) on the sale of investments, foreign currency transactions and the disposal of fixed assets.

The following tables present other income (expense), net:

	Three Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Other income (expense), net	$ 730	4.9%	$ (49)	-0.4%	$ 779	-1589.8%

	Six Months Ended December 31,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Other income (expense), net	$ 727	2.7%	$ (59)	-0.2%	$ 786	-1332.2%

The increase in other income (expense), net for the three and six months ended December 31, 2006 as compared to the same period one year ago is primarily due to $700,000 of income recognized on the sale of our investment in Xanboo.

Liquidity and Capital Resources

Since inception through fiscal 2007, we have financed our operations through the issuance of common stock and operating activities. We refer to the sum of cash and cash equivalents and marketable securities as "cash" for the purposes of discussing our cash balance and liquidity.

The following table presents details of our working capital and cash:

	December 31, 2006	June 30, 2006	Increase (Decrease)
		(In thousands)	
Working capital	$ 5,698	$ 5,372	$ 326
Cash and cash equivalents	$ 7,744	$ 7,729	$ 15
Marketable securities	96	88	8
	$ 7,840	$ 7,817	$ 23

In order of significance, our working capital increased in part due to (i) a decrease in other current liabilities as a result of the timing of payments, (ii) a buildup of inventories and (iii) an increase in accounts receivable as a result of the increase in sales and timing of receipts; offset by (iv) an increase in accounts payable as a result of the timing of cash payments to vendors and (v) a net loss for the year ended December 31, 2006. Our cash balances increased slightly as a result of our cash management activities which include the timing of cash payments to our vendors and the timing of cash receipts from our customers.

We believe that the cumulative effect of expense reductions initiated in fiscal 2005 and the settlement of our patent litigation during fiscal 2006 will result in reduced operating expenses and will lower our cash breakeven point to approximately $14.0 to $15.0 million per fiscal quarter. This target is based upon a financial model, and we expect that actual expenses may vary in any fiscal quarter and therefore financial results impacting cash usage or profitability will vary. Also, uses of cash to fund inventories, receivables and payables will cause results to vary from the financial model.

We believe that our existing cash, cash equivalents, marketable securities and funds available from our line of credit will be adequate to meet our anticipated cash needs through at least the next twelve months. Our future capital requirements will depend on many factors, including the timing and amount of our net revenues, research and

development, expenses associated with any strategic partnerships or acquisitions and infrastructure investments, and expenses related to government investigations and litigation, which could affect our ability to generate additional cash. If cash generated from operations and financing activities is insufficient to satisfy our working capital requirements, we may need to borrow funds through bank loans, sales of securities or other means. There can be no assurance that we will be able to raise any such capital on terms acceptable to us, if at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to operate our business.

In May 2006, we entered into a two-year secured revolving Loan and Security Agreement ("Line of Credit") with a bank, which provides for borrowings up to $5.0 million. The borrowing capacity is limited to eligible accounts receivable as defined under the Line of Credit. Borrowings under the Line of Credit bear interest at the prime rate plus 1.75% per annum. We are required to pay an unused line fee of 0.50% on the unused portion of the Line of Credit. As of December 31, 2006, we had no borrowings against the Line of Credit.

The following table presents our available borrowing capacity and outstanding letters of credit, which were used to secure equipment leases, deposits for a building lease, foreign value added tax account deposits and security deposits:

	December 31, 2006	June 30, 2006
	(In thousands)	
Available borrowing capacity	$ 2,826	$ 2,221
Outstanding letters of credit	$ 1,280	$ 1,594

During March 2006, we entered into a lease agreement whereby the lessor will advance an amount not to exceed $1.0 million for the implementation of a new ERP information system to manage our business operations. During the ERP implementation period, we will pay interest of 9.0% on the amounts advanced. The lease agreement states that the aggregate amount advanced to us by the lessor will be repaid over a three-year period following the completion of the ERP implementation. As of December 31, 2006, we had incurred costs of $483,000 in connection with the ERP implementation which have or will be advanced by the lessor.

As of December 31, 2006, approximately $2.0 million of our cash is held in foreign subsidiary bank accounts. Such cash is unrestricted with regard to foreign liquidity needs; however, our ability to utilize a portion of this cash to satisfy liquidity needs outside of such foreign locations is subject to approval by the foreign location board of directors.

