LANTRONIX INC
Form 10-Q
February 07, 2011

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

FORM 10-Q

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

For the quarterly period ended December 31, 2010

OR

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

167 Technology Drive, Irvine, California
(Address of principal executive offices)

92618
(Zip Code)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

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

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

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

As of February 3, 2011, there were 10,437,001 shares of the Registrant's common stock outstanding.

LANTRONIX, INC.

FORM 10-Q
FOR THE FISCAL QUARTER ENDED
December 31, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LANTRONIX, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2010	June 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$10,645	$10,075
Accounts receivable, net	1,970	1,342
Contract manufacturers' receivable	1,488	1,015
Inventories, net	9,586	6,873
Prepaid expenses and other current assets	366	515
Deferred tax assets	542	542
Total current assets	24,597	20,362
Property and equipment, net	2,094	2,392
Goodwill	9,488	9,488
Purchased intangible assets, net	109	155
Other assets	167	135
Total assets	$36,455	$32,532
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$9,756	$6,545
Accrued payroll and related expenses	1,288	1,568
Warranty reserve	209	183
Short-term debt	667	667
Other current liabilities	4,123	3,776
Total current liabilities	16,043	12,739
Non-current liabilities:		
Long-term liabilities	591	646
Long-term capital lease obligations	91	153
Long-term debt	1,167	111
Deferred tax liabilities	542	542
Total non-current liabilities	2,391	1,452
Total liabilities	18,434	14,191
Commitments and contingencies		
Stockholders' equity:		
Common stock	1	1
Additional paid-in capital	192,084	191,147
Accumulated deficit	(174,463)	(173,206)

Accumulated other comprehensive income	399	399
Total stockholders' equity	18,021	18,341
Total liabilities and stockholders' equity	$36,455	$32,532

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Net revenue (1)	$12,719	$11,478	$24,911	$22,432
Cost of revenue	6,441	5,429	12,406	10,666
Gross profit	6,278	6,049	12,505	11,766
Operating expenses:				
Selling, general and administrative	5,088	4,855	10,141	9,475
Research and development	1,697	1,510	3,520	2,995
Amortization of purchased intangible assets	18	18	36	36
Total operating expenses	6,803	6,383	13,697	12,506
Loss from operations	(525)	(334)	(1,192)	(740)
Interest expense, net	(36)	(42)	(58)	(89)
Other income (expense), net	(5)	11	24	(25)
Loss before income taxes	(566)	(365)	(1,226)	(854)
Provision for income taxes	13	10	31	20
Net loss	$(579)	$(375)	$(1,257)	$(874)
Net loss per share (basic and diluted)	$(0.06)	$(0.04)	$(0.12)	$(0.09)
Weighted-average shares (basic and diluted)	10,429	10,301	10,389	10,234
Net revenue from related parties	$212	$142	$453	$267

(1) Includes net revenue from related parties

See accompanying notes.

LANTRONIX, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Months Ended December 31, 2010	Six Months Ended December 31, 2009
Operating activities		
Net loss	$(1,257)	$(874)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Share-based compensation	1,061	1,143
Depreciation	515	404
Provision (recovery) for inventories	152	(119)
Amortization of purchased intangible assets	46	62
Provision for doubtful accounts	1	12
Changes in operating assets and liabilities:		
Accounts receivable	(629)	77
Contract manufacturers' receivable	(473)	(371)
Inventories	(2,865)	(8)
Prepaid expenses and other current assets	87	(352)
Other assets	(31)	(5)
Accounts payable	3,210	1,928
Accrued payroll and related expenses	(286)	(478)
Warranty reserve	26	-
Restructuring reserve	-	(76)
Other liabilities	440	59
Cash received related to tenant incentives	32	-
Net cash provided by operating activities	29	1,402
Investing activities		
Purchases of property and equipment, net	(220)	(625)
Net cash used in investing activities	(220)	(625)
Financing activities		
Proceeds from term loan	2,000	-
Payment of term loan	(944)	(333)
Minimum tax withholding paid on behalf of employees for restricted shares	(131)	(263)
Payment of capital lease obligations	(238)	(138)
Net proceeds from issuances of common stock	27	150
Net cash provided by (used in) financing activities	714	(584)
Effect of foreign exchange rate changes on cash	47	49
Increase in cash and cash equivalents	570	242
Cash and cash equivalents at beginning of period	10,075	9,137
Cash and cash equivalents at end of period	$10,645	$9,379

See accompanying notes.

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LANTRONIX, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2010

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Lantronix, Inc. (the "Company" or "Lantronix") have been prepared by the Company in accordance with generally accepted accounting principles ("GAAP") for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2010, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on September 13, 2010. The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of the Company at December 31, 2010, and the consolidated results of its operations and cash flows for the three and six months ended December 31, 2010 and 2009. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three and six months ended December 31, 2010 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

2. Computation of Net Loss per Share

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

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands, except per share data)			
Numerator:				
Net loss	$ (579)	$ (375)	$ (1,257)	$ (874)
Denominator:				
Weighted-average shares outstanding	10,617	10,620	10,577	10,553
Less: Unvested common shares outstanding	(188)	(319)	(188)	(319)
Weighted-average shares (basic and diluted)	10,429	10,301	10,389	10,234
Net loss per share (basic and diluted)	$ (0.06)	$ (0.04)	$ (0.12)	$ (0.09)

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands)			
Common stock equivalents	1,222	1,201	1,130	1,351

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3. Inventories

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

	December 31, 2010	June 30, 2010
	(In thousands)	
Finished goods	$ 6,947	$ 4,258
Raw materials	1,703	1,390
Inventory at distributors *	1,621	1,924
Large scale integration chips **	672	516
Inventories, gross	10,943	8,088
Reserve for excess and obsolete inventory	(1,357)	(1,215)
Inventories, net	$ 9,586	$ 6,873

* Balance represents finished goods held by distributors.
** This item is sold individually and is also embedded into the Company's products.

4. Warranty

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

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

	Six Months Ended December 31, 2010	Year Ended June 30, 2010
	(In thousands)	
Beginning balance	$ 183	$ 224
Charged to cost of revenues	127	84
Usage	(101)	(125)
Ending balance	$ 209	$ 183

5. Bank Line of Credit and Debt

In September 2010, the Company entered into an Amendment to Loan and Security Agreement (the “Loan Agreement”), which provides for a two-year $4.0 million maximum revolving line (the “Revolving Line”) with a three-year $2.0 million term loan (the “Term Loan”). Per the Loan Agreement, the proceeds from the Term Loan were used to pay the balance of $611,000 outstanding on the term loan that was made under the original agreement in 2008. The Term Loan was funded on September 28, 2010 and is payable in 36 equal monthly installments of principal and accrued interest. There are no borrowings outstanding on the Revolving Line as of the fiscal quarter end.

Borrowings under the Loan Agreement bear interest at the greater of 4.75% or prime rate plus 0.75% per annum. Upon entering into the Loan Agreement, the Company paid a fully earned, non-refundable commitment fee of $20,000 and will pay an additional $15,000 on September 28, 2011, the first anniversary of the effective date of the Loan Agreement.

