LANTRONIX INC
Form 10-K
September 12, 2006

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

FORM 10-K

(Mark One)
S **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended June 30, 2006

£ **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 92618
(Address of principal executive offices)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.0001 par value	**The NASDAQ Stock Market LLC**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes £ No S

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes £ No S

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 S No £

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. £

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 2b-2 of the Exchange Act. (Check one):

Large accelerated filer £ Accelerated filer £ Non-accelerated filed S

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

The aggregate market value of the registrant's common stock held by non-affiliates based upon the closing sales price of the common stock on December 31, 2005, as reported by the NASDAQ Capital Market, was approximately $40,106,000. Shares of common stock held by each current executive officer and director and by each person who is known by the registrant to own 5% or more of the outstanding common stock have been excluded from this computation in that such persons may be deemed to be affiliates of the registrant. Share ownership information of certain persons known by the registrant to own greater than 5% of the outstanding common stock for purposes of the preceding calculation is based solely on information on Schedule 13G filed with the Securities and Exchange Commission and is as of December 31, 2005. This determination of affiliate status is not a conclusive determination for other purposes.

As of September 1, 2006, there were 59,206,372 shares of the Registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Part III of this Form 10-K incorporate information by reference from portions of the registrant's 2006 Definitive Proxy Statement to be filed not later than 120 days after the close of the 2006 fiscal year.

LANTRONIX, INC.
ANNUAL REPORT ON FORM 10-K
For the Fiscal Year Ended June 30, 2006

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PART IV

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the federal securities laws. Statements that are not purely historical should be considered forward-looking statements. Often they can be identified by the use of forward-looking words and phrases, such as “intend,” “may,” “will,” “could,” “project,” “anticipate,” “ “estimate,” “continue,” “potential,” “plan,” “forecasts,” and the like. Statements concerning current conditions may be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning industry trends, anticipated demand for our products, the impact of pending litigation, our overall business strategy, market acceptance of new products, future customer and sales developments, manufacturing forecasts, including the potential benefits of our contract manufacturers sourcing and supplying raw materials, the significant role of original equipment manufacturers in our business, the future cost and potential benefits of our research and development efforts and liquidity and cash resources forecasts.

Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Readers are urged to carefully review the cautionary statements made by the Company in this report concerning risks and other factors that may affect the Company’s business and operating results, including those made in this report under the caption “Risk Factors,” in Part I, Item 1A and elsewhere in this report as well as the Company’s other reports filed with the Securities and Exchange Commission (“SEC”). We may from time to time make additional forward-looking statements in our filings with the SEC, in our reports to our stockholders, and elsewhere. Readers are cautioned not to place undue reliance on these forward-looking statements. We do not undertake any obligation to update any forward-looking statement that may be made from time to time by us or on our behalf.

PART I

ITEM 1. BUSINESS

Overview

We design, develop and market products that make it possible to access, manage, control and configure electronic devices 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 products that network information technology equipment using standard protocols for connectivity, primarily Ethernet. Our first product 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 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 dedicated our businesses to helping industrial and commercial manufacturers and integrators extend their business processes to the world of remote devices. Our products are primarily targeted to emerging Machine-to-Machine ("M2M") applications which are also known as device networking applications. These applications include vertical markets such as the data center equipment management market and various markets within the security, industrial control, building automation, healthcare, transportation and retail sectors.

Our primary products and technology have focused on "device networking" solutions that enable individual electronic products to be connected to a network and the data center market for "IT management" solutions that connect or bridge groups of devices onto the network for the primary purpose of remote access. We are expanding our IT management solutions to address applications outside the data center and have recently launched a new product category of solutions that provides a reliable, single point of control and data flow management for potentially thousands of networked devices. Together, the device networking and IT management product lines constitute our growth strategy and make up our "core business". In addition, we continue to sell certain older legacy "non-core" products which we expect will continue to decline in sales. Products within the non-core category include print servers, visualization (optically-based video extenders), serial terminal servers and serial cards for servers. Expansion of our business is directed at our core business of device networking and we no longer invest R&D or marketing resources in our non-core product lines.

Today, our solutions include fully integrated hardware and software devices, as well as software tools, to develop related customer applications. Because we deal with network connectivity, we provide solutions to extremely broad market segments, including information technology, security, industrial, retail, medical, building automation, transportation and others. Our technology is used to provide networking capabilities to devices such as building heating ventilation and air conditioning systems, elevators, process control equipment, vending machines, thermostats, security cameras, RF ID readers, bar code scanners, scales, temperature sensors, blood analyzers, turnstiles, card readers, point of sale terminals, audio-visual projectors, time clocks, and virtually any product that has some form of electronic control capability.

We sell our products through a global network of distributors, resellers and manufacturer representatives, systems integrators, value-added resellers ("VARs") and original equipment manufacturers ("OEMs"). In addition, we sell directly to selected accounts.

Our common stock is currently traded on The NASDAQ Capital Market under the symbol LTRX.

Our worldwide headquarters is located in Irvine, California, and we have sales offices in France and Hong Kong. We also have employees (primarily sales) working from home offices in other areas of the world, including Germany, United Kingdom, Japan and the Netherlands. Since September 2003, our international operations have been managed from our Irvine, California facility.

We provide information regarding our company and our products on our Internet website, www.lantronix.com.

Our Strategy

Our business strategy is based on our proven capability to develop fully integrated device networking solutions that increase the value of our customers' products and services by making it easy to access and monitor devices over the Internet or private local network. Our technology is easy to integrate and typically provides our customer's device with compatibility with industry-wide standards such as Ethernet, the Internet, WiFi, standard web browsers and enterprise security standards. By using our device networking technology, customers can reduce basic data connection costs, reduce maintenance and repair costs, create differentiation based on better service and can create new revenue sources from device related services.

This strategy is accomplished by providing our customers with hardware and software that connects devices to a network and intelligently manages and controls them. With our 16 years of networking expertise, knowledge of industry trends and our capability to develop solutions based on open industry standards, we have been able to anticipate our customers' device networking technology requirements and offer solutions that enable them to achieve their connectivity objectives. By providing a complete solution of hardware and integrated software, we have been able to provide "turnkey" solutions for network enabling a device, eliminating the need for our customers to build expensive design and manufacturing expertise in-house. This results in savings to the customer both in terms of financial investment and time.

Our solutions have enabled us to become a technology and industry leader. We focus on the following key areas:

- *Device Networking Solutions* - We offer an array of embedded and external device networking solutions that enable integrators and manufacturers of electronic and electro-mechanical devices 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 products and to improve how they are managed and controlled.

- *IT Management Solutions* - 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. We also offer products such as multi-port device 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. We also currently offer terminal servers that enable multiple users to share access to one or more servers using thin-client "dumb" terminals. 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.