Cash Flows

The following table presents the major components of the consolidated statements of cash flows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2006	2005	2006	2005
	(In thousands)		(In thousands)	
Net cash provided by (used in):				
Net income (loss)	$ 87	$ (3,571)	$ (564)	$ (4,912)
Non-cash operating expenses, net	443	3,282	911	3,716
Changes in operating assets and liabilities:				
Accounts receivable	(735)	308	(401)	153
Inventories	777	(539)	(345)	313
Contract manufacturers' receivable	(352)	(209)	16	(188)
Prepaid expenses and other current assets	(50)	193	(25)	(287)
Other assets	(3)	24	(6)	28
Accounts payable	(685)	449	1,272	1,099
Accrued payroll and related expenses	517	448	304	163
Accrued settlements	-	-	(400)	-
Warranty reserve	(21)	(222)	(219)	(276)
Other liabilities	124	355	(617)	819
Net cash provided (used in) by operating activities	102	518	(74)	628
Net cash used in investing activities	(267)	(94)	(271)	(132)
	166	10	317	121

Net cash provided by financing activities				
Effect of foreign exchange rate changes on cash	56	(93)	43	(113)
Increase in cash and cash equivalents	$ 57	$ 341	$ 15	$ 504

Three months ended

Operating activities provided cash during the three months ended December 31, 2006. This was the result of a net income, cash provided by operating assets and liabilities and non-cash operating expenses. The non-cash items that had a significant impact on the net loss included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash provided in operating activities included (i) a decrease in inventories as a result of the increase in revenues (ii) an increase in accrued payroll due to the timing of payroll periods; offset by (iii) an increase in accounts receivable as a result of higher sales and the timing of cash collections, (iv) a decrease in accounts payable as a result of the timing of payments to vendors and (v) an increase in the contract manufacturers' receivables due to the timing of shipments and cash collections.

Operating activities provided cash for the three months ended December 31, 2005. This was primarily the result of the net loss offset by net cash provided from changes in operating assets and liabilities and non-cash operating expenses. Non-cash items that had a significant impact on net loss included litigation settlement costs, depreciation, amortization of purchased intangible assets and share-based compensation. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash provided in operating activities included (i) an increase in accounts payable and other liabilities as a result of the timing of cash payments (ii) an increase in accrued payroll related to the timing of payroll periods (iii) a decrease in accounts receivable as a result of the timing of cash collections; offset by (iii) an increase in inventories due to the timing of shipments (iv) a reduction in the warranty reserve to reflect lower expected warranty return rates and (v) an increase in the contract manufacturers' receivables due to the timing of shipments and cash collections.

Investing activities used cash during the three months ended December 31, 2006 and 2005. This was due to the purchase of property and equipment.

Financing activities provided cash during the three months ended December 31, 2006 and 2005. This was due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by repayments on capital lease obligations.

Six months ended

Operating activities used cash during the six months ended December 31, 2006. This was the result of a net loss, cash used by operating assets and liabilities, offset by non-cash operating expenses. The non-cash items that had a significant impact on the net loss included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash used in operating activities included (i) an increase in accounts receivable as a result of higher sales and the timing of cash collections, (ii) an increase in inventories, (iii) a decrease in other liabilities as a result of a decrease in customer deposits and the timing of payments to vendors, (iv) a decrease in accrued settlements as a result of the payment of the Digi settlement and (v) a reduction in the warranty reserve to reflect lower expected warranty return rates; offset by (vi) an increase in accounts payable as a result of the timing of cash payments to vendors and an increase in accrued payroll related to the timing of payroll periods.

Operating activities provided cash for the six months ended December 31, 2005. This was primarily the result of the net loss offset by net cash provided from changes in operating assets and liabilities and non-cash operating expenses. Non-cash items that had a significant impact on net loss included litigation settlement costs, depreciation, amortization of purchased intangible assets and share-based compensation. Changes in operating assets and liabilities which had a significant impact on the cash provided by operating activities included accounts payable and other liabilities.

Investing activities used cash during the six months ended December 31, 2006 and 2005. This was due to the purchase of property and equipment.

Financing activities provided cash during the six months ended December 31, 2006 and 2005. This was due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by repayments on capital lease obligations.

Off-Balance Sheet Arrangements

We did not have any off balance sheet arrangements as of December 31, 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We do not use derivative financial instruments for speculative or trading purposes. We place our investments in instruments that meet high credit quality standards, as specified in our investment policy.