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

The Borrowing Base (as defined in the Loan Agreement) under the Revolving Line is based upon eligible accounts receivable as defined per the Loan Agreement. The “Amount Available under the Revolving Line” is defined as at any time (a) the lesser of (i) the Revolving Line maximum or (ii) the Borrowing Base, minus (b) the amount of all outstanding letters of credit (including drawn but unreimbursed letters of credit) minus (c) an amount equal to the letter of credit reserves, minus (d) the foreign currency reserve, minus (e) the outstanding principal balance of any advances, and minus (f) one-half of the principal balance then outstanding on the Term Loan.

The following table presents the balance outstanding on the Term Loan, our available borrowing capacity and outstanding letters of credit, which were used to secure equipment leases, deposits for a building lease, and security deposits:

	December 31, 2010	June 30, 2010
	(In thousands)	
Term Loan	$ 1,834	$ 778
Amount Available under the Revolving Line	1,538	1,031
Outstanding letters of credit	343	343

6. Stockholders’ Equity

Share-Based Plans

On November 18, 2009, Lantronix stockholders approved a proposal to authorize the Company’s board of directors to implement, at its discretion, a reverse stock split of the Company’s outstanding shares of common stock within a range of one-third to one-sixth of a share for each outstanding share of common stock, and to file an Amendment to the Company’s Certificate of Incorporation (the “Certificate of Amendment”) to effect such a reverse stock split. On November 18, 2009, the board of directors authorized a one-for-six reverse stock split of the Company’s common stock. On December 18, 2009, the Company filed the Certificate of Amendment. All references to common shares and per-share data for all periods presented in this report have been retrospectively adjusted to give effect to this reverse stock split.

On December 15, 2010, Lantronix stockholders approved the 2010 Stock Incentive Plan which replaces the expired 2000 Stock Plan and reserves 1.4 million shares of Lantronix common stock as available for issuance under the 2010 Stock Incentive Plan. In addition, Lantronix stockholders approved an amendment to the Lantronix Certificate of Incorporation to reduce the number of common shares authorized from 200 million shares to 100 million shares.

The Company has share-based plans under which non-qualified and incentive stock options have been granted to employees, non-employees and board members. In addition, the Company has granted restricted stock awards to employees and board members under these share-based plans.

The board of directors determines eligibility, vesting schedules and exercise prices for options and shares granted under the plans. Share-based awards are generally granted with an exercise price equal to the market price of the Company’s stock at the date of grant. Option awards generally have a term of 7 to10 years. Share-based awards generally vest and become exercisable over a one- to four-year service period. The Company has granted share-based awards with market conditions whereby vesting is accelerated upon achieving certain stock price thresholds. In addition, the board of directors has approved a share-based performance plan whereby employees will be paid in vested common shares if minimum revenue, income and management objectives are met. The Company issues new shares to satisfy stock option exercises, restricted stock grants, and stock purchases under its share-based plans.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands)			
Cost of revenues	$ 10	$ 10	$ 35	$ 19

Selling, general and administrative		382		428		790		851
Research and development		86		146		236		273
Total share-based compensation	$	478	$	584	$	1,061	$	1,143

The following table presents a summary of remaining unrecognized share-based compensation by the vesting condition for the Company's share-based plans as of December 31, 2010:

Vesting Condition	Unrecognized Compensation Cost	Remaining Years To Vest
	(In thousands)	
Stock Option Awards:		
Service-based	$ 1,794	
Market- and service-based	76	
Stock option awards	$ 1,870	2.6
Restricted Stock Awards:		
Service-based	$ 459	
Market- and service-based	4	
Restricted stock awards	$ 463	1.5

Stock Option Awards

The fair value of each stock option grant was estimated on the grant date using the Black-Scholes-Merton ("BSM") option-pricing formula. To the extent that the stock option grant included market conditions, the Company used a lattice model to estimate the fair value for each stock option grant. Expected volatilities were based on the historical volatility of the Company's stock price. The expected term of options granted was estimated using the simplified method. To the extent that stock option grants included market conditions and therefore did not meet the rules for the simplified method, the Company used a lattice model to estimate the expected term of stock options granted. The risk-free rate for periods within the contractual life of the stock option grant was based on the U.S. Treasury interest rates in effect at the time of grant.

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

	Number of Shares
Balance of options outstanding at June 30, 2010	1,890,339
Options granted	392,755
Options forfeited	(110,852)
Options expired	(23,393)
Options exercised	(10,068)
Balance of options outstanding at December 31, 2010	2,138,781

The following table presents stock option grant date information:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Weighted-average grant date fair value per share	$ 2.19	$ 2.14	$ 2.19	$ 1.88
Weighted-average grant date exercise price per share	$ 3.44	$ 3.06	$ 3.44	$ 2.66

Nonvested Share Awards

The following table presents a summary of nonvested share activity:

	Number of Shares Unvested	Weighted Average Grant - Date Fair Value per Share
Balance of nonvested shares at June 30, 2010	291,646	$ 3.16
Granted	-	-
Forfeited	(13,099)	3.00
Vested	(90,208)	3.08
Balance of nonvested shares at December 31, 2010	188,339	$ 3.21

The following table presents a summary of the total fair value of shares vested for all of the Company's nonvested share awards:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands)			
Fair value of shares vested	$ 345	$ 77	$ 345	$ 425

Performance-Based Share Awards

The compensation committee of the board of directors approved a performance plan for the six months ended December 31, 2010 ("Performance Plan"), which will be paid in a combination of cash and vested common shares based on the board of directors discretion and if minimum revenue, EBITDA and management objectives are met. On January 26, 2011, the board of directors approved the final Performance Plan payout of $307,000 for the six months ending December 31, 2010. The Company recorded $153,500 of share-based compensation and $153,500 of compensation expense in connection with this Performance Plan. The cash portion of the award is recorded as a short-term liability on the consolidated balance sheet and the share-based portion of the award is recorded as a long-term liability on the consolidated balance sheet.

Warrants to Purchase Common Stock

During March 2008, the Company issued warrants to purchase an aggregate of 179,935 shares of Lantronix common stock as consideration for settlement of a shareholder lawsuit. The warrants have an exercise price of $28.08 per share and expire on February 10, 2011.

7. Income Taxes

At July 1, 2010, the Company's fiscal 2003 through fiscal 2009 tax years remained open to examination by the federal, state, and foreign taxing authorities. The Company has annual net operating losses ("NOLs") beginning in fiscal 2001 that would cause the statute of limitations to remain open for the year in which the NOL was incurred.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Effective tax rate	2%	3%	3%	2%

The federal statutory rate was 34% for all periods. The difference between the Company's effective tax rate and the federal statutory rate is primarily due to its domestic losses being recorded with a fully reserved tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate.

