

LANTRONIX INC  
Form 10-Q  
November 14, 2006

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

**FORM 10-Q**

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

**For the quarterly period ended September 30, 2006**

**OR**

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

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

**Commission file number: 1-16027**

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

**Delaware**  
**(State or other jurisdiction**  
**of incorporation or organization)**

**33-0362767**  
**(I.R.S. Employer**  
**Identification No.)**

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

**92618**  
**(Zip Code)**

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**(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

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Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

Large accelerated filer o

Accelerated filer o

Non-accelerated filer x.

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

As of November 10, 2006, 59,596,957 shares of the Registrant’s common stock were outstanding.

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**LANTRONIX, INC.**

**FORM 10-Q  
FOR THE FISCAL QUARTER ENDED  
September 30, 2006**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****LANTRONIX, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006</b>		<b>June 30, 2006</b>
	<b>(In thousands)</b>		
<b><u>ASSETS</u></b>			
Current Assets:			
Cash and cash equivalents	\$ 7,687	\$	7,729
Marketable securities	94		88
Accounts receivable, net	2,734		3,087
Inventories, net	9,234		8,113
Contract manufacturers' receivable	681		1,049
Settlements recovery	14,096		15,325
Prepaid expenses and other current assets	553		577
Total current assets	35,079		35,968
Property and equipment, net	1,651		1,589
Goodwill	9,488		9,488
Purchased intangible assets, net	590		610
Officer loans	124		122
Other assets	38		38
Total assets	\$ 46,970	\$	47,815
<b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>			
Current Liabilities:			
Accounts payable	\$ 9,821	\$	7,865
Accrued payroll and related expenses	1,386		1,596
Warranty reserve	495		693
Accrued settlements	15,153		16,767
Other current liabilities	3,055		3,675
Total current liabilities	29,910		30,596
Long-term liabilities	269		230
Long-term capital lease obligations	174		211
Commitments and contingencies			
Stockholders' equity:			
Common stock	6		6
Additional paid-in capital	183,355		182,857
Accumulated deficit	(167,101)		(166,450)
Accumulated other comprehensive income	357		365
Total stockholders' equity	16,617		16,778
Total liabilities and stockholders' equity	\$ 46,970	\$	47,815

See accompanying notes.

## LANTRONIX, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share data)</b>	
Net revenues (1)	\$ 12,514	\$ 12,240
Cost of revenues (2)	5,907	6,120
Gross profit	6,607	6,120
Operating expenses:		
Selling, general and administrative	5,498	6,072
Research and development	1,718	1,403
Litigation settlement costs	15	-
Amortization of purchased intangible assets	18	2
Restructuring recovery	-	(29)
Total operating expenses	7,249	7,448
Loss from operations	(642)	(1,328)
Interest income, net	6	3
Other expense, net	(3)	(10)
Loss before income taxes	(639)	(1,335)
Provision for income taxes	12	6
Net loss	\$ (651)	\$ (1,341)
Net loss per share (basic and diluted)	\$ (0.01)	\$ (0.02)
Weighted-average shares (basic and diluted)	59,262	58,499
(1) Includes net revenues from related party	\$ 279	\$ 295
(2) Includes amortization of purchased intangible assets	\$ 2	\$ 297

See accompanying notes.

## LANTRONIX, INC.

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
Cash flows from operating activities:		
Net loss	\$ (651)	\$ (1,341)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Share-based compensation	314	239
Depreciation	100	116
Amortization of purchased intangible assets	20	297
Provision for doubtful accounts	18	6
Litigation settlement costs	15	-
Provision for inventories	1	(213)
Restructuring recovery	-	(29)
Gain on disposal of fixed assets	-	4
Foreign currency transaction gain	-	14
Changes in operating assets and liabilities:		
Accounts receivable	334	(155)
Inventories	(1,122)	852
Contract manufacturers' receivable	368	21
Prepaid expenses and other current assets	25	(480)
Other assets	(3)	4
Accounts payable	1,957	650
Accrued payroll and related expenses	(213)	(285)
Accrued settlements	(400)	-
Warranty reserve	(198)	(54)
Other liabilities	(741)	464
Net cash (used in) provided by operating activities	(176)	110
Cash flows from investing activities:		
Purchases of property and equipment, net	(4)	(38)
Net cash used in investing activities	(4)	(38)
Cash flows from financing activities:		
Net proceeds from issuances of common stock	184	150
Payment of capital lease obligations	(33)	(39)
Net cash provided by financing activities	151	111
Effect of foreign exchange rate changes on cash	(13)	(20)
(Decrease) increase in cash and cash equivalents	(42)	163
Cash and cash equivalents at beginning of period	7,729	6,690
Cash and cash equivalents at end of period	\$ 7,687	\$ 6,853

See accompanying notes.



