CASTELLE \CA\
Form 10-K
April 15, 2005

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

FORM 10-K

|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the year ended December 31, 2004

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 0-220-20

CASTELLE
(Exact name of Registrant as specified in its charter)

California	77-0164056
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

855 Jarvis Drive, Suite 100, Morgan Hill, California 95037
(Address of principal executive offices, including zip code)

(408) 852-8000
(Registrant's telephone number, including area code)

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, No Par Value

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes |_| No |X|

The approximate aggregate market value of the common stock held by non-affiliates of the Registrant, based upon the last sale price of the common stock reported on the Nasdaq SmallCap Market on June 30, 2004 was $10,086,628.

The number of shares of common stock outstanding at March 14, 2005 was 3,832,796.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this Form 10-K will be incorporated by reference from certain portions of Castelle's proxy statement relating to its 2004 Annual Meeting of Shareholders to be filed with the SEC or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2005.

Castelle
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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that are based on our current expectations about our company and our industry. All of our forward-looking statements involve risks and uncertainties. Our actual results could differ significantly from our expectations and from the results expressed in or implied by these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed elsewhere in this Annual Report on Form 10-K. We urge you to consider these cautionary statements carefully in evaluating our forward-looking statements. Except as required by law, we undertake no obligation to publicly update any forward-looking statements to reflect subsequent events and circumstances. Important factors that may cause results to differ from expectations include those discussed in Risk Factors beginning on page 28 in this document.

EXPLANATORY NOTE

This Annual Report on Form 10-K for the year ended December 31, 2004 includes restated financial statements as of December 31, 2003 and for each of the two fiscal years in the period ended December 31, 2003.

In April 2005, the Company completed a review of its accounting practices with respect to the historical classification of cost of service revenues, procedures for recognizing revenue associated with extended support contracts and procedures for establishing the accrual for paid-time-off, and determined that its historical financial statements as of and for the years ended December 31, 2002 and 2003 contained certain errors in the application of generally accepted accounting principles as described below:

1. Classification of cost of service revenues

The Company has concluded that its historical classification of cost of service revenues did not conform to Generally Accepted Accounting Principles. Historically, such costs have been improperly included as a component of sales and marketing expenses on the Company's consolidated statements of earnings; however under generally accepted accounting principles, such costs are required to be classified as cost of service revenues. The Company has reclassified $711,000 and $729,000 in fiscal 2002 and 2003 out of sales and marketing and included these amounts within cost of service revenues in its statements of earnings. The reclassification had no impact on reported sales, net income, earnings per share, or cash flows from operations for the respective periods. The misclassification, however, did result in cost of sales being understated, and gross profit and operating expenses being overstated by equal amounts. The Company has concluded that the internal control deficiency that led to the errors in the historical classification of cost of service revenues is a "material weakness" as defined by the Public Company Accounting Oversight Board's Auditing Standard No. 2.

Effective January 1, 2005, the Company established a separate cost center to capture solely the cost of service revenues and such costs will be classified as a component of cost of sales.

The Company's review of such costs was prompted in part by the receipt in November 2004 and thereafter of a series of comment letters issued by the Division of Corporation Finance of the Securities and Exchange Commission to the Company.

2. Revenue recognition related to extended support contracts

The Company has determined that as a result of an internal control deficiency, service revenues attributable to extended support contracts were overstated by approximately $39,000 and $34,000 for fiscal 2002 and fiscal 2003, respectively. These amounts should have been deferred and recognized as service revenues in subsequent periods. Such errors were the result of inadequate procedures in place to correctly recognize sales related to extended support contracts. The revenue overstatements represent less than 1% of the Company's total sales for the respective periods. In connection with their audit of the Company's consolidated financial statements for the year ended December 31, 2004, the Company's independent registered public accounting firm, Grant Thornton LLP, concluded that the internal control deficiency that led to the aforementioned revenue recognition errors is a "material weakness" as defined by the Public Company Accounting Oversight Board's Auditing Standard No. 2.

During the first quarter of 2005, the Company enhanced its internal accounting system to ensure that revenue is recognized over the actual contract term.

3. Accrual for paid-time-off

The Company has also identified an error that resulted in an overstatement of its accrual for paid-time-off beginning in 2002 and continuing through 2004. This error resulted in the overstatement of expenses by approximately $15,000 and $7,000 in fiscal 2002 and 2003, respectively. During the first quarter of 2005, the Company corrected the error that led to such over-accrual. The reported results as of and for the year ended December 31, 2004 reflect the appropriate accrual and expense for paid-time-off.

The Company has restated its consolidated financial statements for fiscal 2002 and 2003 in this 2004 Annual Report on Form 10-K to correct for these errors. The Company has also restated the unaudited quarterly consolidated financial statements for each of the 2003 and 2004 periods included in Item 8 in this 2004 Annual Report on Form 10-K to correct for the quarterly impact of such errors. Consequently, the historical financial statements and related financial information contained in Castelle's Annual Report on Form 10-K for the year ended December 31, 2003 and each of Castelle's Forms 10-Q for the year ended December 31, 2004 should no longer be relied upon and are superceded by the financial statements and financial information in this Annual Report on Form 10-K.