8. Comprehensive Income (Loss)

The components of comprehensive income (loss) are as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
	(In thousands)			
Net loss	$ (579)	$ (375)	$ (1,257)	$ (874)
Other comprehensive income (loss):				
Change in translation adjustments, net of taxes of $0	-	(25)	-	22
Total comprehensive loss	$ (579)	$ (400)	$ (1,257)	$ (852)

9. Litigation

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

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

Cautionary Statement

You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained elsewhere in this Quarterly Report on Form 10-Q. The information contained in this Report is not a complete description of our business. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the fiscal year ended June 30, 2010 and subsequent reports on our Current Reports on Form 8-K.

This Report contains forward-looking statements, which include, but are not limited to, statements concerning projected net revenues, expenses, gross profit and net income (loss), the need for additional capital, market acceptance of our products, our ability to achieve further product integration, the status of evolving technologies and their growth potential and our production capacity. Among these forward-looking statements are statements regarding a potential decline in net revenue from non-core product lines, potential variances in quarterly operating expenses, the adequacy of existing resources to meet cash needs, some reduction in the average selling prices and gross margins of products, need to incorporate software from third-party vendors and open source software in our future products and the potential impact of an increase in interest rates or fluctuations in foreign exchange rates on our financial condition or results of operations. These forward-looking statements are based on our current expectations, estimates and projections about our industry, our beliefs and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are inte to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, including but not limited to those identified under the heading "Risk Factors" set forth in Part II, Item 1A hereto. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

We design, develop, market and sell products that make it possible to access, manage, connect, control and configure electronic products over the Internet or other networks. Our primary products and technology are focused on device enablement solutions that enable individual electronic products to be connected to a wired or wireless network for the primary purpose of remote access. In addition, our device management solutions address applications that manage equipment at data centers and remote branch offices to provide a reliable, single point of control and data flow management for potentially thousands of networked devices.

Our innovative networking 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 broad market segments, including industrial, security, energy, information technology ("IT"), data centers, transportation, government, healthcare, and many others. This past year we identified medical device connectivity as a particularly promising direction for investment and growth.

Products and Solutions

Device Enablement Solutions

Device networking is the technology that enables connectivity within a multitude of vertical markets such as healthcare, industrial, security, energy, IT, data centers, transportation, government and many others. Our device enablement solutions released after 2009 support our ManageLinx VIP Access, which allows equipment to be remotely, safely and securely managed behind firewalls. We provide manufacturers, integrators and end users with device enablement solutions for products to be connected, securely accessed, managed and controlled over networks. Our device enablement solutions dramatically shorten a manufacturer's development time to implement network connectivity and provide competitive advantages with new features, greatly reducing engineering and marketing risks.

Our device servers allow a wide range of equipment to be quickly network-enabled without the need for intermediary gateways, workstations or personal computers ("PC"). Our device servers and web servers eliminate the high cost of ownership and added support issues associated with networking, which frequently would otherwise require using PCs or 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 information. The accumulated data can then be formatted by the device server and presented to users via web pages, e-mail, and other network, transport and application level protocols. Our device servers have a built-in HTTP server, making them easy to manage using any standard Web browser. These device servers include the latest security protocols, such as AES, IPsec, SSL, and SSH, which support the stringent security requirements of the medical, banking, and physical security markets.

Device Management Solutions

We offer single and multi-port products (up to 48 ports) that provide IT professionals with the tools they need to remotely connect to the out-of-band management ports on computers and associated equipment. These solutions include console servers, remote keyboard, video, mouse ("KVM") servers and managed power distribution products.

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 that 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 an operationally effective 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 on servers and special purpose data center equipment, such as environmental monitoring/ control systems, communications switches and storage devices. With remote access, system downtime can be reduced, thereby 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.

Other Products

Our other products are comprised primarily of legacy products such as print servers, software and other miscellaneous products.

Financial Highlights and Other Information for the Fiscal Quarter Ended December 31, 2010

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended December 31, 2010:

Net revenue was $12.7 million for the fiscal quarter ended December 31, 2010, an increase of $1.2 million or 10.8%, compared to $11.5 million for the fiscal quarter ended December 31, 2009. The increase was primarily the result of a $1.2 million, or 13.1%, increase in sales of our device enablement product lines and a $177,000, or 9.3%, increase in sales of our device management product lines, offset by a $150,000 decrease in our non-core product lines. As part of an ongoing corporate initiative to optimize our sales distribution channel, we renegotiated our agreement with a direct customer that removed stock rotation and price protection terms, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was recognition of approximately $342,000 of net revenue that would have potentially been deferred as of December 31, 2010. As part of this same initiative, we removed stock rotation and price protection terms from certain low volume direct customers and redirected them to master distributors, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was the recognition of approximately $297,000 of net revenue that would have potentially been deferred as of December 31, 2010.

Gross profit margin was 49.4% for the fiscal quarter ended December 31, 2010, compared to 52.7% for the fiscal quarter ended December 31, 2009. The decrease in gross profit margin was due to a change in product mix during the quarter primarily related to an increase in unit sales as a percentage of total sales of our embedded device enablement products, which have a lower margin than our other product lines. Gross profit margin was also negatively impacted by an increase in the reserve for excess and obsolete inventory related to an end of life product and an increase in warranty reserves related to a specific product. Freight costs also contributed to the decrease in gross profit margin compared to the equivalent period ended December 31, 2009 primarily related to an increase in volume of inventory receipts during the quarter.

Loss from operations was $525,000 for the fiscal quarter ended December 31, 2010, compared to $334,000 for the fiscal quarter ended December 31, 2009. The loss from operations in the current fiscal quarter was negatively impacted by approximately $372,000 in legal and consulting expenses related to the proxy contest initiated by a dissident director and shareholder that was settled in November 2010.

Net loss was $579,000, or $0.06 per basic and diluted share, for the fiscal quarter ended December 31, 2010, compared to $375,000, or $0.04 per basic and diluted share, for the fiscal quarter ended December 31, 2009. The net loss in the current fiscal quarter was negatively impacted by approximately $372,000 in legal and consulting expenses related to the proxy contest that was settled in November 2010.

Cash and cash equivalents were $10.6 million as of December 31, 2010, an increase of $570,000, compared to $10.1 million as of June 30, 2010.

Net accounts receivable were $2.0 million as of December 31, 2010, an increase of $628,000, compared to $1.3 million as of June 30, 2010. Days sales outstanding ("DSO") in receivables were 13 days for the fiscal quarter ended December 31, 2010 compared to 15 days for the fiscal quarter ended June 30, 2010. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped to distributors).

Net inventories were $9.6 million as of December 31, 2010, compared to $6.9 million as of June 30, 2010. Inventory turns were 3.0 turns for the fiscal quarter ended December 31, 2010 compared to 3.5 turns for the fiscal quarter ended June 30, 2010.