Interest Rate Risk

Our exposure to interest rate risk is limited to the exposure related to our cash and cash equivalents and marketable securities. Our cash and cash equivalents are held in cash deposit accounts and, as such, we believe our cash and cash equivalents are not subject to significant interest rate risk. We believe our marketable securities would not decline in value by a significant amount if interest rates increase, and therefore would not have a material effect on our financial condition or results of operations.

The following table presents our cash and cash equivalents and marketable securities:

	December 31, 2006	June 30, 2006
	(In thousands)	
Cash and cash equivalents	$ 7,744	$ 7,729
Marketable securities	96	88
	$ 7,840	$ 7,817

Foreign Currency Risk

We hold a significant portion of our cash balance in foreign currencies (particularly the euro) and, as such, we are subject to foreign currency fluctuations. In addition, we sell products internationally. As a result, our financial results could be harmed by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. We do not currently enter into forward exchange contracts to hedge exposure denominated in foreign currencies or any other derivative financial instruments for trading or speculative purposes. In the future, if we feel our foreign currency exposure has increased, we may consider entering into hedging transactions to help mitigate that risk.

The following table presents our cash balance held in foreign currencies:

	December 31, 2006	June 30, 2006
	(In thousands)	
Cash held in foreign currencies	$ 2,194	$ 2,554

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of our fiscal quarter ended December 31, 2006. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer to allow timely decisions regarding required disclosure.

(b) Changes in internal controls over financial reporting

There have been no changes in our internal controls over financial reporting identified during the fiscal quarter that ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The information set forth in Note 10 and 11 to our Notes to the Unaudited Condensed Consolidated Financial Statements of Part I, Item 1 of this Form 10-Q is hereby incorporated by reference.

Item 1A. Risk Factors

Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described below, in addition to the other cautionary statements and risks described elsewhere and the other information contained in this Quarterly Report on Form 10-Q and in our other filings with the SEC, including our subsequent reports on Forms 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. This should be read in conjunction with our unaudited condensed consolidated financial statements and the accompanying notes thereto, and other parts of Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q. If any of these known or unknown risks or uncertainties actually occurs with material adverse effects on Lantronix, our business, financial condition and results of operations could be seriously harmed. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

Our quarterly operating results may fluctuate, which could cause our stock to decline.

We have experienced, and expect to continue to experience, significant fluctuations in revenues, expenses and operating results from quarter to quarter. We, therefore, believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance, and you should not rely on them to predict our future performance or the future performance of our stock. Our short-term expense levels for ongoing operations are relatively fixed and are based on our expectations of future net revenues. If we were to experience a reduction in revenues in a quarter, we would likely be unable to adjust our short-term expenditures. If this were to occur, our operating results for that fiscal quarter would be harmed. If our operating results in future fiscal quarters fall below the expectations of market analysts and investors, the price of our common stock would likely fall. Other factors that might cause our operating results to fluctuate on a quarterly basis include:

- changes in the mix of net revenues attributable to higher-margin and lower-margin products;
- customers’ decisions to defer or accelerate orders;
- variations in the size or timing of orders for our products;
- changes in demand for our products;
- fluctuations in exchange rates;
- defects and other product quality problems;
- loss or gain of significant customers;
- short-term fluctuations in the cost or availability of our critical components;
- announcements or introductions of new products by our competitors;
- effects of terrorist attacks in the U.S. and abroad; and
- changes in demand for devices that incorporate our products.

Current or future litigation over intellectual property rights could adversely affect us.

Substantial litigation regarding intellectual property rights exists in our industry. For example, in May 2006 we settled a patent infringement lawsuit with Digi International, Inc. (“Digi”) in which we signed an agreement with Digi to cross-license each other’s patents. In addition, we paid Digi $600,000 as part of the settlement. The results of litigation are inherently uncertain, and adverse outcomes are possible. Adverse outcomes may have a material adverse effect on our business, financial condition or results of operations. For a more detailed description of pending litigation, see Note 10 and 11 to the notes to our condensed consolidated financial statements of Part I, Item I of this Form 10-Q.

There is a risk that other third parties could claim that our products, or our customers’ products, infringe on their intellectual property rights or that we have misappropriated their intellectual property. In addition, software, business processes and other property rights in our industry might be increasingly subject to third-party infringement claims as the number of competitors grows and the functionality of products in different industry segments overlaps. Other parties might currently have, or might eventually be issued, patents that pertain to the proprietary rights we use. Any of these third parties might make a claim of infringement against us. The results of litigation are inherently uncertain, and adverse outcomes are possible.