Note 3, Restatement of Previously Issued Financial Statements, to the notes to the consolidated financial statements discloses the impact of the adjustments arising from the accounting errors described above on the statements of earnings and balance sheets for the restated annual periods. In addition, Note 3 to the consolidated financial statements discloses the effect of the restatement on opening retained earnings as of January 1, 2002, which adjustment reflects the impact of the restatement on periods prior to 2002. This adjustment decreased previously reported accumulated deficit by $27,000 with a corresponding decrease to deferred revenue relating to extended support contracts. For information on the impact of the restatement on fiscal 2000 and 2001, reference is made to Item 6, Selected Financial Data, in Part II of this Form 10-K.

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PART I

ITEM 1. BUSINESS

The following summary should be read in conjunction with, and is qualified in its entirety by, the more detailed information and Consolidated Financial

Statements and Notes thereto appearing elsewhere in this Annual Report on Form 10-K.

OVERVIEW

Castelle was incorporated in California in 1987, and its principal offices are located at 855 Jarvis Drive, Suite 100, Morgan Hill, California 95037. Unless the context otherwise requires, references in this Form 10-K to "we," "us," or the "Company" refer to Castelle. Our telephone number is (408) 852-8000. Castelle(R), LANpress(R) and JetPress(R) are registered tradeMARKS of the Company. FaxPressTM, FaxPress PremierTM and InfoPressTM are trademarks of the Company. This Annual Report on Form 10-K includes trademarks and trade names of other companies. Our common stock is listed on the Nasdaq SmallCap Market under the symbol CSTL. We maintain a Website with the address www.castelle.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available free of charge through our website our Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. In addition, we intend to disclose on our website any amendments to, or waivers from, our code of business conduct and ethics, that are required to be publicly disclosed pursuant to rules of the Securities and Exchange Commission and the Nasdaq Stock Market.

We develop, manufacture, market and support office automation systems that allow organizations to implement faxing over local area networks and the Internet. A market leader in fax solutions for small to medium sized workgroups, our FaxPress fax servers provide a simple way to integrate fax with email, desktop and back-end applications. Our products are designed to be easy to use and maintain, and provide an economical way for companies to share resources over their networks.

Our products have historically centered on fax and print servers and related technologies. Beginning in 1997, our revenues declined as competition increased, primarily with the print server products in the Asia Pacific region, while at the same time the Internet and other networking technologies advanced. As a result, we experienced annual operating losses during 1997 through 1999. During the past eight years, management has redirected our efforts to focus on server appliances and on development efforts to integrate existing and future products with the Internet and emerging networking technologies. During 2004, we discontinued our LANpress print server and InfoPress product lines, but will continue to provide support to our customers during the warranty periods. Through the introduction of enhanced fax automation products that generate higher gross profits, restructuring and cost reductions, we were able to report operating profits in the fourth quarter of 1999 and in each of the four quarters of 2000. In 2000, we recorded a profit of $732,000 with sales at $14.8 million. We incurred a loss of $591,000 in 2001 with sales of $9.4 million, resulting from a decrease in demand for our products due in part to the slowness of the economy. Our sales and profitability rebounded beginning in the third quarter of 2001, and since then, we have recorded fourteen straight quarters of profitability.

Industry Background

In the mid-1980s, organizations began to interconnect personal computers into local area networks (known as "LANs") in order to allow workgroups to share files, peripherals such as printers, and other specialized applications. As LANs have proliferated throughout organizations and client/server architectures have gained acceptance, they have become increasingly complex and the applications operating on computer networks have become more critical to the success of the business enterprise. The further proliferation of the Internet and Intranets and popularity of electronic communications expanded the role of LANs as a means to provide common access to the Internet, email and other office automation applications. Installation, maintenance and administration of LAN equipment required a staff of highly skilled professionals. The costs associated with LANs and related equipment, server-class hardware, specialized software, network integration and support services are significant and typically affordable only by larger organizations. Many businesses were not able to afford office automation applications beyond basic email, such as integrating fax technology into the network. This has created the opportunity for specialized networking equipment that would perform a single application very well, known in the industry as a "server appliance." It is similar to using a toaster instead of an oven, as it does a specific job better and it costs less. A server appliance is an integrated hardware and software product designed to reduce the complexity and cost for a specific server-based application. Internet routers, email servers, remote access servers, communication servers, fax servers and print servers are examples of server appliances used by businesses today.

We are a pioneer in server appliances, establishing a benchmark for "plug-and-play" and ease of use with our fax and print server product families.

Fax Office Automation Products: Fax machines have become a basic method of doing business worldwide. Fax is ubiquitous in business; many homes even have fax machines. While computers have automated many business applications, faxing remains as a basic method of business communication. We believe fax is here to stay, just as the computer, in its quest for the paperless society, has not replaced paper. Fax servers integrate legacy fax business methods into the network to improve office productivity. Fax servers also provide the opportunity for new business applications to be developed to take advantage of the inherent strength and prevalence of fax machines. Virtually every business in the world has a fax machine that can be used to receive information. Sending purchase orders, invoices, order confirmations, etc. directly to a fax machine, as compared to using the mail, is a growing segment of the fax server market.