**LANTRONIX, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2006****1. Basis of Presentation**

The condensed consolidated financial statements included herein are unaudited. They contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of Lantronix, Inc. and its subsidiaries (collectively, the "Company") at September 30, 2006, and the consolidated results of its operations and cash flows for the three months ended September 30, 2006 and 2005. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

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

**2. Computation of Net 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:

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share data)</b>	
Numerator:		
Net loss	\$ (651)	\$ (1,341)
Denominator:		
Weighted-average shares outstanding	59,262	58,831
Less: Unvested common shares outstanding	-	(332)
Weighted-average shares (basic and diluted)	59,262	58,499
Net loss per share (basic and diluted)	\$ (0.01)	\$ (0.02)

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.

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Common stock equivalents	2,587,780	1,173,926

**3. Inventories**

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

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	<b>September 30, 2006</b>	<b>June 30, 2006</b>
	<b>(In thousands)</b>	
Raw materials	\$ 4,336	\$ 3,863
Finished goods	6,628	6,518
Inventory at distributors	1,476	1,690
Large scale integration chips *	1,256	731
	13,696	12,802
Reserve for excess and obsolete inventories	(4,462)	(4,689)
	\$ 9,234	\$ 8,113

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

#### 4. Warranty

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

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

	<b>Three Months Ended September 30, 2006</b>	<b>Year Ended June 30, 2006</b>
	<b>(In thousands)</b>	
Beginning balance	\$ 693	\$ 1,248
Recovered to cost of revenues	(94)	(35)
Usage	(104)	(520)
Ending balance	\$ 495	\$ 693

#### 5. Bank Line of Credit and Debt

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

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

The Company is subject to a number of covenants under the Line of Credit, pursuant to which, among other things, the Company has agreed that it will not, without the Bank's prior written consent: (a) sell, lease, transfer or otherwise dispose, any of the Company's business or property, provided, however, that the Company may sell inventory in the ordinary course of business consistent with the provisions of the Line of Credit; (b) change the Company's business

structure, liquidate or dissolve, or permit a change in beneficial ownership of more than 20% of the outstanding shares; (c) acquire, merge or consolidate with or into any other business organization; (d) incur any debts outside the ordinary course of the Company's business, except for permitted indebtedness, or grant any security interests in or permit a lien, claim or encumbrance upon all or any portion of the Company's assets, except in favor of or agreed to by the bank; (f) make any investments other than permitted investments; (g) make or permit any payments on any subordinated debt, except under the terms of existing subordinated debt or on terms acceptable to the bank, or amend any provision in any document related to the subordinated debt that would increase the amount thereof, or (h) become an "investment company" as such term is defined under the Investment Company Act of 1940. The Line of Credit also contains a number of affirmative covenants, including, among other things, covenants regarding the delivery of financial statements and notice requirements, accounts receivable, payment of taxes, access to collateral and books and records, maintenance of properties and insurance policies, and litigation by third parties.

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

As of September 30, 2006, the Company had no borrowings against the Line of Credit.

## 6. Share-Based Compensation

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

	<b>Number of Shares</b>
Balance at June 30, 2006	5,467,753
Options granted	411,000
Options forfeited	(196,958)
Options expired	(498)
Options exercised	(2,200)
Balance at September 30, 2006	5,679,097

The following table presents stock option grant date information:

		<b>Three Months Ended September 30,</b>	
		<b>2006</b>	<b>2005</b>
Weighted-average grant date fair value	\$	1.24	\$ 1.09
Weighted-average grant date exercise price	\$	1.60	\$ 1.37

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

		<b>Three Months Ended September 30,</b>	
		<b>2006</b>	<b>2005</b>
		<b>(In thousands)</b>	
Cost of revenues	\$	12	\$ 20
Selling, general and administrative		209	167
Research and development		93	52
	\$	314	\$ 239