Responding to any infringement claim, regardless of its validity, could:

- be time-consuming, costly and/or result in litigation;
- divert management’s time and attention from developing our business;
- require us to pay monetary damages, including treble damages if we are held to have willfully infringed;
- require us to enter into royalty and licensing agreements that we would not normally find acceptable;

- require us to stop selling or to redesign certain of our products; or
- require us to satisfy indemnification obligations to our customers.

If any of these occur, our business, financial condition or results of operations could be adversely affected.

Our use of contract manufacturers in China and Taiwan involves risks that could adversely affect us.

We use contract manufacturers based in China and Taiwan. There are significant risks of doing business in these locations, including the following:

- These locations do not afford the same level of protection to intellectual property as do domestic or many foreign countries. If our products were reverse-engineered or our intellectual property were otherwise pirated (reproduced and duplicated without our knowledge or approval), our revenues would be reduced;
- Delivery times are extended due to the distances involved, requiring more lead-time in ordering and increasing the risk of excess inventories;
- We could incur ocean freight delays because of labor problems, weather delays or customs problems; and
- U.S. foreign relations with these locations have, historically, been subject to change. Political considerations and actions could interrupt our expected supply of products from these locations.

Delays in deliveries or quality problems with our component suppliers could damage our reputation and could cause our net revenues to decline and harm our results of operations.

We and our contract manufacturers are responsible for procuring raw materials for our products. Our products incorporate components or technologies that are only available from single or limited sources of supply. In particular, some of our integrated circuits are only available from a single source and in some cases are no longer being manufactured. From time to time, integrated circuits used in our products will be phased out of production. When this happens, we attempt to purchase sufficient inventory to meet our needs until a substitute component can be incorporated into our products. Nonetheless, we might be unable to purchase sufficient components to meet our demands, or we might incorrectly forecast our demands, and purchase too many or too few components. In addition, our products use components that have, in the past, been subject to market shortages and substantial price fluctuations. From time to time, we have been unable to meet our orders because we were unable to purchase necessary components for our products. We do not have long-term supply arrangements with many of our vendors to obtain necessary components or technology for our products. If we are unable to purchase components from these suppliers, product shipments could be prevented or delayed, which could result in a loss of sales. If we are unable to meet existing orders or to enter into new orders because of a shortage in components, we will likely lose net revenues and risk losing customers and harming our reputation in the marketplace, which could adversely affect our business, financial condition or results of operations. We have recently redesigned many of our products to comply with the new environmental Reduction of Hazardous Substances standard. This standard is new for our supply chain and interruptions in parts supply due to the additional complexities and limited number of second source supply choices could adversely impact our business.

If we lose the services of any of our contract manufacturers or suppliers, we may not be able to obtain alternate sources in a timely manner, which could harm our customer relations and adversely affect our net revenues and harm our results of operations.

We do not have long-term agreements with our contract manufacturers or suppliers. If any of these subcontractors or suppliers ceased doing business with us, we may not be able to obtain alternative sources in a timely or cost-effective

manner. Due to the amount of time that it usually takes us to qualify contract manufacturers and suppliers, we could experience delays in product shipments if we are required to find alternative subcontractors and suppliers. Some of our suppliers have or provide technology or trade secrets, the loss of which could be disruptive to our procurement and supply processes. If a competitor should acquire one of our contract manufacturers or suppliers, we could be subjected to more difficulties in maintaining or developing alternative sources of supply of some components or products. Any problems that we may encounter with the delivery, quality or cost of our products could damage our customer relationships and materially and adversely affect our business, financial condition or results of operations.

If a major customer cancels, reduces or delays purchases, our net revenues might decline and our business could be adversely affected.

The number and timing of sales to our distributors have been difficult for us to predict. While our distributors are customers in the sense they buy our products, they are also part of our product distribution system. To some extent, any business lost from a distributor would likely be replaced by sales to other customer/distributors in a reasonable period, rather than a total loss of that business such as from a customer who used our products in their business or products. Some of our distributors could be acquired by a competitor and stop buying product from us.

The following table presents sales to our significant customers as a percentage of net revenue:

	Six Months Ended December 31,	
	2006	**2005**
Top five customers (1)	34.1%	43.0%
Ingram Micro	11.5%	13.0%
Tech Data	7.2%	13.0%

(1) Includes Ingram Micro and Tech Data.