Critical Accounting Policies and Estimates

The accounting policies that have the greatest impact on our financial condition and results of operations and that require the most judgment are those relating to revenue recognition, warranty reserves, allowance for doubtful accounts, inventory valuation, valuation of deferred income taxes, and goodwill. These policies are described in further detail in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010. There have been no significant changes in our critical accounting policies and estimates during the fiscal quarter ended December 31, 2010 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

Recent Accounting Pronouncements

In September 2009, the FASB reached a consensus on Accounting Standards Update ("ASU") 2009-13, Revenue Recognition (Topic 605) – Multiple-Deliverable Revenue Arrangements ("ASU 2009-13") and ASU 2009-14, Software (Topic 985) – Certain Revenue Arrangements That Include Software Elements ("ASU 2009-14"). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (1) vendor-specific objective evidence ("VSOE") or (2) third-party evidence ("TPE") before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We adopted the provisions of this guidance effective July 1, 2010, which did not have a material impact on our financial statements

Consolidated Results of Operations

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	50.6%	47.3%	49.8%	47.5%
Gross profit	49.4%	52.7%	50.2%	52.5%
Operating expenses:				
Selling, general and administrative	40.0%	42.3%	40.7%	42.2%
Research and development	13.3%	13.2%	14.1%	13.4%
Amortization of purchased intangible assets	0.1%	0.2%	0.1%	0.2%
Total operating expenses	53.5%	55.6%	55.0%	55.8%
Loss from operations	(4.1%)	(2.9%)	(4.8%)	(3.3%)
Interest expense, net	(0.3%)	(0.4%)	(0.2%)	(0.4%)
Other income (expense), net	(0.0%)	0.1%	0.1%	(0.1%)
Loss before income taxes	(4.5%)	(3.2%)	(4.9%)	(3.8%)
Provision for income taxes	0.1%	0.1%	0.1%	0.1%
Net loss	(4.6%)	(3.3%)	(5.0%)	(3.9%)

Comparison of the Fiscal Quarters Ended December 31, 2010 and 2009

Net Revenue by Product Line

The following table presents fiscal quarter net revenue by product line:

	Three Months Ended December 31,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Device enablement	$ 10,469	82.3%	$ 9,255	80.6 %	$ 1,214	13.1%
Device management	2,076	16.3%	1,899	16.5 %	177	9.3%
Device networking	12,545	98.6%	11,154	97.2 %	1,391	12.5%
Non-core	174	1.4%	324	2.8 %	(150)	(46.3%)
Net revenue	$ 12,719	100.0%	$ 11,478	100.0 %	$ 1,241	10.8%

The increase in net revenue for the three months ended December 31, 2010, compared to the three months ended December 31, 2009 was the result of an increase in net revenue from our device enablement and device management product lines, partially offset by a decrease in net revenue from our non-core product lines. The increase in net revenue from our device enablement product line was due to an increase in unit sales of some of our embedded device enablement products, in particular our XPort, XPort Pro and ASIC product families, partially offset by a decrease in unit sales of some of our external device enablement products, in particular our WiBox and UDS product families, offset by an increase in our EDS product family. The increase in net revenue from our device management product line was due to an increase in unit sales of our Spider and SCS product families, partially offset by a decrease in unit sales of our SLC product family. As part of an ongoing corporate initiative to optimize our sales distribution channel, we renegotiated our agreement with a direct customer that removed stock rotation and price protection terms, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was recognition of approximately $342,000 of net revenue that would have potentially been deferred as of December 31, 2010. As part of this same initiative, we removed stock rotation and price protection terms from certain low volume direct customers and redirected them to master distributors, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was the recognition of approximately $297,000 of net revenue that would have potentially been deferred as of December 31, 2010.

The following table presents fiscal year-to-date net revenue by product line:

	Six Months Ended December 31,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Device enablement	$ 20,352	81.7%	$ 17,995	80.2 %	$ 2,357	13.1%
Device management	4,234	17.0%	3,902	17.4 %	332	8.5%
Device networking	24,586	98.7%	21,897	97.6 %	2,689	12.3%
Non-core	325	1.3%	535	2.4 %	(210)	(39.3%)
Net revenue	$ 24,911	100.0%	$ 22,432	100.0 %	$ 2,479	11.1%

The increase in net revenue for the six months ended December 31, 2010, compared to the six months ended December 31, 2009 was the result of an increase in net revenue from our device enablement and device management product lines, partially offset by a decrease in net revenue from our non-core product lines. The increase in net revenue from our device enablement product line was due to an increase in unit sales of some of our embedded device enablement products, in particular our XPort, XPort Pro, MatchPort AR and ASIC product families, partially offset by a decrease in unit sales of some of our external device enablement products, in particular our WiBox, UBox and MSS product families, offset by an increase in our EDS product family. The increase in net revenue from our device management product line was due to an increase in unit sales of our Spider and SCS product families, partially offset by a decrease in sales of our SLC product family. As part of an ongoing corporate initiative to optimize our sales distribution channel, we renegotiated our agreement with a direct customer that removed stock rotation and price protection terms, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was recognition of approximately $342,000 of net revenue that would have potentially been deferred as of December 31, 2010. As part of this same initiative, we removed stock rotation and price protection terms from certain low volume direct customers and redirected them to master distributors, which allows us to recognize revenue uopon shipment as opposed to a sell-through basis. The result was the recognition of approximately $297,000 of net revenue that would have potentially been deferred as of December 31, 2010.

Net Revenue by Geographic Region

The following table presents fiscal quarter net revenue by geographic region:

	Three Months Ended December 31,					
		% of Net		% of Net	Change	
	2010	Revenue	2009	Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 6,106	48.0 %	$ 6,135	53.5 %	$ (29)	(0.5%)
EMEA	4,613	36.3 %	3,548	30.9 %	1,065	30.0%
Asia Pacific	2,000	15.7 %	1,795	15.6 %	205	11.4%
Net revenue	$ 12,719	100.0 %	$ 11,478	100.0 %	$ 1,241	10.8%

The increase in net revenue for the three months ended December 31, 2010 compared to the three months ended December 31, 2009 reflects increased unit sales from the Europe, Middle East and Africa (the "EMEA") and Asia Pacific regions. The increase in net revenue from the EMEA region was mainly due to an increase in unit sales in our device enablement product lines, in particular our XPort, XPort Pro, ASIC and EDS product families. The increase in net revenue in the Asia Pacific region was due to an increase in unit sales of our device management product lines, in particular our Spider product family, as well as our device enablement product lines, in particular our WiPort and MatchPort AR product families, partially offset by a decrease in sales of our UDS product family

The following table presents fiscal year-to-date net revenue by geographic region:

	Six Months Ended December 31,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 12,677	50.9 %	$ 12,386	55.2 %	$ 291	2.3%
EMEA	8,144	32.7 %	6,457	28.8 %	1,687	26.1%
Asia Pacific	4,090	16.4 %	3,589	16.0 %	501	14.0%
Net revenue	$ 24,911	100.0 %	$ 22,432	100.0 %	$ 2,479	11.1%

The increase in net revenue for the six months ended December 31, 2010 compared to the six months ended December 31, 2009 reflects increased unit sales across all geographic regions. The increase in net revenue from the Americas region was due to an increase in unit sales of our device enablement product lines, in particular our XPort, XPort Pro, WiPort and EDS product families, partially offset by a decrease in our MSS and WiBox product families and an increase in unit sales of our device management product lines, in particular our Spider and SCS product families, partially offset by a decrease in our SLC product family. The increase in net revenue from the EMEA region was due to an increase in unit sales in our device enablement product lines, in particular our XPort, XPort Pro, ASIC, Xpress and EDS product families, partially offset by a decrease in our WiPort product family. The increase in net revenue in the Asia Pacific region was due to an increase in unit sales of our device management product lines, in particular our Spider product family and our device enablement product lines, in particular our Micro, MatchPort AR and WiPort product families.