- *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 visualization solutions, legacy print servers, software and other miscellaneous products.

Our strategy is to drive the product development and revenues of our core products, which includes device networking solutions, IT management solutions.

Products

Device Networking Solutions

Device networking is the technology that enables connectivity within a multitude of commercial and industrial vertical markets such as security, building automation, medical, industrial automation, point-of-sale, and many others. We provide manufacturers, integrators and users with device networking solutions that in some applications include the technology for products to be connected, managed and controlled over networks using standard protocols for connectivity, including wired Ethernet and WiFi wireless. As common everyday devices leverage the power of network connectivity, manufacturers and users are realizing the benefits of networking. Our device networking solutions represent complete engineered solutions that dramatically shorten a manufacturer's development time to implement network connectivity, provide competitive advantages with new features, greatly reducing engineering and marketing risks. Our hardware solutions include large scale integration ("LSI") chips, embedded modules (embedded web servers) for mounting onto the printed circuit board of our customer's devices, and external hardware modules (device servers) with one or two ports that can be connected to the cutomer's product by cables. These products incorporate a real-time operating system and application software. We also offer application- and industry-specific solutions for certain markets such as industrial automation.

Our device servers and web servers eliminate the high cost of ownership associated with networking, which frequently would otherwise require using PCs and workstations to perform connectivity and remote management functions. Our solutions contain high-performance processors capable of not only controlling the attached device, but in many cases are also capable of accumulating data and status. The accumulated data can then be formatted by the device server and presented to users via SNMP or e-mail. Device servers have a built-in HTTP server, making them easy to manage using any standard Web browser.

In 2003, we introduced our XPort embedded web server, which represented an improvement in physical size and price for this type of functionality. The thumb-sized XPort is a self-contained network communications server and miniaturized web server enclosed within a rugged RJ-45 connector package, which can be embedded in virtually any electronic product. Products incorporating XPort often have their own IP address on a network and can be configured to be accessible from any web browser, including a wireless PC or Internet-enabled cell phone, from anywhere in the world. The XPort can serve up Internet-standard web pages, initiate e-mails for notifications or alerts, and can be configured to run other applications as defined and developed by the device manufacturer. XPort makes it simple for a product manufacturer to connect, because the XPort includes a complete, integrated solution with a 10/100 Base-T Ethernet connection, a reliable and proven operating system, an embedded web server, flexible firmware, a full TCP/IP protocol stack, and optional encryption. The relatively low price of the XPort, and the speed and ease with which a manufacturer can design the device into its products, can make many products more attractive by cost-effectively providing network connectivity.

In March 2004, we introduced WiPort, a wireless (and wired) embedded web server with substantially the same functionality as XPort, but with an 802.11 standard wireless configuration for embedded application in products and situations where a wired Ethernet environment is not available or practical. In August 2004, we introduced WiBox, an external wireless device server.

IT Management Solutions

Our IT management solutions are muti-port products (up to 48 ports) that primarily provide IT professionals with the tools they need to remotely connect to the out-of-band management ports on computers and associated corporate data center equipment. These solutions include console servers, remote keyboard, video, mouse (“KVM”) servers and managed power distribution products and terminal servers. We also offer products such as multi-port device 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. We also currently offer terminal servers that enable multiple users to share access to one or more servers using thin-client ‘dumb’ terminals.

Our customers use these solutions to monitor and run their systems to ensure the performance and availability of critical business information systems, network infrastructure and telecommunications equipment. The equipment our solutions manage includes routers, switches, servers, phone switches and public branch exchanges that are often located in remote or inaccessible locations.

Our console servers provide system administrators and network managers a way to connect with their remote equipment through an interface called a console port, helping them work more efficiently without having to leave their desk or office. Console ports are usually found in Unix servers, Linux servers and on special purpose data center equipment such as environmental monitoring/control systems, communications switches and storage devices. With remote access, system downtime can be reduced, improving business efficiency. Our console servers provide IT professionals with peace-of-mind through extensive security features, and in some cases, provisions for dial-in access via modem. These solutions are provided in various configurations and can manage up to 48 devices from one console server.

Our remote KVM products provide customers with the ability to extend traditional server keyboard, video, and mouse controls over long distances using standard IP networks. These solutions are typically used to remotely manage Windows based servers.

In addition, our data center Management Appliance, introduced in September 2005, provides IT professionals with the tools they need to remotely manage large data centers that are using many individually networked devices or multiple infrastructure products. These enterprise level solutions provide a secure, single point of management at the top of a hierarchical structure, making it simple to maintain, configure, monitor and control large deployments.

Non-core Businesses: Visualization Solutions, Print Servers and Other Legacy Products

Over a period of years, primarily as a result of product technology acquired through acquisitions, we have product categories that no longer represent the focus of future research and development and expansion; in other cases these products are legacy products developed and sold in the past, but are no longer part of our strategic focus. To support our customers, we continue to distribute and sell these older products. These non-core products are generally declining in revenues over time, and we expect this decline to continue.

We offer visualization solutions that provide switching and optical extension of high performance video, audio, keyboard and mouse over long distances within a building or campus environment. Products include video display extenders, analog KVM extension systems and matrix hubs. Our analog remote KVM products provide a valuable solution for extending and sharing audio, video, keyboard and mouse signals among many users and over optical cable without loss of resolution. KVM products enable a single keyboard, monitor and mouse to be switched between multiple computers, providing immediate access and control from a single location. The customers for these devices typically are companies that need to isolate users from the core computing center for security reasons, or require high speed video sources to be shared among many users. Our visualization solutions can be found in government agencies and at customers involved with large scale simulation and display applications. We have announced the end of life of these Visualization products and plan on exiting this product line in fiscal year 2007.

Early in our business history, we provided external print servers that connect various printers to a network for shared printing tasks. Over the years, we have updated and continue to provide print servers that work with a myriad of operating systems and network configurations. The requirement for external print servers is decreasing, as printer manufacturers have incorporated networking hardware and software as part of many printers.

We acquired a line of low-cost products that we market under the “Stallion” brand. Stallion products include a variety of network servers and a range of multi-port serial I/O cards.

Various other small categories of our legacy business are included in the non-core category, such as software revenues and other product lines we have discontinued or that are being de-emphasized.

The following table presents net revenues by product line. Definitions of these families have been modified slightly from time to time, and the data has been revised to conform to the current definitions:

		Years Ended June 30,		
Product Family	**Primary Product Function**	**2006**	**2005**	**2004**
		(In thousands)		
Device networking	Enable electronic products to become network enabled.	$ 35,419	$ 29,979	$ 27,481
IT management	Allow the user to control equipment by way of a network using a wide range of protocols. This category includes console servers and remote digital KVM.	11,499	12,341	12,555
Non-core	Includes visualization solutions, legacy print servers, software and miscellaneous products.	5,025	6,182	8,849
		$ 51,943	$ 48,502	$ 48,885

Financial Accounting Standards Board (“FASB”) Statement No. 131, “Disclosures about Segments of an Enterprise and Related Information,” establishes standards for disclosures about operating segments in annual consolidated financial statements. It also establishes standards for related disclosures about products and services, geographic areas and major customers. We operate in one segment, networking and Internet connectivity.