The increasing popularity of email and the Internet has provided a boost to all types of electronic communications as many users and organizations become more comfortable and accustomed to their use. To further simplify and improve inter- and intra-organizational communications, corporate Management Information Services departments are looking for ways to integrate different types of messaging into a unified messaging environment. Fax remains one of the key business communication tools and is one of the essential components of the corporate messaging environment. In corporate communication infrastructures, fax is being integrated into email. To facilitate this capability companies install email-integrated fax server systems.

Fax servers allow users to send and receive faxes as easily as emails, using the same email application for both types of messages. A fax server can sort incoming faxes directly and deliver them electronically and confidentially to the electronic mailboxes of the intended recipients. A fax server can also be used as an independent network shared system in environments that require high volume incoming and outgoing faxes. Users are able to send and receive faxes directly from their computers or workstations, eliminating the need to print a document, take it to a stand-alone fax machine and wait for its transmission. Fax servers can help reduce fax transmission costs by sending non-urgent faxes at "offpeak" telephone rates and by utilizing fax over the Internet technology.

Many fax servers are implemented using complex software that requires the installation of a Windows or UNIX network operating system, a server-class computer, and specialized expensive fax modems. Our fax servers, FaxPress and FaxPress Premier, are self-contained units with all the necessary hardware and software to integrate fax into network, desktop, email and back-end applications. As server appliances, they are designed to be easy to use and maintain and we believe that they are more economical than other solutions.

Server appliances, such as communications/messaging servers, have emerged and gained market acceptance due to their ability to significantly reduce complexity and cost associated with the installation and maintenance of networking systems. These appliances also make the complex functionality of Internet and Intranet communications available and affordable to smaller businesses. As professionals in enterprises and small organizations alike continue to recognize the benefits of server appliances, such as remote access, scanning, faxing, electronic mail and related functions, we believe that the demand for such network systems will increase.

Our Strategy

Our objective is to be a leading worldwide supplier of network server appliances. We established a benchmark for "plug-and-play" and ease of use with our fax server product family. Our products are installed in many Fortune 1000 firms, small and medium sized businesses worldwide, integrating desktop fax automation, email, Internet connectivity and other shared services.

Focus on Server Appliances: We focus exclusively on providing innovative, reliable, easy-to-use network products. Since our inception, we have focused on developing networking products that tightly integrate proprietary hardware systems with standard computing platforms. As a result, we believe we have developed a high level of expertise in networking, software development, hardware design and telephony technology. We plan to capitalize on these attributes by continuing to focus on providing network enhancement products that enable users to communicate more effectively.

Focus on Application Solutions and Communications: We focus on developing application solutions for inter and intra-company communications. We believe that our focus on application servers rather than on infrastructure systems enables us to offer products that bring higher value services to customers and provide a higher margin to us.

Expand Product Line: We are leveraging our expertise in server appliances to offer new easy-to-use, cost-effective solutions. We continue to expand our fax server products and apply our proven technology to other areas.

Focus on E-commerce and Other High Volume Distribution Channels: We have established a two-tier domestic and international distribution network of leading national and regional network product distributors and resellers including Ingram Micro and Tech Data. Our products are well suited for sale by e-commerce vendors and we have been successful working with leading resellers such as CDW and Insight. We are focused on maintaining and strengthening our current distribution network in North America, Europe and Pacific Rim.

Leverage Strategic Relationships: We augment our product offerings by establishing relationships with companies able to provide products in areas outside of our core technical competencies or in instances where internal development of such products is not cost-effective. We also establish relationships with numerous leaders in hardware and software technology to keep abreast of, and respond quickly to, technological changes that may affect the network enhancement market.

Products

We develop and market a range of server appliances that enhance network productivity, performance and functionality.

Fax Server Products: We offer the FaxPress family of network fax servers. We position FaxPress and FaxPress Premier as the easiest way to add faxing to a company's network and integrate fax with email. FaxPress and FaxPress Premier allow network users to send, receive, route, print, store, edit and retrieve fax transmissions from their own personal computers on a network. FaxPress and FaxPress Premier can be integrated into an email system creating a unified fax/email environment. FaxPress and FaxPress Premier enable users to transmit documents directly to a fax device as easily as if they were printing to a laser printer or sending an email message. The product also provides network administration features such as, monitoring, logging or configuring FaxPress and FaxPress Premier users. Our fax server products are designed to comply with current regulatory standards in the United States, Europe and the Pacific Rim. During 2004, 2003, and 2002, fax products represented 99%, 97%, and 95%, respectively, of total net sales.

Key features of FaxPress and FaxPress Premier products (configured with its current software versions) include:

- Easy Installation and maintenance: FaxPress and FaxPress Premier are network fax servers that include all the necessary hardware and software. The hardware system is a box with an integrated 10/100 Base-T Ethernet interface and one to seventy-two fax channels. FaxPress and FaxPress Premier include all required server and client software.

- Support for popular network operating environments: FaxPress and FaxPress Premier operate in any local area network based on Microsoft Windows 98, ME, 2000 and 2003; Windows NT/XP, and NT Terminal Server; Novell NetWare; or Linux servers.

- Ability to create a unified fax/email messaging environment: FaxPress and FaxPress Premier have the ability to integrate fax into a corporate email system, allowing users to send and receive faxes in the same manner as emails. FaxPress and FaxPress Premier support Microsoft Exchange/Outlook, Lotus Notes, Novell GroupWise, Netscape and other SMTP compatible email systems. Our unique Outlook Direct interface offloads fax processing from the Microsoft Exchange Server while maintaining tight integration with the Outlook client.