## 7. Income Taxes

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

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Effective tax rate	2%	0%

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

**8. Comprehensive Loss**

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The components of comprehensive loss are as follows:

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
Net loss	\$ (651)	\$ (1,341)
Other comprehensive income (loss):		
Change in net unrealized gain on investment, net of taxes of \$0	6	7
Change in translation adjustments, net of taxes of \$0	(14)	(5)
Total comprehensive loss	\$ (659)	\$ (1,339)

## 9. Litigation Settlements

### Securities Litigation Settlements

#### *Securities Class Action Lawsuits (“Class Action”)*

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

On October 18, 2004, the plaintiff filed the third amended complaint, which is now the operative complaint in the action. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933, as amended (the “Securities Act”) and violations of Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The Securities Act claims are brought on behalf of all persons who purchased common stock of Lantronix pursuant or traceable to the Company’s August 4, 2000 initial public offering (“IPO”). The Exchange Act claims are based on alleged misstatements related to the Company’s financial results that were contained in the Registration Statement and Prospectus for the IPO. The claims brought under the Exchange Act are brought on behalf of all persons and entities that purchased or acquired Lantronix securities from November 1, 2000 through May 30, 2002 (the “Class Period”). The complaint alleges that defendants issued false and misleading statements concerning the business and financial condition in order to allegedly inflate the value of the Company’s securities during the Class Period. The complaint alleges that during the Class Period, Lantronix overstated financial results through improper revenue recognition and failure to comply with Generally Accepted Accounting Principles (“GAAP”). Defendants have filed an answer to the complaint and the case is now in discovery. While the complaint does not specify the damages plaintiff may seek on behalf of the purported classes of stockholders, a recovery by the plaintiff and the plaintiff classes could have a material adverse impact on the Company. The proceeds from certain insurance policies have funded and continue to fund much of the Company’s defense to the Class Action lawsuit.

The Company has reached an agreement with plaintiffs to settle the Class Action lawsuit. The Company has also reached agreements with its relevant insurance carriers with respect to the funding of the cash portions of the settlement with plaintiffs. Under the terms of the agreement with the Class Action plaintiffs, the Company will not be required to contribute any cash to the Class Action settlement, as all cash contributed would be from the Company’s insurance carriers. However, as part of the agreement with the plaintiffs in the Class Action lawsuit, the Company has agreed to issue certain Lantronix securities to the plaintiffs. As a result of the anticipated issuance of such securities, and in connection with the issuance of securities for the settlement of the Synergetic action described below, the Company recorded a charge of \$1.2 million in the consolidated statement of operations for the fiscal year ended June

30, 2006. As of September 30, 2006, the Company has recorded an accrued settlement of \$15.2 million of which the Company's insurance carriers have agreed to fund \$14.1 million. After a hearing on August 29, 2006, the Court gave its preliminary approval to the settlement on September 8, 2006. The settlement is subject to final approval of the Court, and a hearing for final Court approval of the settlement is scheduled for November 22, 2006.

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

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



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

### Government Investigation

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

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

### Accrued Settlements and Settlements Recovery

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

	<b>September 30, 2006</b>	<b>June 30, 2006</b>
	<b>(In thousands)</b>	
Accrued settlements:		
Class Action and Synergetic	\$ 15,153	\$ 15,167
Derivative	-	1,200
Patent infringement	-	400
	15,153	16,767
Settlements recovery:		
Class Action and Synergetic	14,096	14,125
Derivative	-	1,200
	14,096	15,325
Direct settlement obligations of the Company	\$ 1,057	\$ 1,442

## 10. Litigation

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. Except as discussed in Note 9, 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.

**11. Subsequent Event**

On October 19, 2006, the Company sold its remaining ownership interest in Xanboo for cash consideration of \$700,000. The Company will record the sale as other income during the fiscal second quarter ending December 31, 2006.

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

### Cautionary Statement

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

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

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

### Overview

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

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

provide a product manufacturer with the ability to network its products within the industrial, service and commercial markets.