Customers

Distributors

Our principal customers are our distributors, which account for the largest percentage of our net revenues. Distributors resell our products to a wide variety of end customers, including consumers, corporate customers and VARs. We sell to a group of ten major distributors, some of which operate from multiple warehouses. Our major distributors in the Americas region include: Ingram Micro, Tech Data, KMJ Communications, Symmetry Electronics and Arrow Electronics, Inc. In Europe, the Middle East and Africa ("EMEA") region, we distribute to the following major distributors: transtec AG (a related party due to common ownership by our largest stockholder), Sphinx Computer Vertriebs GmbH, Jade Communications, LTD, Astradis Elecktronik GmbH and Atlantik Systems GmbH. In the Asia Pacific region, we distribute to the following major distributors: PowerCorp Pty Ltd and Nissin Systems, Co., Ltd.

OEM Manufacturers

We have established a broad range of OEM customers in various industries, such as industrial automation, medical, security, building automation, consumer and audiovisual. To shorten the development cycle and add network connectivity to a product, OEMs can use our external devices to network-enable their installed base of products, while board-level embedded modules are typically used in new product designs. Our capabilities and solutions enable OEMs to focus on their core competencies, resulting in reduced research and development costs, fewer integration problems and faster time to market. We also sell development tools to our customers and sometimes use internal resources to develop customized solutions for large or strategic opportunities.

End User Businesses

We have a broad range of end user customers in various vertical markets such as retail, universities/education, manufacturing, healthcare/hospitals and financial/banking. End user businesses require solutions that are simple to install, set up and operate, and can provide immediate results. Generally, these customers need to connect to a diverse range of products and equipment, without modifying existing software and systems.

Our external device networking solutions enable end users to quickly, securely and easily connect their devices and equipment to networks, extending the life of existing investments. We provide a number of support services including telephone-based sales and technical support as well as a wide array of Internet-based resources. After buying the devices from us or one of our distributors, a customer often only has to plug a cable from their device to our external device, and then plug our device into their network.

Sales and Marketing

We maintain both an inside and a field sales force to provide management and support to our worldwide network of selling partners. Over the past several years, we expanded our network of sales partners and developed an indirect sales model, using manufacturers' representatives, VARs and other resellers throughout the world. We have sales managers in major regions throughout the world to manage our relationship with our sales partners, identify and develop major new sales opportunities and increase penetration at high potential accounts. We implement marketing programs, products, tools and services specifically geared to drive demand for our products.

The following table presents the number of our employees that participate in sales and marketing activities:

	Years Ended June 30,		
	2006	**2005**	**2004**
Sales and marketing	64	56	82

We believe that our multi-channel approach provides several advantages. We can engage the customers and end users through their channel of choice, making our solutions available from a variety of sources and we can concentrate on developing relationships at accounts that we believe represent our largest opportunities while our sales partners continue to identify new opportunities and service existing customers.

Our embedded device networking solutions are principally sold to manufacturers by our worldwide OEM sales force and our group of manufacturers' representatives. We have continued to expand our use of manufacturers' representatives and other resellers, leveraging their established relationships.

We market and sell our IT management solutions and select external device networking solutions through information technology resellers, industry-specific system integrators, VARs and directly to end user organizations. Resellers and integrators will often obtain our products through distributors. These distributors supply our products to a broad range of VARs, system integrators, direct marketers, government resellers and e-commerce resellers. In turn, these distributor customers market, sell, install and, in some cases, support our solutions to the end users.

The following table presents our net revenues by geographic region:

	Years Ended June 30,		
	2006	2005	2004
Americas	62.5%	64.3%	69.3%
EMEA	27.1%	27.2%	23.0%
Asia Pacific	10.4%	8.5%	7.7%
	100.0%	100.0%	100.0%

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Information concerning our sales by geographic region can be found in Part IV, Item 15 of this Form 10-K and is presented in footnote 14. Please see Part I, Item 1A "Risk Factors" below for a discussion of the risks associated with foreign sales.

Manufacturing

A key element of our operations strategy is to outsource manufacturing to produce reliable, high quality products at competitive prices and to achieve on-time delivery to our customers. This practice enables us to concentrate our resources on engineering and marketing.

We utilize contract manufacturers located in the U.S., China, Malaysia and Taiwan. Both Lantronix and our contract manufacturers source raw materials, components and integrated circuits, in accordance with our pre-determined specifications and forecasts, and perform printed circuit board assembly, final assembly, functional testing and quality control. We believe this arrangement decreases our working capital requirements and provides better raw material and component pricing, enhancing our gross margins and operating margins. Please see Part I, Item 1A "Risk Factors" below for a discussion of the risks associated with contract manufacturing.

Research and Development

Our research and development efforts are focused on the development of technology and products that will enhance our competitive position in the markets we serve. Products are developed in-house and through outside research and development resources.

The following table presents the number of our employees that participate in research and development activities and our research and development expenses:

	Years Ended June 30, (In thousands, except number of employees)		
	2006	**2005**	**2004**
Number of employees	45	37	60
Research and development expenses	$ 5,999	$ 6,325	$ 7,854

Industry Partners

In keeping with our business strategy, we have engaged or participated with a portfolio of partners, consortia and standards committees in an effort to provide the most complete networking solutions to our customers.

Developer Relations

Recruiting, informing and participating with third-party developers is an integral part of our ongoing strategy. We encourage, enable and support others in the development of vertical applications using our hardware, firmware and software products. With their help and investment in creating additional applications and markets for our products, we improve our ability to secure a defensible market position and loyal customers.

Competition

The markets in which we compete are dynamic and highly competitive. As these markets grow and develop, we expect competition to intensify. Companies with the following technologies are our current and potential competitors:

Device Network-enabling Technologies

Companies such as Digi International, Inc., DPAC Technologies Corp., Echelon Corporation, Freescale Semiconductor, Inc., Moxa Technologies, MRV Communications, Inc., Quatech, Inc., Sena Technologies Inc., Wind River Systems, Inc., and ZiLOG, Inc.

Equipment for IT Management Solutions

Companies such as Avocent Corporation, Cisco Systems, Inc., Digi International, Inc., Moxa Technologies, MRV Communications, Inc., Open Gear, Perle Systems, Raritan and Rose Electronics.

The principal competitive factors that affect the market for our products are:

- product quality, technological innovation, compatibility with standards and protocols, reliability, functionality, ease of use and compatibility;
- product pricing;
- potential customers' awareness and perception of our products and of network-enabling technologies; and
- the customer's decision to make vs. buy.