The loss or deferral of one or more significant sales in a quarter could harm our operating results. We have in the past, and might in the future, lose one or more major customers. If we fail to continue to sell to our major customers in the quantities we anticipate, or if any of these customers terminate our relationship, our reputation, the perception of our products and technology in the marketplace, could be harmed. The demand for our products from our OEM, VAR and systems integrator customers depends primarily on their ability to successfully sell their products that incorporate our device networking solutions technology. Our sales are usually completed on a purchase order basis and we have few long-term purchase commitments from our customers.

Our future success also depends on our ability to attract new customers, which often involves an extended selling process. The sale of our products often involves a significant technical evaluation, and we often face delays because of our customers' internal procedures for evaluating and deploying new technologies. For these and other reasons, the sales cycle associated with our products is typically lengthy, often lasting six to nine months and sometimes longer. Therefore, if we were to lose a major customer, we might not be able to replace the customer in a timely manner, or at all. This would cause our net revenues to decrease and could cause our stock price to decline.

If we fail to develop or enhance our products to respond to changing market conditions and government and industry standards, our competitive position will suffer and our business will be adversely affected.

Our future success depends in large part on our ability to continue to enhance existing products, lower product cost and develop new products that maintain technological competitiveness and meet government and industry standards. The demand for network-enabled products is relatively new and can change as a result of innovations, changes or new government and industry standards. For example, a recent directive in the European Union bans the use of lead and other heavy metals in electrical and electronic equipment after July 1, 2006. As a result, in advance of this deadline, some of our customers selling products in Europe had begun demanding product from component manufacturers that did not contain these banned substances. Any failure by us to develop and introduce new products or enhancements in response to new government and industry standards could harm our business, financial condition or results of operations. These requirements might or might not be compatible with our current or future product offerings. We might not be successful in modifying our products and services to address these requirements and standards. For example, our competitors might develop competing technologies based on Internet Protocols, Ethernet Protocols or other protocols that might have advantages over our products. If this were to happen, our net revenues might not grow at the rate we anticipate, or could decline.

If our research and development efforts are not successful, our net revenues could decline and our business could be harmed.

If we are unable to develop new products as a result of our research and development efforts, or if the products we develop are not successful, our business could be harmed. Even if we do develop new products that are accepted by our target markets, we do not know whether the net revenue from these products will be sufficient to justify our investment in research and development. In addition, if we do not invest sufficiently in research and development, we may be unable to maintain our competitive position. Our research and development may decrease, which may put us at a competitive disadvantage compared to our competitors and adversely affect our market position.

We expect the average selling prices of our products to decline, which could reduce our net revenues, gross margins and profitability.

In the past, we have experienced some reduction in the average selling prices and gross margins of products, and we expect that this will continue for our products as they mature. We expect competition to continue to increase, and we anticipate this could result in additional downward pressure on our pricing. Our average selling prices for our products might decline as a result of other reasons, including promotional programs and customers who negotiate price reductions in exchange for longer-term purchase commitments. We also may not be able to increase the price of our products if the prices of components or our overhead costs increase. In addition, we may be unable to adjust our prices in response to currency exchange rate fluctuations resulting in lower gross margins. If these were to occur, our gross margins would decline and we may not be able to reduce the cost to manufacture our products to keep up with the decline in prices.

Current or future litigation could adversely affect us.

We are currently involved in litigation, including a federal securities class action lawsuit. We recently concluded multiple securities lawsuits and litigation with a former executive officer. We may have an obligation to continue to indemnify the former executive officer and defend any violations that he may be charged with. There is a risk that our insurance carriers may not reimburse us for such costs. Any lawsuit may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources. Except as described in this Form 10-Q, we do not know what the outcome of outstanding legal proceedings will be and cannot determine the extent to which these resolutions might have a material adverse effect on our business, financial condition or results of operations. The results of litigation are inherently uncertain, and adverse outcomes are possible. For a more detailed description of our current and recent litigation, see Note 10 and 11 to the notes to our condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q.

Our products may contain undetected software or hardware errors or defects that could lead to an increase in our costs, reduce our net revenues or damage our reputation.

We currently offer warranties ranging from one to two years on each of our products. Our products could contain undetected errors or defects. If there is a product failure, we might have to replace all affected products without being able to book revenue for replacement units, or we may have to refund the purchase price for the units. We do not have a long history with which to assess the risks of unexpected product failures or defects for our device server product line. Regardless of the amount of testing we undertake, some errors might be discovered only after a product has been installed and used by customers. Any errors discovered after commercial release could result in loss of net revenues and claims against us. Significant product warranty claims against us could harm our business, reputation and financial results and cause the price of our stock to decline.