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

The following describes our core product lines:

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- *Device Enablement* - We offer an array of embedded and external device enablement solutions that enable integrators and manufacturers of electronic and electro-mechanical products to add network connectivity, manageability and control. Our customers' products originate from a wide variety of applications within the machine-to-machine ("M2M") market, from blood analyzers that relay critical patient information directly to a hospital's information system, to simple devices such as time clocks, allowing the user to obtain information from these products and to improve how they are managed and controlled.
- *Device Management* - We offer off-the-shelf appliances such as console servers, remote KVM servers, and power control products that enable IT professionals to remotely connect, monitor and control network infrastructure equipment and large groups of servers using highly secure out-of-band management technology. We also offer products such as multi-port devices servers that enable devices outside the data center to cost effectively share the network connection and convert various protocols to industry standard interfaces such as Ethernet and the Internet. In addition, we offer off-the-shelf appliances that enable IT professionals to reliably, remotely and simply monitor, configure and manage multiple devices from a single point of control.

The following describes our non-core product line:

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

### **Financial Highlights and Other Information for the Fiscal Quarter Ended September 30, 2006**

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended September 30, 2006:

- Net revenues of \$12.5 million for the fiscal quarter ended September 30, 2006 increased by \$274,000 or 2.2% as compared to \$12.2 million reported during the fiscal quarter ended September 30, 2005. The increase in net revenues is due to an increase of \$597,000 in our core product lines as a result of a \$746,000 increase in our device enablement product line, which was offset by a \$149,000 decrease in our device management product line. Our non-core product line decreased by \$323,000.
- Gross profit as a percentage of net revenues was 52.8% for the fiscal quarter ended September 30, 2006, increasing 2.8 percentage points from the 50.0% reported in the fiscal quarter ended September 30, 2005. As a percentage of net revenues, the increase in gross profit is in part due to a decrease in the amortization of purchased intangible assets as a result of a majority of our purchased intangible assets becoming fully amortized and a reduction in manufacturing overhead costs.
- Loss from operations as a percentage of net revenues was 5.1% for the fiscal quarter ended September 30, 2006 compared to a 10.8% loss from operations in the fiscal quarter ended September 30, 2005.
- Net loss of \$651,000 or \$0.01 per basic and diluted share, in the fiscal quarter ended September 30, 2006, decreased from a net loss of \$1.3 million, or \$0.02 per basic and diluted share, in the fiscal quarter ended September 30, 2005.

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- Cash, cash equivalents and marketable securities remained consistent at \$7.8 million as of September 30, 2006 and June 30, 2006, respectively.
- Accounts receivable, net were \$2.7 million as of September 30, 2006 as compared to \$3.1 million at June 30, 2006. Annualized days sales outstanding (“DSO”) in receivables as of September 30, 2006 increased to 21 days from 16 days as of June 30, 2006. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped to distributors).
- Inventories, net were \$9.2 million as of September 30, 2006 as compared to \$8.1 million as of June 30, 2006. Our annualized inventory turns decreased with 2.7 annualized turns during the fiscal quarter ended September 30, 2006 compared to 3.4 annualized turns during the fiscal quarter ended June 30, 2006.

## Critical Accounting Policies and Estimates

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

## Recent Accounting Pronouncements

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

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

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

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

**Consolidated Results of Operations**

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

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net revenues	100.0%	100.0%
Cost of revenues	47.2%	50.0%
Gross profit	52.8%	50.0%
Operating expenses:		
Selling, general and administrative	43.9%	49.6%
Research and development	13.7%	11.5%
Litigation settlement costs	0.1%	0.0%
Amortization of purchased intangible assets	0.1%	0.0%
Restructuring recovery	0.0%	(0.2%)
Total operating expenses	57.9%	60.8%
Loss from operations	(5.1%)	(10.8%)
Interest income, net	0.0%	0.0%
Other expense, net	(0.0%)	(0.1%)
Loss before income taxes	(5.1%)	(10.9%)
Provision for income taxes	0.1%	0.0%
Net loss	(5.2%)	(11.0%)

**Comparison of the Three Months Ended September 30, 2006 and 2005****Net Revenues by Product Line**

The following table presents net revenues by product line:

	<b>Three Months Ended September 30,</b>				<b>Change</b>	
	<b>2006</b>	<b>% of Net Revenues</b>	<b>2005</b>	<b>% of Net Revenues</b>	\$	%
	(In thousands, except percentages)					
Device enablement	\$ 9,003	71.9%	\$ 8,257	67.5%	\$ 746	9.0%
Device management	1,714	13.7%	1,863	15.2%	(149)	(8.0%)
Core	10,717	85.6%	10,120	82.7%	597	5.9%
Non-core	1,797	14.4%	2,120	17.3%	(323)	(15.2%)
	\$ 12,514	100.0%	\$ 12,240	100.0%	\$ 274	2.2%

The increase in net revenues for the three months ended September 30, 2006 as compared to the same period one year ago was a result of an increase in net revenues from our device enablement products, offset by a decrease in our non-core products, and to a lesser extent, our device management products. The increase in our device enablement product line is primarily due to an increase in volume in our embedded device enablement products, which includes our XPort and WiPort product families, offset by a decline in our external device enablement products. We are no longer investing in the development of our non-core product lines and expect net revenues related to these products to



continue to decline in the future as we focus our investment in our core product lines.

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**Net Revenues by Region**

The following table presents net revenues by geographic region:

	<b>Three Months Ended September 30,</b>					
	<b>2006</b>	<b>% of Net Revenues</b>	<b>2005</b>	<b>% of Net Revenues</b>	<b>Change</b>	
					<b>\$</b>	<b>%</b>
<b>(In thousands, except percentages)</b>						
Americas	\$ 7,656	61.2%	\$ 8,179	66.8%	\$ (523)	(6.4%)
EMEA	2,991	23.9%	2,959	24.2%	32	1.1%
Asia Pacific	1,867	14.9%	1,102	9.0%	765	69.4%
	\$ 12,514	100.0%	\$ 12,240	100.0%	\$ 274	2.2%

The increase for the three months ended September 30, 2006 as compared to the same period one year ago is primarily a result of an increase in net revenues in the Asia Pacific region offset by a decrease in the Americas. In order of significance, the increase in net revenues in the Asia Pacific region is primarily attributable to an increase in sales of our embedded device enablement products. The decrease in net revenues in the Americas region is primarily due to a decrease in sales of our device management products.

**Gross Profit**

The following table presents gross profit:

	<b>Three Months Ended September 30,</b>					
	<b>2006</b>	<b>% of Net Revenues</b>	<b>2005</b>	<b>% of Net Revenues</b>	<b>Change</b>	
					<b>\$</b>	<b>%</b>
<b>(In thousands, except percentages)</b>						
Gross profit	\$ 6,607	52.8%	\$ 6,120	50.0%	\$ 487	8.0%

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

In order of significance, the increase in gross profit as a percentage of net revenues for the three months ended September 30, 2006 as compared to the same period one year ago is in part due to the following factors: (i) a decrease in the amortization of purchased intangible assets as a result of a majority of our purchased intangible assets becoming fully amortized; and (ii) a reduction in manufacturing overhead costs.

**Selling, General and Administrative**

The following table presents selling, general and administrative expenses:

	<b>Three Months Ended September 30,</b>					
	<b>2006</b>	<b>% of Net Revenues</b>	<b>2005</b>	<b>% of Net Revenues</b>	<b>Change</b>	
					<b>\$</b>	<b>%</b>
<b>(In thousands, except percentages)</b>						
Selling, general and administrative	\$ 5,498	43.9%	\$ 6,072	49.6%	\$ (574)	(9.5%)

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

and accounting fees offset by reimbursement of legal fees from insurance proceeds.

In order of significance, the decrease in selling, general and administrative expense for the three months ended September 30, 2006 as compared to the same period one year ago is in part due to the following factors: (i) a decrease in legal and professional fees primarily as a result of the settlement of our outstanding litigation and (ii) a decrease in direct advertising and marketing expenses; offset by an increase in personnel-related and facilities expenses as a result of an increase in headcount.

## Research and Development

The following table presents research and development expenses:

	Three Months Ended September 30,		Three Months Ended September 30,		Change	
	2006	% of Net Revenues	2005	% of Net Revenues	\$	%
	(In thousands, except percentages)					
Research and development	\$ 1,718	13.7%	\$ 1,403	11.5%	\$ 315	22.5%

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 increase in research and development expenses for the three months ended September 30, 2006 as compared to the same period one year ago is in part due to an increase in personnel-related expenses as a result of an increase in headcount.