- Integration with many popular accounting and Customer Relationship Management applications: FaxPress and FaxPress Premier are available with the Reform-for-FaxPress software package from FabSoft that allows users to send faxes from many popular accounting, financial and payroll systems including Oracle, SAP, PeopleSoft, Great Plains, ACCPAC and Macola. Reform can support any application that supports form printing.

- Ability to send faxes from many applications: Faxing from within any Windows, Windows 95/98 and Windows NT/2000/XP application such as Microsoft Office and Lotus Smart Suite.

- Electronic delivery of faxes to desktops: FaxPress and FaxPress Premier support several

methods to deliver incoming faxes direct to the email or fax inbox of the intended recipient. Such methods include Direct Inward Dialing, Dual Tone Multifrequency, T.30 sub-addressing, and line routing.

- Internet faxing capabilities reduce transmission costs: FaxPress and FaxPress Premier enable users to connect several units via the Internet or the Intranet to form a private Fax-over-IP network that can significantly reduce the cost of fax transmissions.

- Integration into custom applications: We provide a software development kit that allows programmers to integrate fax functions into their current applications or to create new customized applications that use the FaxPress or FaxPress Premier servers.

- Software Options: We offer a range of value-added software options that increase the functionality of our FaxPress and FaxPress Premier systems and enable the FaxPress and FaxPress Premier to address specialized applications as mentioned above. Software upgrades and options are available to the installed base of FaxPress and FaxPress Premier units at prices starting at $495.

We offer a family of FaxPress and FaxPress Premier fax server systems ranging from entry-level products targeted for small businesses with fewer than 50 users to high-end fax solutions capable of supporting enterprise-wide installations. The suggested list prices for FaxPress and FaxPress Premier fax servers range from $1,495 to $48,995. Server pricing is based on hardware model, with no per-user costs. The FaxPress 2500, 5000 and 7000 families come with the FaxPress 8.X network fax software that adds integration with popular email packages, and many advanced fax management and integration features. Our FaxPress Small Business Edition ("SBE") fax server does not include email integration started with our FaxPress 7.1.1 network fax software. The FaxPress Premier family comes with the FaxPress Premier 3.X network fax software. The following table summarizes our FaxPress and FaxPress Premier system products:

				Network Envi	
Product Model	Number of Channels	Email Integration	Network Topology	NetWare 3.x, 4.x, 5.x, 6.x (IPX,IP)	NT
FaxPress SBE	1	Not available	Ethernet	x	
FaxPress 2500	2	x	Ethernet	x	
FaxPress 5000	2, 4 or 8	x	Ethernet	x	
FaxPress 7000	8	x	Ethernet	x	

FaxPress 7500	8	x	Ethernet	x
FaxPress Premier Analog	4, 8, 12, 16	x	Ethernet	n/a
FaxPress Premier Digital T1	8, 24, 48, 72	x	Ethernet	n/a
FaxPress Premier ISDN	4, 8, 12	x	Ethernet	n/a
FaxPress Premier Digital E1	10, 30, 60, 90	x	Ethernet	n/a

Research and Product Development

We have invested substantially in research and product development since inception. We believe our future performance will depend in large part on our ability to enhance our current products, to expand

our product offerings, to maintain technological competitiveness and meet an expanding range of customer requirements. We spent $1.7 million, $1.6 million and $1.4 million in research and product development activities in 2004, 2003 and 2002, respectively.

We continue to invest in enhancing our server appliance product lines by developing new versions of client and server software and server hardware. The product feature set is driven by the increasing complexity of user needs. The changing corporate communications/messaging environment and increasing demand for easy-to-use networking systems define these needs. The development efforts are focused on enhancing functionality of existing products and developing other systems to expand our product offerings. Our development efforts are focusing on high value applications, while relying on our partners to provide basic functionality for some of our product lines.

In 2004, we developed and released version 8.0 of our FaxPress software and version 3.0 of our FaxPress Premier software. The new releases of FaxPress 8.0 and FaxPress Premier 3.0 Network Fax Software offer a new level of email integration, expanded operating environments and fax automation. It includes a new gateway for IBM Lotus Notes email integration, improved integration with Microsoft Exchange, enhanced Windows XP and Citrix MetaFrame XP support, improved Novell client support, production faxing and fax automation made easy.

The current FaxPress and FaxPress Premier fax server product lines are continuously being enhanced to offer greater integration into corporate networking environments.

Sales, Marketing and Distribution

We sell our products through multiple channels, determined by the product, market and customer need. We have an established two-tier domestic and international distribution network of leading national and regional network product distributors and resellers. Software enhancements and options that complement the FaxPress products are primarily marketed directly by us to registered end users. The direct sales group works closely with distributors and value-added resellers ("VARs") in qualifying sales opportunities for the fax server products. We also sell some products through the on-line store on our Web site. Demand for our products is created through a variety of marketing programs. These programs are targeted toward end-users to stimulate demand for the products and toward distributors, resellers, VARs and e-commerce vendors to promote the product in the sales channel. These programs include targeted and active participation in industry networking and communication trade shows, as well as advertising in associated publications. We increase awareness of our products by Internet marketing via targeted e-advertising, publishing and sponsoring email newsletters, enhancing our Web presence, print advertising, conducting direct mail campaigns, offering seminars, trade shows and conferences, and other forms of public relations efforts. Our Web site has been updated and designed to assist customers in obtaining information about our products and contacting our sales personnel.