If software that we license or acquire from the open source software community and incorporate into our products were to become unavailable or no longer available on commercially reasonable terms, it could adversely affect sales of our products, which could disrupt our business and harm our financial results.

Certain of our products contain components developed and maintained by third-party software vendors or are available through the “open source” software community. We also expect that we may incorporate software from third-party vendors and open source software in our future products. Our business would be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our products to function with alternate third-party software or open source software, or develop these components ourselves, which would result in increased costs and could result in delays in our product shipments. Furthermore, we might be forced to limit the features available in our current or future product offerings. We are presently developing products for use on the Linux platform. The SCO Group (“SCO”) has filed and threatened to file lawsuits against companies that operate Linux

for commercial purposes, alleging that such use of Linux infringes SCO's rights. These allegations may adversely affect the demand for the Linux platform and, consequently, the sales of our Linux-based products.

If our contract manufacturers are unable or unwilling to manufacture our products at the quality and quantity we request, our business could be harmed.

We outsource substantially all of our manufacturing to three manufacturers: Venture Electronics Services, Uni Precision Industrial Ltd., and Universal Scientific Industrial Company, LTD. Our reliance on these third-party manufacturers exposes us to a number of significant risks, including:

- reduced control over delivery schedules, quality assurance, manufacturing yields and production costs;
- lack of guaranteed production capacity or product supply; and
- reliance on these manufacturers to maintain competitive manufacturing technologies.

Our agreements with these manufacturers provide for services on a purchase order basis. If our manufacturers were to become unable or unwilling to continue to manufacture our products at requested quality, quantity, yields and costs, or in a timely manner, our business would be seriously harmed. As a result, we would have to attempt to identify and qualify substitute manufacturers, which could be time consuming and difficult, and might result in unforeseen manufacturing and operations problems. For example, Jabil Circuit, Inc. acquired Varian, Inc. in March 2005 and closed the facility that manufactured our products. We transferred this production to another contract manufacturer. Moreover, as we shift products among third-party manufacturers, we may incur substantial expenses, risk material delays or encounter other unexpected issues.

In addition, a natural disaster could disrupt our manufacturers' facilities and could inhibit our manufacturers' ability to provide us with manufacturing capacity in a timely manner or at all. If this were to occur, we likely would be unable to fill customers' existing orders or accept new orders for our products. The resulting decline in net revenues would harm our business. We also are responsible for forecasting the demand for our individual products. These forecasts are used by our contract manufacturers to procure raw materials and manufacture our finished goods. If we forecast demand too high, we may invest too much cash in inventory, and we may be forced to take a write-down of our inventory balance, which would reduce our earnings. If our forecast is too low for one or more products, we may be required to pay charges that would increase our cost of revenues or we may be unable to fulfill customer orders, thus reducing net revenues and therefore earnings.

We are exposed to foreign currency exchange risks, which could harm our business and operating results.

We hold a significant portion of our cash balance in foreign currencies (particularly euros), and as such are exposed to adverse changes in exchange rates associated with foreign currency fluctuations. However, we do not currently engage in any hedging transactions to mitigate these risks. Although from time to time we review our foreign currency exposure and evaluate whether we should enter into hedging transactions, we may not adequately hedge against any future volatility in currency exchange rates and, if we engage in hedging transactions, the transactions will be based on forecasts which later may prove to be inaccurate. Any failure to hedge successfully or anticipate currency risks properly could adversely affect our operating results.

Because we depend on international sales for a substantial amount of our net revenues, we are subject to international economic, regulatory, political and other risks that could harm our business, financial condition or results of operations.

The following table presents our sales within geographic regions:

	Six Months Ended December 31,				Change	
	2006	% of Net Revenue	2005	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 17,229	63.0%	$ 16,072	63.8%	$ 1,157	7.2%
EMEA	6,711	24.5%	6,568	26.1%	143	2.2%
Asia Pacific	3,403	12.5%	2,555	10.1%	848	33.2%
	$ 27,343	100.0%	$ 25,195	100.0%	$ 2,148	8.5%

We expect that international revenues will continue to represent a significant portion of our net revenues in the foreseeable future. Doing business internationally involves greater expense and many risks. For example, because the products we sell abroad and the products and services we buy abroad are priced in foreign currencies, we are affected by fluctuating exchange rates. In the past, we have lost money because of these fluctuations. We might not successfully protect ourselves against currency rate fluctuations, and our financial performance could be harmed as a result. In addition, we face other risks of doing business internationally, including:

- unexpected changes in regulatory requirements, taxes, trade laws and tariffs;
- reduced protection for intellectual property rights in some countries;
- differing labor regulations;

- compliance with a wide variety of complex regulatory requirements;
- changes in a country's or region's political or economic conditions;
- effects of terrorist attacks in the U.S. and abroad;
- greater difficulty in staffing and managing foreign operations; and
- increased financial accounting and reporting burdens and complexities.