## Provision for Income Taxes

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

	Three Months Ended September 30,	
	2006	2005
Effective tax rate	2%	0%

We utilize the liability method of accounting for income taxes as set forth in SFAS No. 109, "Accounting for Income Taxes." The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from the effect of our domestic losses recorded without a tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. As a result of our cumulative losses, we provided a full valuation allowance against our net deferred tax assets for the three months ended September 30, 2006 and 2005.

## Liquidity and Capital Resources

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

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

	September 30,	June 30,	Increase (Decrease)
	2006	2006	
	(In thousands)		
Working capital	\$ 5,169	\$ 5,372	\$ (203)
Cash and cash equivalents	\$ 7,687	\$ 7,729	\$ (42)
Marketable securities	94	88	6
	\$ 7,781	\$ 7,817	\$ (36)

In order of significance, our working capital decreased in part due to (i) a net loss (ii) an increase in accounts payable as a result of the timing of cash payments to vendors; offset by (iii) a buildup of inventories in anticipation of

increased sales during our second fiscal quarter. Our cash balances remained consistent with the prior quarter as a result of our cash management activities which include the timing of cash payments to our vendors and the timing of cash receipts from our customers.

We believe that the cumulative effect of expense reductions initiated in fiscal 2005 and the settlement of our patent litigation during fiscal 2006 will result in reduced operating expenses and will lower our cash breakeven point to approximately \$13.0 to \$14.0 million per fiscal quarter. This target is based upon a financial model, and we expect that actual expenses may vary in any fiscal quarter and therefore financial results impacting cash usage or profitability will vary. Also, uses of cash to fund inventories, receivables and payables will cause results to vary from the financial model.

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

In May 2006, we entered into a two-year secured revolving Loan and Security Agreement ("Line of Credit") with a bank, which provides for borrowings up to \$5.0 million. The borrowing capacity is limited to eligible accounts receivable as defined under the Line of Credit. Borrowings under the Line of Credit bear interest at the prime rate plus 1.75% per annum. We are required to pay an unused line fee of 0.50% on the unused portion of the Line of Credit. As of September 30, 2006, we had no borrowings against the Line of Credit.

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

	<b>September 30,</b>		<b>June 30,</b>	
	<b>2006</b>		<b>2006</b>	
	<b>(In thousands)</b>			
Available borrowing capacity	\$	1,874	\$	2,221
Outstanding letters of credit	\$	1,594	\$	1,594

During March 2006, we entered into a lease agreement whereby the lessor will advance an amount not to exceed \$1.0 million for the implementation of a new ERP information system to manage our business operations. During the ERP implementation period, we will pay interest of 9.0% on the amounts advanced. The lease agreement states that the aggregate amount advanced to us by the lessor will be repaid over a three-year period following the completion of the ERP implementation. As of September 30, 2006, we had incurred costs of \$463,000 in connection with the ERP implementation which will be advanced by the lessor.

As of September 30, 2006, approximately \$2.2 million of our cash is held in foreign subsidiary bank accounts. Such cash is unrestricted with regard to foreign liquidity needs; however, our ability to utilize a portion of this cash to satisfy liquidity needs outside of such foreign locations is subject to approval by the foreign location board of directors.

*Cash Flows*

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

	<b>Three Months Ended</b>		<b>September 30,</b>	
	<b>2006</b>		<b>2005</b>	
	<b>(In thousands)</b>			
Net cash provided by (used in):				
Net loss	\$	(651)	\$	(1,341)
Non-cash operating expenses, net		468		434
Changes in operating assets and liabilities		7		1,017
Net cash (used in) provided by operating activities		(176)		110

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Net cash used in investing activities		(4)		(38)
Net cash provided by financing activities		151		111
Effect of foreign exchange rate changes on cash		(13)		(20)
(Decrease) increase in cash and cash equivalents	\$	(42)	\$	163

Operating activities used cash during the three months ended September 30, 2006. This was the result of a net loss, offset by non-cash operating expenses and cash provided by operating assets and liabilities. The non-cash items that had a significant impact on the net loss included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash used in operating activities included (i) an increase in accounts payable as a result of the timing of cash payments to vendors and (ii) a decrease in receivable balances as a result of our cash collection efforts; offset by (iii) an increase in inventories, (iv) a decrease in other liabilities as a result of a decrease in customer deposits, (v) a decrease in accrued settlements as a result of the payment of the Digi settlement and (vi) a reduction in the warranty reserve to reflect lower expected warranty return rates.