Our products are well suited for sale by e-commerce vendors, and we have experienced success working with leading resellers such as CDW and Insight.

In 2004, Ingram Micro and Tech Data individually accounted for more than 10% of our sales and collectively represented approximately 44% of our net sales. In 2003 and 2002, the same distributors accounted for approximately 50% and 51% of our net sales for the respective years. Total sales to customers located in the Pacific Rim, Europe and rest of Americas comprised approximately 18%, 19%, and 21% of our net sales in 2004, 2003 and 2002, respectively.

Customer Service and Support

We provide customers with support services, which are available to assist customers with installation, use and operation issues in an effort to ensure smooth and reliable operation of our products. Our network engineers, located at corporate headquarters, provide technical support via telephone, fax and email during normal Company business days from 6:00 a.m. to 5:00 p.m. (Pacific Time). As part of our global partner program, VARs have access to "priority technical support" via a special toll-free number that provides immediate access to our network engineers. Support is provided under warranty terms as well as through extended warranty agreements sold directly to the customer by us. We also provide other customer support through our Web site. We have an automated call management distribution system that provides improved levels of support to help resolve customer issues.

Manufacturing

Our current in-house manufacturing operations consist primarily of material planning, assembly, final testing, quality control and service repair. Most of our products are manufactured by third-party manufacturers that provide customized, integrated manufacturing services, including procurement, manufacturing, printed circuit board assembly and final testing. These arrangements enable us to shift certain costs to such providers, thereby allowing us to focus resources on our product development efforts. The failure of such manufacturers, to meet their contractual commitments to us could cause delays in product shipments, thereby potentially adversely affecting our business, operating results and financial condition.

We do not currently have any material long-term supply contracts with any of our manufacturing subcontractors or component suppliers. We purchase finished products and components on a purchase order basis. We own all engineering, sourcing documentation, functional test equipment and tooling used in manufacturing our products and believe that we could shift product assembly to alternate suppliers if necessary. Certain key components of our products, including a modem chip set from Conexant, microprocessors from Motorola, integrated circuits from Intel and Kendin, are currently available from single sources. Other components of our products are currently available from only a limited number of sources. In addition, certain manufacturers have announced the end-of-life of certain standard off-the-shelf components which are being used by us in the making of our FaxPress Products. However, we have purchased at least two years worth of supplies of these end-of-life components, and are constantly replenishing our inventory from secondary markets too, in an effort to guarantee an uninterrupted supply of FaxPress Products to our customers for the next two years, while we decide whether to re-engineer our Products with the manufacturers' suggested replacement parts, or develop new replacement products.

Competition

The network enhancement products and computer software markets are highly competitive, and we believe that such competition will intensify in the future. The competition is characterized by rapid change and improvements in technology along with constant pressure to reduce the prices of products. We currently compete principally in the market for network fax servers and fax-on-demand software.

The principal competitive factors affecting the market for our products include product functionality, performance, quality, reliability, ease of use, quality of customer training and support, name recognition, price, and compatibility and conformance with industry standards and changing operating system environments. Several of our existing and potential competitors, have substantially greater financial, engineering, manufacturing and marketing resources than us. We also experience competition from a number of other software, hardware and service companies. In addition to our current competitors, we may face substantial competition from new entrants into the network enhancement

market, including established and emerging computer, computer peripheral, communications and software companies. In the fax server market we compete with companies such as Captaris, Inc., Omtool, Ltd. and Esker Software. In addition, certain competing methods of communications such as the Internet or electronic mail could adversely affect the market for fax products.

Proprietary Rights

Our success depends to a certain extent upon our technological expertise and proprietary software technology. We rely upon a combination of contractual rights and copyright, trademark and trade secret laws to establish and protect our technologies. Additionally, we generally enter into confidentiality agreements with those employees, distributors, customers and suppliers who have access to sensitive information and limits access to and distribution of our software documentation and other proprietary information. Because of the rapid pace of technological change in the LAN product industry, we believe that patent protection for our products is less significant to our success than the knowledge, ability and experience of our employees, the frequent introduction and market acceptance of new products and product enhancements, and the timeliness and quality of our support services. We may not be able to obtain the necessary intellectual property rights and other parties may contest our intellectual property rights.

Government Regulation

Certain aspects of the networking industry in which we compete are regulated both in the United States and in foreign countries. Imposition of public carrier tariffs, taxation of telecommunications services and the necessity of incurring substantial costs and expenditure of managerial resources to obtain regulatory approvals, particularly in foreign countries could have a material, adverse effect on our business, operating results and financial condition. Additionally, our products must comply with a variety of equipment, interface and installation standards promulgated by communications regulatory authorities in different countries.

Employees

As of March 1, 2005, we employed a total of 48 full-time equivalent personnel, 9 in operations, 13 in sales and marketing, 9 in engineering, 11 in customer service and 6 in finance and administration. We have not experienced a work stoppage, no employees are represented by a labor organization and we consider our employee relations to be good.