Gross Profit

Gross profit represents net revenue less cost of revenue. Cost of revenue consists primarily of the cost of raw material components, subcontract labor assembly from contract manufacturers, freight, amortization of purchased intangible assets, establishing or relieving inventory reserves for excess and obsolete products or raw materials, warranty costs, royalties and manufacturing overhead, which includes personnel related expenses, such as payroll, facilities expenses and share-based compensation.

The following table presents fiscal quarter gross profit:

	Three Months Ended December 31,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 6,278	49.4%	$ 6,049	52.7%	$ 229	3.8%

The decrease in gross profit as a percent of net revenue (referred to as “gross profit margin”) for the three months ended December 31, 2010 was due to a change in product mix during the quarter primarily related to an increase in unit sales as a percentage of total sales of our embedded device enablement products, which have a lower margin than our other product lines. Gross profit margin was also negatively impacted by an increase in the reserve for excess and obsolete inventory related to the end of life of a product and an increase in warranty reserves related to a specific product. Freight costs also contributed to the decrease in gross profit margin compared to the equivalent period ended December 31, 2009 primarily related to an increase in volume of inventory receipts during the quarter.

The following table presents fiscal year-to-date gross profit:

	Six Months Ended December 31,					
		% of Net		% of Net	Change	
	2010	Revenue	2009	Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 12,505	50.2%	$ 11,766	52.5%	$ 739	6.3%

The decrease in gross profit margin for the six months ending December 31, 2010 was partly due to a change in product mix primarily related to an increase in unit sales as a percentage of total sales of our embedded device enablement products, which have a lower margin than our other product lines. Gross profit margin was also negatively impacted by an increase in freight costs due to expediting charges relating to component and product shortages, transitional costs associated with the implementation of third-party logistics providers in Los Angeles and Hong Kong for inventory management and the increase in the volume of inventory receipts.

Selling, General and Administrative

Selling, general and administrative expenses consist of personnel-related expenses, including salaries and commissions, share-based compensation, facility expenses, and information technology, as well as trade show expenses, advertising, and legal and accounting fees.

The following table presents fiscal quarter selling, general and administrative expenses:

	Three Months Ended December 31,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 2,612		$ 2,540		$ 72	2.8%
Professional fees and outside services	885		491		394	80.2%
Advertising and marketing	333		596		(263)	(44.1%)
Facilities	283		306		(23)	(7.5%)
Share-based compensation	382		428		(46)	(10.7%)
Depreciation	166		147		19	12.9%
Bad debt expense	-		17		(17)	(100.0%)
Other	427		330		97	29.4%
Selling, general and administrative	$ 5,088	40.0%	$ 4,855	42.3%	$ 233	4.8%

In order of significance, the increase in selling, general and administrative expenses for the three months ended December 31, 2010, compared to the three months ended December 31, 2009 was primarily due to: (i) an increase in professional fees and outside services mainly due to $372,000 of legal and consulting expenses as a result of the proxy contest which was settled in November 2010 and (ii) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago; partially offset by (iii) a decrease in advertising and marketing expense due to cost saving efforts. As noted above, higher payroll costs reflect a return to normal levels following the suspension of the Company-wide furlough program.

The following table presents fiscal year-to-date selling, general and administrative expenses:

	Six Months Ended December 31,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 5,172		$ 4,938		$ 234	4.7%
Professional fees & outside services	1,690		1,107		583	52.7%
Advertising and marketing	783		1,054		(271)	(25.7%)
Facilities	571		634		(63)	(9.9%)
Share-based compensation	790		851		(61)	(7.2%)
Depreciation	331		280		51	18.2%
Bad debt expense (recovery)	1		12		(11)	(91.7%)
Other	803		599		204	34.1%

Selling, general and administrative	$	10,141	40.7%	$ 9,475	42.2%	$ 666	7.0%

In order of significance, the increase in selling, general and administrative expenses for the six months ended December 31, 2010, compared to the six months ended December 31, 2009 was primarily due to: (i) an increase in professional fees and outside services mainly due to $561,000 of legal and consulting expenses as a result of the proxy contest which was settled in November of 2010 and (ii) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago, partially offset by (iii) a decrease advertising and marketing expense due to cost saving efforts. As noted above, higher payroll costs reflect a return to normal levels following the suspension of the Company-wide furlough program.

Research and Development

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

The following table presents fiscal quarter research and development expenses:

	Three Months Ended December 31,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 1,062		$ 946		$ 116	12.3%
Facilities	266		278		(12)	(4.3%)
Professional fees and outside services	169		95		74	77.9%
Share-based compensation	86		146		(60)	(41.1%)
Depreciation	11		16		(5)	(31.3%)
Other	103		29		74	255.2%
Research and development	$ 1,697	13.3%	$ 1,510	13.2%	$ 187	12.4%

In order of significance, the increase in research and development expenses for the three months ended December 31, 2010, compared to the three months ended December 31, 2009 was primarily due to: (i) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago and (ii) an increase in professional fees and outside services related to development projects for upcoming product releases. As noted above, higher payroll costs reflect a return to normal levels following the suspension of the Company-wide furlough program. Research and development expenses could increase as we continue to invest in new development efforts.

The following table presents fiscal year-to-date research and development expenses:

	Six Months Ended December 31,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 2,187		$ 1,919		$ 268	14.0%
Facilities	532		522		10	1.9%
Professional fees & outside services	360		143		217	151.7%
Share-based compensation	236		273		(37)	(13.6%)
Depreciation	23		32		(9)	(28.1%)
Other	182		106		76	71.7%
Research and development	$ 3,520	14.1%	$ 2,995	13.4%	$ 525	17.5%

In order of significance, the increase in research and development expenses for the six months ended December 31, 2010, compared to the six months ended December 31, 2009 was primarily due to: (i) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago and (ii) an increase in professional fees and outside services related to development projects for upcoming product releases. As noted above, higher payroll costs reflect a return to normal levels following the suspension of the Company-wide furlough program. Research and development expenses could increase as we continue to invest in new development efforts.

Provision for Income Taxes

At July 1, 2010, our fiscal 2003 through fiscal 2009 tax years remained open to examination by the Federal, state, and foreign taxing authorities. We have annual net operating losses ("NOLs") beginning in fiscal 2001, which causes the statute of limitations to remain open for the year in which the NOL was incurred.