Operating activities provided cash during the three months ended September 30, 2005. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses offset by a net loss. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash provided by operating activities included (i) a decrease in inventories, (ii) an increase in accounts payable as a result of the timing of cash payments to vendors; offset by an increase in prepaid expenses and other current assets. In order of significance, the non-cash items that had a significant impact on net loss included amortization of purchased intangible assets, share-based compensation and depreciation partially offset by a recovery of inventory reserves.

Investing activities used cash during the three months ended September 30, 2006. This was due to the purchase of property and equipment.

Investing activities used cash during the three months ended September 30, 2005. This was due to the purchase of property and equipment.

Financing activities provided cash during the three months ended September 30, 2006. This was due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by repayments on capital lease obligations.

Financing activities provided cash during the three months ended September 30, 2005. This was due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by repayments on capital lease obligations.

#### **Off-Balance Sheet Arrangements**

We did not have any off balance sheet arrangements as of September 30, 2006.

#### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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

#### **Interest Rate Risk**

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

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

	<b>September 30, 2006</b>	<b>June 30, 2006</b>
	<b>(In thousands)</b>	
Cash and cash equivalents	\$ 7,687	\$ 7,729
Marketable securities	94	88
	<b>\$ 7,781</b>	<b>\$ 7,817</b>

#### **Foreign Currency Risk**



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

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

	September 30, 2006	June 30, 2006
	(In thousands)	
Cash held in foreign currencies	\$ 2,354	\$ 2,554

#### Item 4. Controls and Procedures

##### (a) Evaluation of disclosure controls and procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of our fiscal quarter ended September 30, 2006. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer to allow timely decisions regarding required disclosure.

##### (b) Changes in internal controls over financial reporting

There have been no changes in our internal controls over financial reporting identified during the fiscal quarter that ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

The information set forth in Note 9 and 10 to our notes to the unaudited condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q is hereby incorporated by reference.

### Item 1A. Risk Factors

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

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

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

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

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

Substantial litigation regarding intellectual property rights exists in our industry. For example, in May 2006 we settled a patent infringement lawsuit with Digi International, Inc. ("Digi") in which we signed an agreement with Digi to cross-license each other's patents. In addition, we paid Digi \$600,000 as part of the settlement. The results of litigation are inherently uncertain, and adverse outcomes are possible. Adverse outcomes may have a material adverse effect on our business, financial condition or results of operations. For a more detailed description of pending litigation, see Note 9 and 10 to the notes to our condensed consolidated financial statements of Part I, Item I of this Form 10-Q.

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

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

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

- require us to satisfy indemnification obligations to our customers.

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

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

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

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

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

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

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

We do not have long-term agreements with our contract manufacturers or suppliers. If any of these subcontractors or suppliers ceased doing business with us, we may not be able to obtain alternative sources in a timely or cost-effective manner. Due to the amount of time that it usually takes us to qualify contract manufacturers and suppliers, we could experience delays in product shipments if we are required to find alternative subcontractors and suppliers. Some of our suppliers have or provide technology or trade secrets, the loss of which could be disruptive to our procurement and supply processes. If a competitor should acquire one of our contract manufacturers or suppliers, we could be subjected to more difficulties in maintaining or developing alternative sources of supply of some components or products. Any problems that we may encounter with the delivery, quality or cost of our products could damage our customer relationships and materially and adversely affect our business, financial condition or results of operations.

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

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

The following table presents our research and development expenses:

<b>Three Months Ended September 30,</b>					
	<b>% of Net</b>		<b>% of Net</b>	<b>Change</b>	
<b>2006</b>	<b>Revenues</b>	<b>2005</b>	<b>Revenues</b>	<b>\$</b>	<b>%</b>

(In thousands, except percentages)

Research and development	\$	1,718	13.7%	\$	1,403	11.5%	\$	315	22.5%
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***If a major customer cancels, reduces or delays purchases, our net revenues might decline and our business could be adversely affected.***

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

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

	<b>Three Months Ended</b>	
	<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>
Top five customers (1)	35.6%	41.7%
Tech Data	9.9%	14.0%
Ingram Micro	9.2%	12.6%

(1) Includes Ingram Micro and Tech Data.