Our international operations require significant attention from our management and substantial financial resources. We do not know whether our investments in other countries will produce desired levels of net revenues or profitability.

If we are unable to sell our inventory in a timely manner it could become obsolete, which could require us to increase our reserves and harm our operating results.

At any time, competitive products may be introduced with more attractive features or at lower prices than ours. There is a risk that we may be unable to sell our inventory in a timely manner to avoid it becoming obsolete.

The following table presents our inventory and reserve for excess and obsolete inventory reserve:

	December 31, 2006	June 30, 2006
	(In thousands)	
Raw materials	$ 3,266	$ 3,863
Finished goods	6,136	6,518
Inventory at distributors	1,552	1,690
Large scale integration chips *	964	731
	11,918	12,802
Reserve for excess and obsolete inventories	(3,390)	(4,689)
	$ 8,528	$ 8,113

* This item is both sold individually and embedded into the Company's products.

In the event we are required to substantially discount our inventory or are unable to sell our inventory in a timely manner, we would be required to increase our reserves and our operating results could be substantially harmed.

If we are unable to attract, retain or motivate key senior management and technical personnel, it could seriously harm our business.

Our financial performance depends substantially on the performance of our executive officers and key technical employees. We are dependent in particular on Marc Nussbaum, our President and Chief Executive Officer, with whom we have no employment contract. We are also dependent upon our technical personnel, due to the specialized technical nature of our business. If we were to lose the services of Mr. Nussbaum or any of our key technical personnel and were not able to find replacements in a timely manner, our business could be disrupted, other key personnel might decide to leave, and we might incur increased operating expenses associated with finding and compensating replacements.

If our OEM customers develop their own expertise in network-enabling products, it could result in reduced sales of our products and harm our operating results.

We sell to both resellers and OEMs. Selling products to OEMs involves unique risks, including the risk that OEMs will develop internal expertise in network-enabling products or will otherwise incorporate network functionality in their products without using our device networking solutions. If this were to occur, our sales to OEMs would likely decline, which could reduce our net revenue and harm our operating results.

New product introductions and pricing strategies by our competitors could reduce our market share or cause us to reduce the prices of our products, which would reduce our net revenues and gross margins.

The market for our products is intensely competitive, subject to rapid change and is significantly affected by new product introductions and pricing strategies of our competitors. We face competition primarily from companies that network-enable devices, semiconductor companies, companies in the automation industry and companies with significant networking expertise and research and development resources. Our competitors might offer new products with features or functionality that are equal to or better than our products. In addition, since we work with open standards, our customers could develop products based on our technology that compete with our offerings. We might not have sufficient engineering staff or other required resources to modify our products to match our competitors. Similarly, competitive pressure could force us to reduce the price of our products. In each case, we could lose new and existing customers to our competition. If this were to occur, our net revenues could decline and our business could be harmed.

We may not be able to adequately protect or enforce our intellectual property rights, which could harm our competitive position.

We have not historically relied on patents to protect our proprietary rights, although we are now building a patent portfolio. In May 2006, we entered into a patent cross-license agreement with Digi in which the parties agreed to cross-license each other’s patents, which could reduce the value of our existing patent portfolio. We rely primarily on a combination of laws, such as copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights. Despite any precautions that we have taken:

- laws and contractual restrictions might not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies;
- other companies might claim common law trademark rights based upon use that precedes the registration of our marks;
- other companies might assert other rights to market products using our trademarks;
- policing unauthorized use of our products and trademarks is difficult, expensive and time-consuming, and we might be unable to determine the extent of this unauthorized use;
- courts may determine that our software programs use open source software in such a way that deprives the entire programs of intellectual property protection; and
- current federal laws that prohibit software copying provide only limited protection from software pirates.