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

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Effective tax rate	2%	3%	3%	2%

We utilize the liability method of accounting for income taxes. The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from our domestic losses being recorded with a fully reserved tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. As a result of our cumulative losses, we provided a full valuation allowance against our domestic net deferred tax assets for the fiscal quarters ended December 31, 2010 and 2009.

Liquidity and Capital Resources

The following table presents information about our working capital and cash:

	December 31, 2010	June 30, 2010	Increase (Decrease)
	(In thousands)		
Working capital	$ 8,554	$ 7,623	$ 931
Cash and cash equivalents	$ 10,645	$ 10,075	$ 570

In order of significance, our working capital as of December 31, 2010 increased as compared to June 30, 2010, primarily due to: (i) an increase in inventory due to the timing of shipments and inventory receipts, (ii) an increase in accounts receivable as a result of the timing of shipments, cash collections and an increase in revenue, and (iii) and increase in cash due to the proceeds from the amended term loan. This was partially offset by an increase in accounts payable related to the increase in inventory.

We believe that our existing cash and cash equivalents and funds available from our line of credit will be adequate to meet our anticipated cash needs through at least the next 12 months. Our future capital requirements will depend on many factors, including the timing and amount of our net revenue, research and development, expenses associated with any strategic partnerships or acquisitions and infrastructure investments, and expenses related to litigation, which could affect our ability to generate additional cash. If cash generated from operations and financing activities is insufficient to satisfy our working capital requirements, we may need to raise capital by borrowing additional funds through bank loans, the selling of securities or other means. There can be no assurance that we will be able to raise any such capital on terms acceptable to us, if at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to operate our business.

In September 2010, we entered into an Amendment to the Loan and Security Agreement (the “Loan Agreement”), which provides for a two-year $4.0 million maximum revolving line (the “Revolving Line”) with a three-year $2.0 million term loan (the “Term Loan”). Per the Loan Agreement, the proceeds from the Term Loan were used to pay the balance of $611,000 outstanding on the term loan that was made under the original agreement in 2008. The Term Loan was funded on September 28, 2010 and is payable in 36 equal monthly installments of principal and accrued interest. There are no borrowings outstanding on the Revolving Line as of the fiscal quarter end.

Borrowings under the Loan Agreement bear interest at the greater of 4.75% or prime rate plus 0.75% per annum. Upon entering into the Loan Agreement, we paid a fully earned, non-refundable commitment fee of $20,000 and will pay an additional $15,000 on September 28, 2011, the first anniversary of the effective date of the Loan Agreement.

The Borrowing Base (as defined in the Loan Agreement) under the Revolving Line is based upon eligible accounts receivable as defined per the Loan Agreement. The "Amount Available under the Revolving Line" is defined as at any time (a) the lesser of (i) the Revolving Line maximum or (ii) the Borrowing Base, minus (b) the amount of all outstanding letters of credit (including drawn but unreimbursed letters of credit), minus (c) an amount equal to the letter of credit reserves, minus (d) the foreign currency reserve, minus (e) the outstanding principal balance of any advances, and minus (f) one-half of the principal balance then outstanding of the Term Loan

The following table presents the balance outstanding on the Term Loan, our available borrowing capacity and outstanding letters of credit, which were used to secure equipment leases, deposits for a building lease, and security deposits:

	December 31, 2010	June 30, 2010
	(In thousands)	
Term Loan	$ 1,834	$ 778
Amount Available under the Revolving Line	1,538	1,031
Outstanding letters of credit	343	343

As of December 31, 2010 and June 30, 2010, approximately $366,000 and $400,000, respectively, of our cash was held by our foreign subsidiaries in foreign bank accounts. Such cash may be unrestricted with regard to foreign liquidity needs; however, our ability to utilize a portion of this cash to satisfy liquidity needs outside of such foreign locations may be subject to approval by the foreign subsidiaries' board of directors.

Cash Flows for the Three and Six Months Ended December 31

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

	Three Months Ended December 31, 2010	2009	Six Months Ended December 31, 2010	2009
	(In thousands)			
Net cash provided by (used in):				
Net loss	$ (579)	$ (375)	$ (1,257)	$ (874)
Non-cash operating expenses, net	907	757	1,775	1,502
Changes in operating assets and liabilities:				
Accounts receivable	(205)	(114)	(629)	77
Contract manufacturers' receivable	(345)	(343)	(473)	(371)
Inventories	(2,225)	(414)	(2,865)	(8)
Prepaid expenses and other current assets	(38)	(363)	87	(352)
Other assets	6	9	(31)	(5)
Accounts payable	2,743	1,756	3,210	1,928
Accrued payroll and related expenses	(354)	(165)	(286)	(478)
Warranty reserve	57	-	26	-
Restructuring reserve	-	(31)	-	(76)
Other liabilities	682	211	440	59
Cash received related to tenant incentives	-	-	32	-
Net cash provided by operating activities	649	928	29	1,402
Net cash used in investing activities	(137)	(420)	(220)	(625)
Net cash (used in) provided by financing activities	(323)	(244)	714	(584)
	(2)	(5)	47	49

Effect of foreign exchange rate changes on cash				
Increase in cash and cash equivalents	$ 187	$ 259	$ 570	$ 242

Cash Flows for the Three Months Ended December 31

Operating activities provided $649,000 in cash during the three months ended December 31, 2010. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses offset by a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided operating activities included (i) an increase in accounts payable due to the timing of payments and the increase in inventory and (ii) an increase in other liabilities related to the increase in customer pre-payments, offset by (iii) an increase in inventories mainly due to sourcing components directly to ensure supply, (iv) an increase in accounts and contract manufacturers' receivables due to the timing of collections and the increase in sales and (v) a decrease in accrued payroll and related expenses as a result of the timing of the payroll cycle.

Operating activities provided $928,000 in cash during the three months ended December 31, 2009. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses offset by a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided by operating activities included (i) an increase in accounts payable due to the timing of payments; offset by (ii) an increase in inventory due to the timing of receipts (iii) an increase in prepaid expenses and other current assets due to a large receivable from the Company's landlord for reimbursements related to improvements on the new corporate headquarters and (iv) an increase in contract manufacturers' receivables due to the timing of collections and shipments.

Investing activities used cash during the three months ended December 31, 2010 and 2009, due to the purchase of property and equipment.

Financing activities used cash during the three months ended December 31, 2010 and 2009, due to payments on capital lease obligations and the Term Loan.

Cash Flows for the Six Months Ended December 31

Operating activities provided $29,000 in cash during the six months ended December 31, 2010. This was the result of cash provided by non-cash operating expenses offset by a net loss and cash used by operating assets and liabilities. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided operating activities included (i) an increase in accounts payable due to the timing of payments and (ii) an increase in other liabilities related to timing of payments on legal and consulting fees as a result of the proxy contest, offset by (iii) an increase in inventories mainly due to sourcing components directly to ensure supply and (iv) an increase in accounts and contract manufacturers' receivables due to the timing of collections and the increase in sales.