Intellectual Property Rights

We have developed proprietary methodologies, tools, processes and software in connection with delivering our services. We have not historically relied on patents to protect our proprietary rights, although our patent portfolio has increased in recent years. We have historically relied on a combination of copyright, trademark, trade secret laws and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights.

On May 2, 2006, we entered into a six-year patent cross-license and litigation dismissal agreement with Digi International, Inc. ("Digi"). The cross-license includes all pre-existing patents (not including design patents) held by us and Digi. In addition, the cross-license covers all future patents (not including design patents) during the six-year cross-license term.

Gordian, Inc. ("Gordian") developed certain intellectual property used in our micro serial server line of products. These products represented and continue to represent a significant portion of our net revenues. An agreement with Gordian gives us joint ownership of the Gordian intellectual property that is embodied in the products Gordian designed for us.

United States and Foreign Government Regulation

Many of our products and the industries in which they are used are subject to federal, state or local regulation in the U.S. In addition, our products are exported worldwide. Therefore, we are subject to the regulation of foreign governments. For example, wireless communication is highly regulated in both the U.S. and elsewhere. Some of our products employ encryption technology; the export of some encryption software is restricted. At this time our activities comply with existing laws, but we cannot determine whether future, more restrictive laws, if enacted, would adversely affect us. Please see Part I, Item 1A "Risk Factors" below for risks associated with foreign operations.

Employees

We have never experienced a work stoppage, none of our employees are currently represented by a labor union, and we consider our employee relations to be good.

The following table presents our part- and full-time employees:

	Years Ended June 30,		
	2006	2005	2004
Research and development	45	37	60
Sales and marketing	64	56	82
Operations	21	24	21
General and administrative	27	27	35
Total	157	144	198

Backlog

Normally, we manufacture our products in advance of receiving firm product orders from our customers based upon our forecasts of worldwide customer demand. Most customer orders are placed on an as-needed basis and may be canceled or rescheduled by the customer without significant penalty. Accordingly, backlog as of any particular date is not necessarily indicative of our future sales. Because most of our business is on an as-needed basis, we do not rely on backlog as a metric of our operations. We have no significant non-cancelable customer orders extending more than several months into the future.

Available Information

Our annual report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Section 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are available free of charge on our website at www.lantronix.com shortly after we electronically file such material with, or furnish it to, the SEC. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The SEC also maintains a website at www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that file electronically. We assume no obligation to update or revise forward looking statements in this Form 10-K, whether as a result of new information, future events or otherwise, unless we are required to do so by law.

Executive Officers of the Registrant

The following table presents the names, ages and positions held by all our executive officers as of August 31, 2006. There are no family relationships between any director or executive officer and any other director or executive officer of Lantronix. Executive officers serve at the discretion of the Board of Directors.

Name	**Age**	**Position**
Marc Nussbaum	50	President and Chief Executive Officer
James Kerrigan	70	Chief Financial Officer and Secretary

MARC NUSSBAUM has served as our President and Chief Executive Officer since May 2002 (on an Interim basis until February 2003). From April 2000 to March 2002, Mr. Nussbaum served as Senior Vice President and Chief Technical Officer for MTI Technology Corporation, a developer of enterprise storage solutions. From April 1981 to November 1998, Mr. Nussbaum served in various positions at Western Digital Corporation, a manufacturer of PC components, communication controllers, storage controllers and hard drives. Mr. Nussbaum led business development, strategic planning and product development activities, serving as Western Digital's Senior Vice President, Chief Technical Officer from 1995 to 1998 and Vice President, Storage Technology and Product Development from 1988 through 1995. Mr. Nussbaum holds a BA degree in physics from the State University of New York.

JAMES KERRIGAN has served as our Chief Financial Officer since May 2002 (on an Interim basis until February 2003) and as Secretary since July 2005. From March 2000 to October 2000, he was Chief Financial Officer of Motiva, a privately-owned company that developed, marketed and sold collaboration software systems. From January 1998 to February 1999, he was Chief Financial Officer of Who?Vision Systems, Inc., an incubator company that developed biometric fingerprint devices and software. From April 1995 to March 1997, Mr. Kerrigan was Chief Financial Officer of Artios, Inc., a privately-owned company that designs, manufactures, and sells prototyping hardware and software to the packaging industry. Previously, Mr. Kerrigan has served as chief financial officer for other larger, public companies. Mr. Kerrigan has a BS degree in engineering and a MBA degree from Northwestern University. On August 15, 2006, we issued a press release announcing the retirement of Mr. Kerrigan during fiscal 2007. We are currently conducting an extensive executive search, and following his retirement, Mr. Kerrigan will continue to assist us in an advisory role to ensure a smooth transition.

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 Report 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. 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 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 fiscal 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;
- 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 agreed to pay Digi $600,000 as part of the settlement of which $200,000 was paid in May 2006 with the remaining balance to be paid in July 2006. 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 to the notes to our consolidated financial statements of Part IV, Item 15 of this Form 10-K.

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, Malaysia and Taiwan involves risks that could adversely affect us.

We use contract manufacturers based in China, Malaysia 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 effect 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 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 spending has decreased, which may put us at a competitive disadvantage compared to our competitors and adversely affect our market position.

The following table presents our research and development expenses as a percentage of net revenues:

	Years Ended June 30,					
	2006	% of Net Revenues	2005	% of Net Revenues	Change $	Change %
	(In thousands, except percentages)					
Research and development	$ 5,999	11.5%	$ 6,325	13.0%	$ (326)	(5.2%)

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 and a related party as a percentage of net revenues:

	Years Ended June 30,		
	2006	2005	2004
Top five customers (1)	38.0%	42.0%	38.0%
Ingram Micro	13.0%	16.0%	14.0%
Tech Data	10.0%	11.0%	9.0%
Related party	3.0%	2.0%	3.0%

(1) Includes Ingram Micro, Tech Data and related party.

The loss or deferral of one or more significant sales in a fiscal quarter could harm our operating results. We have in the past, and might in the future, lose one or more of our 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 their relationship with us, our reputation, the perception of our products and technology in the marketplace, could be harmed. The demand for our products from our OEMs, VARs 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.

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, and we expect that will continue as these products 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-K, 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 to the notes to our consolidated financial statements of Part IV, Item 15 of this Form 10-K.

If the SEC should levy fines against us, or if we have violated the rules regarding offering securities to the public, it could damage our reputation with customers and vendors and adversely affect our stock price.