Executive Officers

The names and ages of our executive officers as of February 28, 2005 are set forth below:

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Name	Age	Position
Scott C. McDonald	51	President, Chief Executive Officer
Eric Chen	52	Senior Vice President, Engineering and Business Development
Paul Cheng	56	Vice President, Finance and Administration, Chief Financial Officer and Secretary
Richard Fernandez	45	Vice President, Operations
Edward J. Heinze	59	Vice President, Sales, U.S.
Michael Petrovich	43	Vice President, Sales, International

Scott C. McDonald

Mr. McDonald has served as our President and Chief Executive Officer since April 2002. Mr. McDonald has served as a director since April 1999. From May 2001 to the first quarter of 2002, Mr. McDonald served on the board of directors for Octant Technologies and Digital Power Corporation and provided consulting services. Mr. McDonald served as the Chief Financial and Administrative Officer at Conxion Corporation, a network and Internet services company, from December 1999 to April 2001. From 1997 to 1999, Mr. McDonald served on the board of directors for CIDCO, Inc, Octant Technologies Inc. and Digital Power Corporation; in addition to providing consulting services to CIDCO, Inc. Mr. McDonald currently serves on the board of directors of privately held Octant Technologies, Inc. Mr. McDonald holds a BS in Accounting from the University of Akron and an MBA from Golden Gate University.

Eric Chen

Mr. Chen has served as our Senior Vice President, Engineering and Business Development since May 2002. From May 2000 to May 2002, Mr. Chen served as our Vice President, Engineering. Upon joining us i(n) 1989, Mr. Chen initially worked on software development projects including developing the first FaxPress e-mail gateways, porting FaxPress to non-Novell platforms, and the first menu-driven installation and configuration programs for both FaxPress and LANpress. Most recently, Mr. Chen served as the Director of Print Server Product Marketing and Business Unit and has managed the engineering development and manufacturing business relationships with our partners. Before joining our company, Mr. Chen was with 3COM, a network solutions provider. Mr. Chen has a BS in

Engineering from Taiwan and an MS in Computer Science from the University of Massachusetts.

Paul Cheng

Mr. Cheng has served as our Vice President, Finance and Administration since April 2000. In March 2001, Mr. Cheng was appointed as Chief Financial Officer and Secretary. Mr. Cheng brings more than 20 years of financial experience from a career that was launched in Hong Kong where he was the Plant Controller of Fairchild Semiconductor Hong Kong Ltd. Before joining our company, he served as the Vice President of Finance and Administration at Eclipse International, Inc., a systems development company, from April 1997 to March 2000. In addition, he has held various executive positions including Vice President of Finance at Quintus Corporation, a developer of customer relations management software from 1993 to 1995 and Corporate Controller at Power Integration, Inc., a semiconductor manufacturer from 1995 to 1997. Mr. Cheng is a member of the Chartered Certified Accountants and holds a BS in Accounting from Hong Kong.

Richard Fernandez

Mr. Fernandez has served as our Vice President of Operations since December 2002. From June 2002 to December 2002, Mr. Fernandez served as our Director of Operations. Mr. Fernandez has more than 22 years of manufacturing and materials planning experience prior to joining the Company. Prior to joining our company, Mr. Fernandez managed the acquisition of servers and storage devices for Conxion Corporation from June 2000 to May 2002. Prior to joining Conxion, Mr. Fernandez was Director of Operations with CIDCO, Inc. since March 1994. In addition, Mr. Fernandez has held various management positions with Computer Products Inc., MAD Intelligent Systems and Sperry Univac.

Edward J. Heinze

Mr. Heinze has served as our Vice President, Sales, U.S. since January 2000. From 1994 to January 2000, Mr. Heinze served in several capacities including Product Manager of the Fax Product Line, and Regional Sales Manager. Before joining our company, Mr. Heinze served in several capacities at Visual/White Pine Software, a software developer, including Vice President of Sales. Prior to his tenure at White Pine, he was Chief Operations Officer for XMARK, a computer systems manufacturer, and Vice President of Sales and Marketing at EIT, Millicom, Olympia, and Ontel. He holds a BS degree from Waynesburg College.

Michael Petrovich

Mr. Petrovich has served as our Vice President, Sales, International since October 2000 and has been with us since 1992. Mr. Petrovich concentrates on developing the sales channels for all sales outside of the Americas, including Asia, the Asia Pacific and Europe. Prior to joining us, Mr. Petrovich was the marketing communications manager for Novell's National Reseller Organization, a software company. In this role Mr. Petrovich focused on business strategies and development of Novell's direct reseller sales channel. Before joining Novell, Mr. Petrovich held sales and marketing positions at Excelan, a LAN manufacturer, and International Microcircuits Incorporated, a semiconductor company. Mr. Petrovich holds a BA in Behavioral Sciences from San Jose State

University.