Operating activities provided $1.4 million in cash during the six months ended December 31, 2009. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses, partially offset by a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided by operating activities included (i) an increase in accounts payable due to the timing of payments; offset by (ii) a decrease in accrued payroll and related expenses due to the timing of payroll periods (iii) an increase in contract manufacturers' receivables due to the timing of collections and shipments and (iv) an increase in prepaid expenses and other current assets due to a large receivable from the Company's landlord for reimbursements related to improvements on the new corporate headquarters.

Investing activities used cash during the six months ended December 31, 2010 and 2009, due to the purchase of property and equipment.

Financing activities provided cash during the six months ended December 31, 2010 due to (i) proceeds from the amended term loan and (ii) proceeds from the sale of common shares through employee stock option exercises, partially offset by (iii) payments related to the Term Loan, (iv) minimum tax withholding paid on behalf of employees related to the vesting of restricted shares and (v) payments on capital lease obligations.

Financing activities used cash during the six months ended December 31, 2009 due to (i) payments for the minimum tax withholdings on behalf of employees for vested restricted shares and (ii) payments on capital lease obligations and the Term Loan; offset by (iii) proceeds from the sale of common shares through employee stock option exercises.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

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

(b) Changes in internal controls over financial reporting

There have been no changes in our internal controls over financial reporting identified during the fiscal quarter that ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

We operate in a rapidly changing environment that involves numerous risks and uncertainties. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q and in the risks described in our Annual Report on Form 10-K. If any of these 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.

We have a history of losses.

We incurred a net loss of approximately $1.2 million for the six months ended December 31, 2010. There can be no assurance that we will net profits in future periods. In addition, while we were cash flow positive in the recently completed quarter, there can be no assurance that we will be cash flow positive in future periods. In the event we fail to achieve profitability in future periods, the value of our common stock my decline. In addition, if we were unable to maintain positive cash flows, we would be required to seek additional funding, which may not be available on favorable terms, if at all.

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

We have experienced, and expect to continue to experience, significant fluctuations in net revenues, expenses and operating results from quarter to quarter. We therefore believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance, and you should not rely on them to predict our future performance or the future performance of our stock. A high percentage of our operating expenses are relatively fixed and are based on our forecast of future net revenue. If we were to experience an unexpected reduction in net revenue in a quarter, we would likely be unable to adjust our short-term expenditures significantly. If this were to occur, our operating results for that fiscal quarter would be harmed. In addition, if our operating results in future fiscal quarters were to 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 business and economic conditions, including the recent global economic recession;

changes in the mix of net revenue attributable to higher-margin and lower-margin products;

customers' decisions to defer or accelerate orders;

variations in the size or timing of orders for our products;

changes in demand for our products;

fluctuations in exchange rates;

defects and other product quality problems;

loss or gain of significant customers;

short-term fluctuations in the cost or availability of our critical components;

announcements or introductions of new products by our competitors;

effects of terrorist attacks in the U.S. and abroad;

natural disasters in the U.S. and abroad;

changes in demand for devices that incorporate our products; and

our customers' decisions to integrate network access and control directly onto their own platforms.

Delays in deliveries or quality problems with our component suppliers could damage our reputation and could cause our net revenue 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 some components and 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 by the manufacturer. 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. Due to the downturn in the economy, we have been experiencing higher component shortages and extended lead-times. 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 most of our vendors to obtain necessary components or technology for our products. If we are unable to purchase components from these suppliers, product shipments could be prevented or delayed, which could result in a loss of sales. If we are unable to meet existing orders or to enter into new orders because of a shortage in components, we will likely lose net revenues and risk losing customers and harming our reputation in the marketplace, which could adversely affect our business, financial condition or results of operations.

If we are unable to raise additional capital, our business could be adversely affected.

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

If a major distributor or 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 that they buy our products from us, they are also part of our product distribution system. One or more of our distributors could be acquired by a competitor and stop buying product from us. The following table presents sales to our significant customers as a percentage of net revenue:

	Six Months Ended December 31,	
	2010	2009
Top five customers (1)(2)	39.3%	37.6%

Ingram Micro	13.1%	7.9%
Tech Data	7.7%	10.8%

(1) Includes Ingram Micro and Tech Data
(2) All top five customers are distributors

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

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

We may experience difficulties in transitioning to third-party logistics providers.

We recently transitioned a majority of our physical inventory management process, as well as the shipping and receiving of our inventory, to third-party logistics providers in Los Angeles and Hong Kong. There is a possibility that these third-party logistics providers will not perform as expected and we could experience delays in our ability to ship, receive, and process the related data in a timely manner. This could adversely affect our financial position, results of operations, cash flows and the market price of our common stock.

Relying on third-party logistics providers could increase the risk of the following: failing to receive accurate and timely inventory data, theft or poor physical security of our inventory, inventory damage, ineffective internal controls over inventory processes or other similar business risks out of our immediate control.

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 revenue and results of operations.

We do not have long-term agreements with our contract manufacturers or suppliers. If any of these subcontractors or suppliers were to cease doing business with us, we might 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 from our contract manufacturers or suppliers could damage our customer relationships and materially and adversely affect our business, financial condition or results of operations.

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 evolving government and industry standards. The demand for network-enabled products is relatively new and can change as a result of innovations, new technologies or new government and industry standards. For example, a directive in the European Union banned 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 demanded 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 revenue might not grow at the rate we anticipate, and it could decline.

Environmental regulations such as the Waste Electrical and Electronic Equipment (“WEEE”) directive may require us to redesign our products and to develop compliance administration systems.

Various countries have begun to require companies selling a broad range of electrical equipment to conform to regulations such as the WEEE directive and we expect additional countries and locations to adopt similar regulations in the future. New environmental standards such as these could require us to redesign our products in order to comply with the standards, and require the development of compliance administration systems. We have already invested significant resources into developing compliance tracking systems, and further investments may be required. Additionally, we may incur significant costs to redesign our products and to develop compliance administration systems, which in turn could have an adverse effect on our gross profit margin. If we cannot develop compliant products in a timely manner or properly administer our compliance programs, our net revenue may also decline due to lower sales, which would adversely affect our operating results.

If our research and development efforts are not successful, our net revenue 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 the research and development of those products. On the other hand, if we do not invest sufficiently in research and development, we may be unable to maintain our competitive position. The continuing effects of the economic recession could require cost-containment measures, which could force us to reduce our investment in research and development and put us at a competitive disadvantage compared to our competitors.

We expect the average selling prices of our products to decline and raw material costs to increase, which could reduce our net revenue and gross margins and adversely affect results of operations.

In the past, we have experienced some reduction in the average selling prices and gross margins of products, and we expect that this will continue for our products as they mature. We expect competition to continue to increase, and we anticipate this could result in additional downward pressure on our pricing. Our average selling prices for our products might also 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 or in response to price increases by our suppliers, resulting in lower gross margins. Further, as is characteristic of our industry, the average selling prices of our products have historically decreased over the products’ life cycles and we expect this pattern to continue. If any of these were to occur, our gross margins could decline and we might 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 subject to a wide range of claims and lawsuits in the course of our business. Any lawsuit may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources. The results of litigation are inherently uncertain, and adverse outcomes are possible.