The SEC is investigating the events surrounding the restatement of our financial statements filed on June 25, 2002 for the fiscal year ended June 30, 2001 and for the six months ended December 31, 2001. During June 2006, we 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. The SEC could conclude that we violated the rules of the Securities Act of 1933, as amended (the “Securities Act”), or the Securities Exchange Act of 1934, as amended (the “Exchange Act”). In either event, the SEC might levy civil fines against us, or might conclude that we lack sufficient internal controls to warrant our being allowed to continue offering our shares to the public. This investigation involves substantial cost. These costs, and the cost of any fines imposed by the SEC, are not covered by insurance. In addition to sanctions imposed by the SEC, an adverse determination could significantly damage our reputation with customers and vendors, and harm our employees’ morale.

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.

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 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 four manufacturers: Venture Electronics Services, Uni Precision Industrial Ltd., Universal Scientific Industrial Company, LTD and eSilicon Corporation. 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.

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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.

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 as a percentage of net revenues:

	Years Ended June 30,		
	2006	**2005**	**2004**
Americas	62.5%	64.3%	69.3%
EMEA	27.1%	27.2%	23.0%
Asia Pacific	10.4%	8.5%	7.7%
	100.0%	100.0%	100.0%

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 and services we buy abroad are priced in foreign currencies, we are affected by fluctuating exchange rates. 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:

	June 30, 2006	June 30, 2005
	(In thousands)	
Raw materials	$ 3,863	$ 3,973
Finished goods	7,249	7,330
Inventory at distributors	1,690	1,181
	12,802	12,484
Reserve for excess and obsolete inventory	(4,689)	(5,656)
	$ 8,113	$ 6,828

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. James Kerrigan, our Chief Financial Officer, has announced his intention to retire before the end of the calendar year 2006, although he intends to remain in an advisory capacity to assist with the transition to a new Chief Financial Officer. We are currently searching for a replacement for Mr. Kerrigan. If we were unable to locate a suitable replacement candidate in a timely manner, our business could suffer. In addition, 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 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.

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 carriers 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.

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 implement and maintain an effective system of disclosure controls and internal controls over financial reporting, we may not be able to report our financial results in an accurate or timely manner, prevent fraud or comply with Section 404 of the Sarbanes-Oxley Act of 2002, which may harm our business and adversely affect the trading price of our stock.

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.

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

During calendar 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 year ended June 30, 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.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

We lease a building in Irvine, California, that comprises our corporate headquarters and includes administration, sales, marketing, research and development, warehouse and order fulfillment functions. During fiscal 2005, we extended the lease for our Irvine facility until July 2010. In addition, we have sales offices in France and Hong Kong. Our leased facilities comprise an aggregate of approximately 55,000 square feet of which our Irvine facility represents the majority.

We continue to make payments on lease obligations for facilities we no longer occupy, including our facilities located in Naperville, Illinois and Ames, Iowa (both leases terminate in February 2007). The remaining liability for these lease obligations is included in our restructuring reserve at June 30, 2006.

We believe our existing facilities are adequate to meet our needs. If additional space is needed in the future, we believe that suitable space will be available on commercially reasonable terms.

ITEM 3. LEGAL PROCEEDINGS

The legal proceedings as required by this item are incorporated by reference from Part IV, Item 15 of this Form 10-K and are presented under footnotes 10 and 11 to our notes to our consolidated financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of our security holders during the fourth fiscal quarter ended June 30, 2006.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Price Range of Common Stock

Our common stock was traded on The NASDAQ National Market under the symbol "LTRX" from our initial public offering on August 4, 2000 through October 22, 2002. On October 23, 2002 our listing was changed to The NASDAQ SmallCap Market, which has since been renamed The NASDAQ Capital Market. The number of holders of record of our common stock as of September 11, 2006 was approximately 80. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock:

	High	Low
Year Ended June 30, 2006		
First Quarter	$ 1.56	$ 1.19
Second Quarter	1.67	1.26
Third Quarter	2.57	1.64
Fourth Quarter	2.77	1.98
Year Ended June 30, 2005		
First Quarter	$ 1.25	$ 0.99
Second Quarter	1.24	0.85
Third Quarter	1.85	1.08
Fourth Quarter	1.80	1.24

We believe that a number of factors, including but not limited to quarterly fluctuations in results of operations, may cause the market price of our common stock to fluctuate significantly. See Part II, Item 7 of this Form 10-K.

Dividend Policy

We have never declared or paid cash dividends on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future, and we intend to retain any future earnings for use in the expansion of our business and for general corporate purposes.

Equity Compensation Plans

The information required by Item 201(d) of Regulation S-K is incorporated by reference to the information set forth under "Equity Compensation Plan Information" in our definitive proxy statement for the 2006 Annual Shareholders to be filed not later than 120 days after June 30, 2006 (the "Proxy Statement").

Recent Sales of Unregistered Securities

We did not repurchase any of our common stock during the fourth fiscal quarter of 2006. Since July 1, 2003, we have issued the following unregistered securities:

In June 2006, we issued an aggregate of 84,053 shares in connection with the settlement of securities claims brought by former stockholders of Synergetic Micro Systems, Inc. The shares in the foregoing transactions were exempt from registration pursuant to Section 3(a)(10) of the Securities Act.

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included below. In March 2004, we completed the sale of our Premise business unit that was originally purchased in January 2002. Accordingly, the information set forth in the table below reflects the Premise business unit as a discontinued operation. The consolidated statements of operations data for the fiscal years ended June 30, 2006, 2005 and 2004 and the balance sheet data as of June 30, 2006 and 2005 are derived from the audited consolidated financial statements included elsewhere in this report. The consolidated statements of operations data for the fiscal years ended June 30, 2003 and 2002, and the balance sheet data as of June 30, 2004, 2003 and 2002, are derived from the audited consolidated financial statements not included elsewhere in this report. The historical results are not necessarily indicative of results to be expected for future periods.

	Years Ended June 30,				
	2006	**2005**	**2004**	**2003**	**2002**
Consolidated Statement of Operations Data	**(In thousands, except per share data)**				
Net revenues (1)	$ 51,943	$ 48,502	$ 48,885	$ 49,389	$ 57,591
Cost of revenues (2)	25,276	24,326	25,026	36,264	40,281
Gross profit	26,667	24,176	23,859	13,125	17,310
Operating expenses:					
Selling, general and administrative	24,203	24,770	23,599	29,734	42,624
Research and development	5,999	6,325	7,854	9,809	9,457
Litigation settlement costs	960	-	-	1,533	1,912
Amortization of purchased intangible assets	20	65	148	602	960
Restructuring (recovery) charge	(17)	-	(2,093)	5,600	3,473
Impairment of goodwill and intangible assets	-	-	-	2,353	50,445
Total operating expenses	31,165	31,160	29,508	49,631	108,871
Loss from operations	(4,498)	(6,984)	(5,649)	(36,506)	(91,561)
Interest income (expense), net	46	(20)	50	248	1,548
Other income (expense), net	1,376	173	(5,333)	(926)	(760)
Loss before income taxes and cumulative effect of accounting changes	(3,076)	(6,831)	(10,932)	(37,184)	(90,773)
(Benefit) provision for income taxes	(31)	229	(325)	250	(6,665)
Loss from continuing operations	(3,045)	(7,060)	(10,607)	(37,434)	(84,108)
Income (loss) from discontinued operations	-	56	(5,047)	(10,115)	(3,444)
Loss before cumulative effect of accounting changes	(3,045)	(7,004)	(15,654)	(47,549)	(87,552)
Cumulative effect of accounting changes:					
Adoption of new accounting standard SFAS No. 142	-	-	-	-	(5,905)
Net loss	$ (3,045)	$ (7,004)	$ (15,654)	$ (47,549)	$ (93,457)