ITEM 2. PROPERTIES

Our headquarters, including our executive offices and corporate administration, development, manufacturing, marketing, sales and technical services/support facilities, are located in Morgan Hill, California in approximately 16,600 square-feet of leased office space. We occupy this facility under a lease, the term of which expires in May 31, 2009 with one conditional three-year option, which if exercised, would extend the lease to May 31, 2012. We also rent office space for sales and customer support in Illinois. We believe our existing facilities will be adequate to meet our requirements for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

From time to time and in the ordinary course of business, we are involved in various legal proceedings and third party assertions of patent or trademark infringement claims against us in the form of letters and other forms of communication. We are not currently involved in any litigation which, in our opinion, would have a material adverse effect on our business, operating results, cash flows or financial condition; however, there can be no assurance that any such proceeding will not escalate or otherwise become material to our business in the future.

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

Subsequent to our Annual Meeting of Shareholders held on May 28, 2004, there were no matters submitted to a vote of securities holders during the remainder of 2004.

PART II

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

Our common stock (Nasdaq symbol "CSTL") began trading on the Nasdaq National Market on December 20, 1995 and was transferred to the Nasdaq SmallCap Market as of April 1999. The following table shows the closing high and low sale prices per share of our common stock as reported on the Nasdaq SmallCap Market. Such quotations do not include retail markups, markdowns or commissions.

2003	HIGH	LOW
First Quarter	$2.91	$1.03
Second Quarter	$3.86	$1.95
Third Quarter	$4.90	$3.01
Fourth Quarter	$3.50	$2.61
2004	HIGH	LOW
First Quarter	$7.80	$2.95
Second Quarter	$5.35	$2.77
Third Quarter	$3.39	$2.31
Fourth Quarter	$4.29	$2.71

The market price of our common stock has been volatile. See "Risk Factors - Our stock price has been volatile, and is likely to continue to be volatile in the future."

As of April 12, 2005 there were 700 holders of record of our common stock. On April 12, 2005 the last sale price reported on the Nasdaq SmallCap Market for our common stock was $3.25 per share.

Stock Buyback

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $2.25 million of our common stock for cash in open market, negotiated or block transactions. The timing of these transactions will depend on market conditions, other corporate strategies and will be at the discretion of management. No time limit was set for the completion of this program. At the time of the approval by the Board of Directors, we had approximately 4.8 million shares of common stock outstanding and as of the end of the third quarter 2002, cash and cash equivalents were approximately $4.8 million. During the fourth quarter of 2002, we repurchased from open market and negotiated transactions a total of 1.62 million shares for $1.8 million, at an average per share price of $1.10. During the first quarter of 2003, we repurchased from open market transactions a total of 46,500 shares for $48,000, at an average per share price of $1.04. We have performed no stock repurchases since then. However, we may continue to execute our buyback program as we deem necessary.

Dividend Policy

We have not paid cash dividends on our common stock. The Board of Directors currently intends to retain any and all earnings for use in our business and we do not anticipate paying cash dividends in the foreseeable future.

Equity Compensation Plan Information

The following table sets forth a summary of our equity compensation plans as of December 31, 2004. Details of the plans are discussed in Note 7 to the Consolidated Financial Statements.

	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights
1988 Equity compensation plan approved by security holders	7,000	$2.38
1998 (1988) Equity compensation plan (As Amended) approved by security holders	896,391	$0.98
2002 Equity compensation plan approved by security holders	389,205	$3.07
Equity compensation plans not		

approved by security holders	-0-	n/a
Total	1,292,596	$1.61

ITEM 6. SELECTED FINANCIAL DATA

The five-year financial summary in this Item 6 has been revised to reflect the Company's restatement of previously reported results (see Note 3 to the consolidated financial statements).

The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related Notes thereto included elsewhere in this Annual Report on Form 10-K.

	Years ended Decem		
	2004	2003	2002
		(Restated)	(Restated)
		(in thousands, except per	
STATEMENT OF EARNINGS DATA:			
Net Sales	$10,457	$10,180	$ 9,720
Gross Profit	$ 7,075	$ 6,969	$ 6,180
Gross Profit as a % of Net Sales	68%	68%	64%
Net income (loss)	$ 2,119(1)	$ 1,606(2)	$ 635
Net income (loss) as a % of Net Sales	20%(1)	16%(2)	7%
Net income (loss) per share - diluted	$ 0.48(1)	$ 0.38(2)	$ 0.14
BALANCE SHEET DATA:			
Cash and Cash Equivalents	$ 5,599	$ 4,614	$ 3,460(3
Working Capital	$ 5,750	$ 4,156	$ 2,437
Total Assets	$10,147	$ 7,803	$ 5,635
Long-term Liabilities	$ 14	$ 29	$ 44
Shareholders' Equity	$ 7,281	$ 4,752	$ 2,926(3

(1) In 2004, we recorded a non-cash tax benefit of $1.1 million, or $0.24 per diluted share. This was a result of releasing a portion of our tax valuation allowance due to our continued profitability and a determination that it is more likely than not that certain future tax benefits will be realized.

(2) In the fourth quarter of 2003, we recorded a non-cash tax benefit of $526,000, or $0.12 per diluted share, resulting from the release of a portion of our tax valuation allowance. Prior to the fourth quarter of 2003, we had not reported significant income tax expenses because we had utilized available Net Operating Loss ("NOL") and tax credit carryforwards. These NOLs were fully reserved by a valuation allowance due to uncertainly surrounding the likelihood of their realization. Due to our continued profitability over the past ten quarters and a determination that it was more likely than not that certain

future tax benefits will be realized, a portion of the deferred tax assets were recognized in the fourth quarter.