In addition, the contested proxy could involve expensive litigation.

Our products may contain undetected software or hardware errors or defects that could lead to an increase in our costs, reduce our net revenue 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 might have to refund the purchase price for the units. 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 revenue and claims against us. Significant product warranty claims against us could harm our business, reputation and financial results and cause the price of our stock to decline.

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

Certain of our products contain components developed and maintained by third-party software vendors or are available through the "open source" software community. We also expect that we may incorporate software from third-party vendors and open source software in our future products. Our business would be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our products to function with alternate third-party software or open source software, or develop these components ourselves, which would result in increased costs and could result in delays in our product shipments. Furthermore, we might be forced to limit the features available in our current or future product offerings.

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 in Asia: Venture Electronics Services, Uni Precision Industrial Ltd., Universal Scientific Industrial Company, LTD and Hana Microelectronics, Inc. In addition, two independent third party foundries located in Asia manufacture substantially all of our large scale integration chips. Our reliance on these third-party manufacturers exposes us to a number of significant risks, including:

reduced control over delivery schedules, quality assurance, manufacturing yields and production costs;

lack of guaranteed production capacity or product supply; and

reliance on these manufacturers to maintain competitive manufacturing technologies.

Our agreements with these manufacturers provide for services on a purchase order basis. If our manufacturers were to become unable or unwilling to continue to manufacture our products at requested quality, quantity, yields and costs, or in a timely manner, our business would be seriously harmed. As a result, we would have to attempt to identify and qualify substitute manufacturers, which could be time consuming and difficult, and might result in unforeseen manufacturing and operations problems.

Due to the downturn in the economy, which has put some suppliers out of business, we have been experiencing higher component shortages. 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 revenue 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 revenue or we may be unable to fulfill customer orders, thus reducing net revenue and therefore earnings.

Our international activities are subject to uncertainties, which include international economic, regulatory, political and other risks that could harm our business, financial condition or results of operations.

The following table presents sales by geographic region as a percentage of net revenue:

	Three Months Ended December 31,					
		% of Net		% of Net	Change	
	2010	Revenue	2009	Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 6,106	48.0 %	$ 6,135	53.5 %	$ (29)	(0.5%)
EMEA	4,613	36.3 %	3,548	30.9 %	1,065	30.0%
Asia Pacific	2,000	15.7 %	1,795	15.6 %	205	11.4%
Net revenue	$ 12,719	100.0 %	$ 11,478	100.0 %	$ 1,241	10.8%

We expect that international revenue will continue to represent a significant portion of our net revenue in the foreseeable future. Doing business internationally involves greater expense than domestic business and many risks. For example, because the products we sell abroad and the products and services we buy abroad may be priced in foreign currencies, we could be affected by fluctuating exchange rates. In the past, we have lost money because of these fluctuations. We might not successfully protect ourselves against currency rate fluctuations, and our financial performance could be harmed as a result. In addition, we use contract manufacturers based in Asia to manufacture substantially all of our products. International revenue and operations are subject to numerous risks, 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;
- fluctuations in currency exchange rates;
- changes in a country’s or region’s political or economic conditions;
- effects of terrorist attacks 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 operating results.

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

We hold a 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.

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 details of our inventories:

	December 31, 2010	June 30, 2010
	(In thousands)	
Finished goods	$ 6,947	$ 4,258
Raw materials	1,703	1,390
Inventory at distributors *	1,621	1,924
Large scale integration chips **	672	516
Inventories, gross	10,943	8,088
Reserve for excess and obsolete inventory	(1,357)	(1,215)
Inventories, net	$ 9,586	$ 6,873

* Balance represents finished goods held by distributors.
** This item is sold individually and is also embedded into the Company's products.

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

We are subject to export control regulations that could restrict our ability to increase our international revenue and may adversely affect our business.

Our products and technologies are subject to U.S. export control laws, including the Export Administration Regulations, administered by the Department of Commerce and the Bureau of Industry Security, and their foreign counterpart laws and regulations, which may require that we obtain an export license before we can export certain products or technology to specified countries. These export control laws, and possible changes to current laws, regulations and policies, could restrict our ability to sell products to customers in certain countries or give rise to delays or expenses in obtaining appropriate export licenses. Failure to comply with these laws and regulations could result in government sanctions, including substantial monetary penalties, denial of export privileges, and debarment from government contracts. Any of these could adversely affect our operations and, as a result, our financial results could suffer.

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 of key engineers, marketing and sales employees. We are particularly dependent upon our technical personnel, due to the specialized technical nature of our business. If we were to lose the services of our executive officers or any of our key 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 revenue 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 revenue could decline and our business could be harmed.

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

Substantial litigation regarding intellectual property rights occurs frequently in our industry. For example, in May 2006, we settled a patent infringement lawsuit with Digi in which we signed an agreement with Digi to cross-license each other's patents for six years. There is a risk that we will not be able to negotiate a new cross-license agreement when the current cross-license agreement expires in May 2012. 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.

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.

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

We have not historically relied on patents to protect our proprietary rights, although we are now in the process of building a patent portfolio. In May 2006, we entered into a six-year 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 practical 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. Consequently, we may be unable to prevent our proprietary technology from being exploited by others in the U.S. or abroad, which could require costly efforts to protect our technology. Policing the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impracticable. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which may harm our business, financial condition and results of operations.

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

We may pursue acquisitions, strategic partnerships and joint ventures that we believe would allow us to complement our growth strategy, increase market share in our current markets and expand into adjacent markets, broaden our technology and intellectual property and strengthen our relationships with distributors and OEMs. Any future acquisition, partnership, joint venture or investment may require that we pay significant cash, issue stock or incur substantial debt. Acquisitions, partnerships or joint ventures may also result in the loss of key personnel and the dilution of existing stockholders as a result of issuing equity securities. In addition, acquisitions, partnerships or joint ventures require significant managerial attention, which may be diverted from our other operations. These capital, equity and managerial commitments may impair the operation of our business. Furthermore, acquired businesses may not be effectively integrated, may be unable to maintain key pre-acquisition business relationships, may contribute to increased fixed costs and may expose us to unanticipated liabilities and otherwise harm our operating results.

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. If a business interruption occurs, our business could be materially and adversely affected.

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

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to evaluate periodically the effectiveness of their internal controls over financial reporting, and to include a management report assessing the effectiveness of their internal controls as of the end of each fiscal year. We are 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.

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

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

Item 6. Exhibits

Exhibit Number	Description of Document
10.1	2010 Stock Incentive Plan
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

* Furnished, not filed.

SIGNATURES

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

Date: February 7, 2011	LANTRONIX, INC. (Registrant)
	By: /s/ Jerry D. Chase Jerry D. Chase President and Chief Executive Officer (Principal Executive Officer)
	By: /s/ Reagan Y. Sakai Reagan Y. Sakai Chief Financial Officer and Secretary (Principal Financial Officer)

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Exhibit Index

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