Basic and diluted loss per share from continuing operations before cumulative effect of accounting changes	$ (0.05)	$ (0.12)	$ (0.19)	$ (0.69)	$ (1.63)
Income (loss) from discontinued operations	-	-	(0.09)	(0.19)	(0.07)
Loss before cumulative effect of accounting changes	(0.05)	(0.12)	(0.28)	(0.88)	(1.70)
Cumulative effect of accounting changes per share:					
Adoption of new accounting standard SFAS No. 142	-	-	-	-	(0.12)
Net loss per share	$ (0.05)	$ (0.12)	$ (0.28)	$ (0.88)	$ (1.82)
Weighted average shares (basic and diluted)	58,702	58,202	56,862	54,329	51,403

	As of June 30,				
	2006	**2005**	**2004**	**2003**	**2002**
Consolidated Balance Sheet Data			**(In thousands)**		
Cash and cash equivalents	$ 7,729	$ 6,690	$ 9,128	$ 7,328	$ 26,491
Marketable securities	88	85	3,050	6,750	6,963
Working capital	5,372	7,824	12,087	17,312	40,317
Goodwill	9,488	9,488	9,488	9,488	7,218
Purchased intangible assets, net	610	559	2,056	4,275	11,891
Total assets	47,815	30,368	37,250	54,947	103,812
Long-term capital lease obligations	211	51	-	867	1,000
Accumulated deficit	(166,450)	(163,082)	(156,078)	(140,424)	(92,875)
Total stockholders' equity	16,778	18,468	24,791	37,717	82,157

(1) Includes net revenues from related party
(2) Includes amortization of purchased intangible assets

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes thereto included elsewhere in this report. In addition to historical information, the discussion in this report contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those anticipated by these forward-looking statements due to factors including, but not limited to, those factors set forth under Part I, Item 1A "Risk Factors" and elsewhere in this report.

Overview

We design, develop and market devices that make it possible to access, manage, control and configure electronic devices over the Internet and 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. Our products are sold to distributors, OEMs, VARs, and systems integrators, as well as directly to end users.

In March 2004, we sold substantially all of the net assets of our Premise business unit. The Company's consolidated financial statements have been presented to reflect Premise as a discontinued operation for all periods presented.

Fiscal Year 2006 Financial Highlights and Other Information

A summary of the key factors and significant events which impacted our financial performance during the fiscal year ended June 30, 2006 are as follows:

- Net revenues of $51.9 million for the fiscal year ended June 30, 2006 increased by $3.4 million or 7.1% as compared to the $48.5 million reported during the fiscal year ended June 30, 2005. The increase was primarily the result of an increase in our device networking product line.

- Gross profit as a percentage of net revenues was 51.3% for the fiscal year ended June 30, 2006, increasing 1.5 percentage points from the 49.8% reported in the fiscal year ended June 30, 2005. The improvement in gross profit is in part due to a decrease in the amortization of purchased intangible assets, a decrease in manufacturing overhead as a percentage of net revenues and a reduction in product warranty reserves to reflect a decrease in our product return rates offset by an increase in direct product costs.

- Loss from operations as a percentage of net revenues was 8.7% for the fiscal year ended June 30, 2006 as compared to 14.4% in the fiscal year ended June 30, 2005.

- Net loss of $3.0 million, or $0.05 per diluted share, in the fiscal year ended June 30, 2006 improved from a loss of $7.0 million, or $0.12 per diluted share, in the fiscal year ended June 30, 2005.

- Cash, cash equivalents and marketable securities increased by $1.0 million during fiscal 2006 to $7.8 million. The increase in cash and cash equivalents is in part the result of our cash management activities which includes the timing of cash payments to vendors and cash collection efforts. In addition, during the fourth quarter of fiscal 2006 we received $1.3 million in cash from the sale of a long-term investment.

- Accounts receivable increased by $190,000 during fiscal 2006. Days sales outstanding ("DSO") in receivables as of June 30, 2006 decreased to 21.0 days from 23.1 days as of June 30, 2005. Our accounts receivable and DSO are affected by the timing of shipments within the quarter, our collections performance and the fact that revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped to distributors). There can be no assurance that we will be able to maintain our DSO ratios consistent with historical trends and DSO ratios may increase in the future.

· Inventories were $8.1 million as of June 30, 2006 as compared to $6.8 million as of June 30, 2005. The increase was in part a result of a build-up in our embedded device networking products. Our annualized inventory turns in fiscal 2006 of 3.4 turns declined from the 3.6 turns in fiscal 2005.

· We have reached agreements to settle or have settled all of our outstanding litigation. We recorded a $960,000 settlement charge during the fiscal year ended June 30, 2006 in connection with such settlement agreements. As of June 30, 2006, we have accrued settlements of $16.8 million of which we expect our insurance carriers to pay $15.3 million with the remaining balance of $1.4 million to be paid by us in the form of warrants, common stock or cash.

Adoption of SFAS 123R

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123R"). Effective the first quarter of fiscal 2006, we adopted SFAS 123R using the modified prospective method, which requires us to record compensation expense for all awards granted after the date of adoption, and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. Accordingly, prior period amounts presented herein have not been restated to reflect the adoption of SFAS 123R.