Also, the laws of some of the countries in which we market and manufacture our products offer little or no effective protection of our proprietary technology. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third-parties to benefit from our technology without paying us for it, which could significantly harm our business.

Acquisitions, strategic partnerships, joint ventures or investments may impair our capital and equity resources, divert our management’s attention or otherwise negatively impact our operating results.

We may pursue acquisitions, strategic partnerships and joint ventures that we believe would allow us to complement our growth strategy, increase market share in our current markets and expand into adjacent markets, broaden our technology and intellectual property and strengthen our relationships with distributors and OEMs. Any future

acquisition, partnership, joint venture or investment may require that we pay significant cash, issue stock or incur substantial debt. Acquisitions, partnerships or joint ventures may also result in the loss of key personnel and the dilution of existing stockholders as a result of issuing equity securities. In addition, acquisitions, partnerships or joint ventures require significant managerial attention, which may be diverted from our other operations. These capital, equity and managerial commitments may impair the operation of our business. Furthermore, acquired businesses may not be effectively integrated, may be unable to maintain key pre-acquisition business relationships, may contribute to increased fixed costs and may expose us to unanticipated liabilities and otherwise harm our operating results.

We may experience difficulties in implementing or enhancing new information systems.

During fiscal 2006, we began the implementation of a new enterprise resource planning (“ERP”) information system to manage our business operations. While we did not use the new ERP information system to manage our business during the fiscal quarter ending December 31, 2006, the possibility exists that our migration to the new ERP information system could adversely affect our disclosure controls and procedures or our operations in future periods. The process of implementing new information systems could adversely impact our ability to do the following in a timely manner: accept and process customer orders, receive inventory and ship products, invoice and collect receivables, place purchase orders and pay invoices, and all other business transactions related to the finance, order entry, purchasing, supply chain and human resource processes within the new ERP systems. Any such disruption could adversely affect our financial position, results of operations, cash flows and the market price of our common stock.

Business interruptions could adversely affect our business.

Our operations and those of our suppliers are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, terrorist attacks and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters and other critical business operations, are located near major earthquake faults and, therefore, may be more susceptible to damage if an earthquake occurs. We do not carry earthquake insurance for direct earthquake-related losses. In addition, we do not carry business interruption insurance for, nor do we carry financial reserves against, business interruptions arising from earthquakes or certain other events. If a business interruption occurs, our business could be materially and adversely affected.

If we fail to maintain an effective system of disclosure controls or internal controls over financial reporting, our business and stock price could be adversely affected.

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to evaluate periodically the effectiveness of their internal controls over financial reporting, and to include a management report assessing the effectiveness of their internal controls as of the end of each fiscal year. Beginning with our annual report on Form 10-K for our fiscal year ending June 30, 2008, we will be required to comply with the requirement of Section 404 of the Sarbanes-Oxley Act of 2002 to include in each of our annual reports an assessment by our management of the effectiveness of our internal controls over financial reporting and a report of our independent registered public accounting firm addressing these assessments.

Our management does not expect that our internal controls over financial reporting will prevent all errors or frauds. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, involving us have been, or will be, detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by individual acts of a person, or by collusion among two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies and procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to errors or frauds may occur and not be detected.

We cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our disclosure controls and internal controls over financial reporting in the future. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

We held our Annual Meeting of Stockholders on November 28, 2006. At the meeting, our stockholders voted on the following proposals and cast their votes as follows:

Proposal 1: To elect the following four directors to serve until the 2007 Annual Meeting of Stockholders and until their successors are duly elected and qualified:

Nominee	For	Against	Abstain
H.K. Desai	52,915,118	-	1,559,259
Thomas W. Burton	54,363,759	-	110,618
Kathryn Braun Lewis	24,750,339	-	29,724,038
Howard T. Slayen	54,402,343	-	72,034

Proposal 2: To ratify the appointment of McGladrey & Pullen, LLP as our independent registered public accounts for the fiscal year ending June 30, 2007:

	Number of Shares			
Nominee	For	Against	Abstain	Broker Non-Votes
McGladrey & Pullen, LLP	54,421,978	33,700	18,700	4,906,182

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit Number	Description of Document
31.1	Certification of Principal Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

* Furnished, not filed.

SIGNATURES

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

Date: February 8, 2007

LANTRONIX, INC.
(Registrant)

By: /s/ Marc H. Nussbaum
Marc H. Nussbaum
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Reagan Y. Sakai
Reagan Y. Sakai
Chief Financial Officer and Secretary
(Principal Financial Officer)