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

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

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

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



at the rate we anticipate, or could decline.

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

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

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***Current or future litigation could adversely affect us.***

We are currently involved in litigation, including a federal securities class action lawsuit. We recently concluded multiple securities lawsuits and litigation with a former executive officer. We may have an obligation to continue to indemnify the former executive officer and defend any violations that he may be charged with. There is a risk that our insurance carriers may not reimburse us for such costs. Any lawsuit may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources. Except as described in this Form 10-Q, we do not know what the outcome of outstanding legal proceedings will be and cannot determine the extent to which these resolutions might have a material adverse effect on our business, financial condition or results of operations. The results of litigation are inherently uncertain, and adverse outcomes are possible. For a more detailed description of our current and recent litigation, see Note 9 and 10 to the notes to our condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q.

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

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

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

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

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

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

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

- lack of guaranteed production capacity or product supply; and
- reliance on these manufacturers to maintain competitive manufacturing technologies.

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

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

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

The following table presents our sales within geographic regions:

	<b>Three Months Ended September 30,</b>						
	<b>2006</b>	<b>% of Net Revenues</b>	<b>2005</b>	<b>% of Net Revenues</b>	<b>Change</b>		
					<b>\$</b>	<b>%</b>	
<b>(In thousands, except percentages)</b>							
Americas	\$ 7,656	61.2%	\$ 8,179	66.8%	\$ (523)	(6.4%)	
EMEA	2,991	23.9%	2,959	24.2%	32	1.1%	
Asia Pacific	1,867	14.9%	1,102	9.0%	765	69.4%	
	\$ 12,514	100.0%	\$ 12,240	100.0%	\$ 274	2.2%	

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

- unexpected changes in regulatory requirements, taxes, trade laws and tariffs;
- reduced protection for intellectual property rights in some countries;
- differing labor regulations;
- compliance with a wide variety of complex regulatory requirements;
- changes in a country's or region's political or economic conditions;
- effects of terrorist attacks in the U.S. and abroad;
- greater difficulty in staffing and managing foreign operations; and
- increased financial accounting and reporting burdens and complexities.

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

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

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

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

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	<b>September 30, 2006</b>	<b>June 30, 2006</b>
	<b>(In thousands)</b>	
Raw materials	\$ 4,336	\$ 3,863
Finished goods	6,628	6,518
Inventory at distributors	1,476	1,690
Large scale integration chips *	1,256	731
	13,696	12,802
Reserve for excess and obsolete inventories	(4,462)	(4,689)
	\$ 9,234	\$ 8,113

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We may pursue acquisitions, strategic partnerships and joint ventures that we believe would allow us to complement our growth strategy, increase market share in our current markets and expand into adjacent markets, broaden our technology and intellectual property and strengthen our relationships with 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. In addition, we do not carry business interruption insurance for, nor do we carry financial reserves against, business interruptions arising from earthquakes or certain other events. If a business interruption occurs, our business could be materially and adversely affected.

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

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

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

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

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

During fiscal 2006, we began the implementation of a new enterprise resource planning ("ERP") information system to manage our business operations. While we did not use the new ERP information system to manage our business during the fiscal quarter ending September 30, 2006, the possibility exists that our migration to the new ERP information system could adversely affect our disclosure controls and procedures or our operations in future periods. The process of implementing new information systems could adversely impact our ability to do the following in a timely manner: accept and process customer orders, receive inventory and ship products, invoice and collect receivables, place purchase orders and pay invoices, and all other business transactions related to the finance, order entry, purchasing, supply chain and human resource processes within the new ERP systems. Any such disruption could adversely affect our financial position, results of operations, cash flows and the market price of our common stock.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

\* Furnished, not filed.

**SIGNATURES**

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

Date: November 14, 2006

LANTRONIX, INC.

(Registrant)

By:

/s/ Marc H. Nussbaum

**Marc H. Nussbaum**

**Chief Executive Officer**

**(Principal Executive Officer)**

By:

/s/ James W. Kerrigan

**James W. Kerrigan**

**Chief Financial Officer and**

**Secretary**

**(Principal Financial Officer)**