As a result of adopting SFAS 123R, our share-based compensation expense is higher for the fiscal year ended June 30, 2006 than if we had continued to account for share-based compensation under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25"). The following table presents the impact of adopting SFAS 123R on loss before income taxes, net loss and basic and diluted loss per share:

		Year Ended June 30, 2006 (In thousands, except per share data)
Loss before income taxes	$	(1,074)
Net loss	$	(1,074)
Net loss per share (basic and diluted)	$	(0.02)

The following table presents the effect on net loss and net loss per share as if we had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock Based Compensation" ("SFAS 123") to options granted under our stock option plans:

	Years Ended June 30, (In thousands, except per share data)			
		2005		2004
Net loss - as reported	$	(7,004)	$	(15,654)
Add: Share-based employee compensation expense included				
in net loss, net of related tax effects - as reported		171		395
Deduct: Share-based employee compensation expense determined				
under fair value method, net of related tax effects - pro forma		(1,186)		(3,092)
Net loss - pro forma	$	(8,019)	$	(18,351)
Net loss per share (basic and diluted) - as reported	$	(0.12)	$	(0.28)
Net loss per share (basic and diluted) - pro forma	$	(0.14)	$	(0.32)

The following table presents total share-based compensation cost related to nonvested awards not yet recognized and the weighted-average period over which the cost is expected to be recognized:

		June 30, 2006 (In thousands)
Cost of revenues	$	229
Sales, general and administrative		1,708
Research and development		649
Total	$	2,586

Weighted-average remaining years	2.8

Recent Accounting Pronouncements

In May 2005, FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"). SFAS 154 requires retroactive application of a voluntary change in accounting principle to prior period financial statements unless it is impracticable. SFAS 154 also requires that a change in method of depreciation, amortization, or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is affected by a change in accounting principle. SFAS 154 replaces APB Opinion 20, "Accounting Changes", and SFAS 3, "Reporting Accounting Changes in Interim Financial Statements." The Company will adopt the provisions of SFAS 154 in fiscal 2007 consolidated financial statements. We believe that adoption of the provisions of SFAS 154 will not have a material impact on our consolidated financial statements.

In June 2006, 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. We are currently evaluating the impact that the adoption of FIN 48 will have on our 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 SEC did not or are not believed by management to have a material impact on our present or future consolidated financial statements.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the U.S. requires us to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenues and expenses during the reporting period. We regularly evaluate our estimates and assumptions related to net revenues, allowances for doubtful accounts, sales returns and allowances, inventory valuation, valuation of deferred income taxes, goodwill and purchased intangible asset valuations, warranty reserves, restructuring costs, litigation and other contingencies. We base our estimates and assumptions on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent there are material differences between our estimates and the actual results, our future results of operations will be affected.

We believe the following critical accounting policies require us to make significant judgments and estimates in the preparation of our consolidated financial statements:

Revenue Recognition

We do not recognize revenue until all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; our price to the buyer is fixed or determinable; and collectibility is reasonably assured. However, a significant portion of our sales are made to distributors under agreements which contain a limited right to return unsold product and price protection provisions. Recognition of revenue and related cost of revenues from sales to distributors are deferred until the distributor resells the product. Net revenue from certain smaller distributors for which point-of-sale information is not available, is recognized approximately one month after the shipment date. This estimate approximates the timing of the sale of the product by the distributor to the end user.

When product sales revenue is recognized, we establish an estimated allowance for future product returns based on historical returns experience; when price reductions are approved, we establish an estimated liability for price protection payable on inventories owned by product resellers. Should actual product returns or pricing adjustments exceed our estimates, additional reductions to revenues would result.

Warranty Reserve

Our 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 we engage in extensive product quality programs and processes, our 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, we sell extended warranty services, which extend the warranty period for an additional one to three years, depending upon the product. Warranty revenue is recognized evenly over the warranty service period.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts, the aging of accounts receivable, our history of bad debts and the general condition of the industry. If a major customer's credit worthiness deteriorates, or our customers' actual defaults exceed our historical experience, our estimates could change and impact our reported results.

We also maintain a reserve for uncertainties relative to the collection of officer notes receivable. Factors considered in determining the level of this reserve include the value of the collateral securing the notes, our ability to effectively enforce collection rights and the ability of the former officers to honor their obligations.

Inventory Valuation

Our policy is to value inventories at the lower of cost or market on a part-by-part basis. This policy requires us to make estimates regarding the market value of our inventories, including an assessment of excess and obsolete inventories. We determine excess and obsolete inventories based on an estimate of the future sales demand for our products within a specified time horizon, generally three to twelve months. The estimates we use for demand are also used for near-term capacity planning and inventory purchasing and are consistent with our revenue forecasts. In addition, specific reserves are recorded to cover risks in the area of end of life products, inventory located at our contract manufacturers, deferred inventory in our sales channel and warranty replacement stock.

If our sales forecast is less than the inventory we have on hand at the end of an accounting period, we may be required to take excess and obsolete inventory charges, which will decrease gross margin and net operating results for that period.

Valuation of Deferred Income Taxes

We have recorded a valuation allowance to reduce our net deferred tax assets to zero, primarily due to historical net operating losses and uncertainty of generating future taxable income. We consider estimated future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. If we determine that it is more likely than not that we will realize a deferred tax asset, which currently has a valuation allowance, we would be required to reverse the valuation allowance that would be reflected as an income tax benefit at that time.

Goodwill and Purchased Intangible Assets

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development. The amounts and useful lives assigned to intangible assets impact future amortization. If the assumptions and estimates used to allocate the purchase price are not correct, purchase price adjustments or future asset impairment charges could be required.

We perform goodwill impairment tests on an annual basis, and more frequently if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Goodwill impairment testing requires us to compare the fair value of each reporting unit to its carrying amount, including goodwill, and record an impairment charge if the carrying amount of a reporting unit exceeds its estimated fair value. The determination of a reporting unit's fair value requires significant judgment and is based on management's best estimate, which generally considers the unit's expected future earnings. If actual results are not consistent with our assumptions and judgments used in estimating fair value, we may be exposed to additional goodwill impairment losses. As of June 30, 2006, we have $9.5 million of goodwill reflected in our consolidated balance sheet.

We evaluate purchased intangible assets when indicators of impairment, such as reductions in demand or significant economic slowdowns, are present. Reviews are performed to determine whether the carrying values of these assets are impaired based on a comparison to the undiscounted expected future cash flows. If the comparison indicates that there is impairment, the expected future cash flows using a discount rate based upon our weighted average cost of capital is used to estimate the fair value of the assets. Impairment is based on the excess of the carrying amount over the fair value of those assets. Significant management judgment is required in the forecast of future operating results that is used in the preparation of expected discounted cash flows. It is reasonably possible that the estimates of anticipated future net revenue, the remaining estimated economic lives of the products and technologies, or both, could differ from those used to assess the recoverability of our purchased intangible assets. In the event they are lower, additional impairment charges or shortened useful lives of certain purchased intangible assets could be required. As of June 30, 2006, we have approximately $610,000 of purchased intangible assets reflected in our consolidated balance sheet.

Settlement Costs

From time to time, we are involved in legal actions arising in the ordinary course of business. We cannot assure you that these actions or other third party assertions against us will be resolved without costly litigation, or in a manner that is not adverse to our financial position, results of operations or cash flows. As facts concerning contingencies become known, we reassess our position and make appropriate adjustments to the financial statements. There are many uncertainties associated with any litigation. If our initial assessments regarding the merits of a claim prove to be wrong, our results of operations and financial condition could be materially and adversely affected. In addition, if further information becomes available that causes us to determine a loss in any of our pending litigation, it is probable and we can reasonably estimate a range of loss associated with such litigation, then we would record at least the minimum estimated liability. However, the actual liability in any such litigation may be materially different from our estimates, which could result in the need to record additional costs or recover amounts previously recorded. Generally, legal expenses billed directly to us are expensed as incurred. Legal expenses covered by an insurance policy have been recorded and paid as incurred; reimbursement of legal expenses from insurance or other sources are recorded upon receipt. This practice was modified in May 2005, when a new insurance carrier became responsible for certain legal expenses related to our stockholder lawsuits. Since May 2005, the new insurance carrier receives invoices from attorneys and reviews and pays these invoices on our behalf directly. Invoices related to stockholder litigation that were unpaid as of June 30, 2006 have been recorded as a liability, with a receivable from insurance to offset that liability. Litigation settlement costs have generally been recognized as a liability, with a receivable from insurance to offset that liability until the settlement is paid by the insurance company.

Consolidated Results of Operations

The following discussion of results of operations includes a discussion of continuing operations only. Certain amounts in the fiscal 2005 and 2004 consolidated financial statements have been reclassified to conform with the current year presentation.

The following table presents the percentage of net revenues represented by each item in our consolidated statements of operations:

	Years Ended June 30,		
	2006	**2005**	**2004**
Net revenues (1)	100.0%	100.0%	100.0%
Cost of revenues (2)	48.7%	50.2%	51.2%
Gross profit	51.3%	49.8%	48.8%
Operating expenses:			
Selling, general and administrative	46.6%	51.1%	48.3%
Research and development	11.5%	13.0%	16.1%
Litigation settlement costs	1.8%	0.0%	0.0%
Amortization of purchased intangible assets	0.0%	0.1%	0.3%
Restructuring recovery	0.0%	0.0%	(4.3%)
Total operating expenses	60.0%	64.2%	60.4%
Loss from operations	(8.7%)	(14.4%)	(11.6%)
Interest income (expense), net	0.2%	(0.1%)	0.1%
Other income (expense), net	2.6%	0.4%	(10.9%)
Loss before income taxes	(5.9%)	(14.1%)	(22.4%)
(Benefit) provision for income taxes	0.0%	0.5%	(0.7%)
Loss from continuing operations	(5.9%)	(14.6%)	(21.7%)
Income (loss) from discontinued operations	0.0%	0.2%	(10.3%)
Net loss	(5.9%)	(14.4%)	(32.0%)

(1) Includes net revenues from related party
(2) Includes amortization of purchased intangible assets

Fiscal Years Ended June 30, 2006 and 2005

Net Revenues by Product Category

The following table presents net revenues by product category:

	Years Ended June 30,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Device networking	$ 35,419	68.2%	$ 29,979	61.9%	$ 5,440	18.1%
IT management	11,499	22.1%	12,341	25.4%	(842)	(6.8%)
Non-core	5,025	9.7%	6,182	12.7%	(1,157)	(18.7%)
	$ 51,943	100.0%	$ 48,502	100.0%	$ 3,441	7.1%

The increase in net revenues for fiscal 2006 as compared to fiscal 2005 was a result of an increase in net revenues from our device networking products, offset by a decrease in our IT management products, and our non-core products. The increase in our device networking product line is in part due to an increase in volume in our embedded device networking products, which includes our XPort products. The decrease in IT management product sales is a result of a decrease in our Secure Console Server and ETS Terminal Server product sales. 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 device networking and IT management products.

Net Revenues by Region

The following table presents net revenues by geographic region:

	Years Ended June 30,					
		% of Net		% of Net	Change	
	2006	Revenues	2005	Revenues	$	%
	(In thousands, except percentages)					
Americas	$ 32,463	62.5%	$ 31,162	64.3%	$ 1,301	4.2%
EMEA	14,094	27.1%	13,213	27.2%	881	6.7%
Asia Pacific	5,386	10.4%	4,127	8.5%	1,259	30.5%
	$ 51,943	100.0%	$ 48,502	100.0%	$ 3,441	7.1%

The increase in net revenues for fiscal 2006 as compared to fiscal 2005 is a result of an increase in net revenues across all of our geographic regions. The increase in net revenues in the Americas region is in part attributable to an increase in sales of device networking products offset by lower sales of IT management and non-core products. The increase in net revenues in the EMEA ("Europe, Middle East and Africa") and Asia Pacific regions is in part due to an increase in sales of our device networking products.

Net Revenues by Significant Customer

The following table presents net revenues by significant customer and a related party as a percentage of net revenues:

	Years Ended June 30,		
	2006	2005	2004
Top five customers (1)	38.0%	42.0%	38.0%
Ingram Micro	13.0%	16.0%	14.0%
Tech Data	10.0%	11.0%	9.0%
Related party	3.0%	2.0%	3.0%

(1) Includes Ingram Micro, Tech Data and related party.

An international customer, transtec AG, is a related party due to common ownership by our largest stockholder, Bernhard Bruscha.

Gross Profit

The following table presents gross profit:

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	Years Ended June 30,					
	2006	% of Net Revenues	2005	% of Net Revenues	Change $	Change %
	(In thousands, except percentages)					
Gross profit	$ 26,667	51.3%	$ 24,176	49.8%	$ 2,491	10.3%

Gross profit represents net revenues less cost of revenues. Cost of revenues consists in part 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.

In order of significance, the increase in gross profit as a percentage of net revenues for fiscal 2006 as compared to fiscal 2005 is in part due to the following factors: (i) a decrease in the amortization of purchased intangible assets as a result of a majority of our purchased intangible assets becoming fully amortized; (ii) a reduction in product warranty reserves to reflect a decrease in our product return rates; and (iii) a reduction in manufacturing overhead costs; offset by an increase in direct standard product costs as a result of a shift in the product mix of device networking sales towards lower margin product sales.

Selling, General and Administrative

The following table presents selling, general and administrative expenses:

	Years Ended June 30,					
	2006	% of Net Revenues	2005	% of Net Revenues	Change $	Change %
	(In thousands, except percentages)					
Selling, general and administrative	$ 24,203	46.6%	$ 24,770	51.1%	$ (567)	(2.3%)

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

In order of significance, the decrease in selling, general and administrative expense for fiscal 2006 as compared to fiscal 2005 is in part due to the following factors: (i) a decrease in personnel-related expenses as a result of a reduction in average headcount for the period; (ii) a reduction in facilities expenses in part due to a reduction in building rent expense for our Irvine facility; (iii) a reduction of advertising expenditures; (iv) a recovery of bad debts; offset by an increase in legal and professional fees in part as a result of legal fees related to the fiscal 2006 patent litigation and an increase in share-based compensation expense as a result of our adoption of SFAS 123R as of July 1, 2005. See above section, Adoption of SFAS 123R, for additional detail.

Research and Development

The fo