(3) In 2002, cash and cash equivalents and shareholders' equity reflect the use of $2 million of cash for the repurchase of 1.62 million shares of our common stock and the associated expenses.

(4) Net loss for 2001 includes net charges for restructuring and other non-recurring items of $239,000.

(5) Net sales in 2001 have been restated to increase service revenues by $27,000 as compared to previously reported net sales in relation to the extended support contracts adjustment. Consequently, the net loss for 2001 decreased to $564,000 as compared to the previously reported net loss of $591,000. There was no impact on previously reported net loss per share for 2001.

(6) Gross profit and operating expenses for 2001 and 2000 have been restated to reduce such balances by equal amounts of $813,000 and $1 million, respectively, as compared to previously reported amounts, as a result of the reclassification of cost of service revenues from operating expenses to cost of sales.

Unaudited Quarterly Results of Operations

The following table sets forth certain consolidated quarterly financial data for the eight quarters ended December 31, 2004. This information is unaudited, but in our opinion, has been prepared on the same basis as the audited consolidated financial statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated

below to present fairly the unaudited interim results. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

The consolidated quarterly financial data presented below reflects the restatement of the periods through September 30, 2004 to reflect the adjustment for certain errors noted by the Company during the fourth quarter of fiscal 2004. For a description of the restatement items and the effect on annual periods for fiscal 2003 and 2002, see Note 3 to the Company's consolidated financial statements.

Selected Quarterly Data (unaudited)

	Year 2004, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
	(Restated)	(Restated)	(Restated)	
Net sales (1)	$2,539	$2,691	$2,685	$2,542
Gross profit (2)	1,702	1,883	1,804	1,686
Operating income (3)	228	272	236	330
Net income(4)	129	146	130	1,714(5
Net income per share, basic (4)	0.04	0.04	0.04	0.46(5

Net income per share, diluted (4)	0.03	0.03	0.03	0.39(5

(1) Net sales in the 2004 quarters ended March 31, June 30 and September 30 have been restated to reduce service revenues by $19,000, $26,000 and $13,000, respectively, as compared to previously reported net sales in relation to the extended support contract adjustments.

(2) Gross profit and operating expenses for the quarters ended March 31, June 30 and September 30, 2004 have been restated to reduce such balances by equal amounts of $198,000, $216,000 and $207,000, respectively, as compared to previously reported amounts, as a result of the reclassification of cost of service revenues from operating expenses to cost of sales.

(3) Operating income for the quarters ended March 31, June 30, and September 30, 2004 has been increased by an additional $1,000 in each of the three quarters, as compared to previously reported amounts to correct the overstatement of the Company's paid-time-off accrual.

(4) The restatement adjustments referred to above reduced previously reported net income by $18,000, $25,000 and $12,000 in 2004 for the quarters ended March 31, June 30 and September 30, respectively. Both basic and diluted net income per share as restated decreased by $0.01 for the quarter ended June 30, 2004 as compared to the amounts previously reported. Basic and diluted net income per share as restated did not change from the amounts previously reported for the quarters ended March 31 and September 30.

(5) Includes a non-cash tax benefit of $1.4 million, or $0.37 per basic share, and $0.31 per diluted share, resulting from the release of a portion of our tax valuation allowance.

	Year 2003, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
	(Restated)	(Restated)	(Restated)	(Restated
Net sales (1)	$2,495	$2,501	$2,561	$2,623
Gross profit (2)	1,626	1,752	1,814	1,777
Operating income (3)	252	232	238	357
Net income (4)	239	220	238	909(
Net income per share, basic (4)	0.07	0.07	0.07	0.27(
Net income per share, diluted (4)	0.06	0.05	0.05	0.21(

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(1) Net sales in the 2003 quarters ended March 31, June 30, September 30 and December 31 have been restated to reflect the reduction of service revenues by $5,000, $10,000, $5,000 and $14,000, respectively, as compared to previously reported amounts in relation to the extended support contract adjustments.

(2) Gross profit and operating expenses for the quarters ended March 31, June

30, September 30 and December 31, 2003 have been restated to reduce such balances by equal amounts of $172,000, $177,000, $193,000 and $187,000, respectively, as compared to previously reported amounts, as a result of the reclassification of cost of service revenues from operating expenses to cost of sales.

(3) Operating income has been increased by $1,000 in the quarter ended March 31, 2003 and $2,000 in each of the remaining quarters of 2003, as compared to previously reported amounts, to correct the overstatement of the Company's paid-time-off accrual.

(4) The restatement adjustments referred to above reduced previously reported net income by $4,000, $8,000, $3,000 and $12,000 for the quarters ended March 31, June 30, September 30 and December 31, respectively. Basic net income per share as restated decreased by $0.01 for the quarter ended March 31 and did not change for the quarters ended June 30, September 30 or December 31, as compared to the amounts previously reported. Diluted net income per share as restated decreased by $0.01 for the quarters ended June 30 and September 30 and did not change for the quarters ended March 31 or December 31, as compared to the amounts previously reported.

(5) Includes a non-cash tax benefit of $526,000, or $0.16 per basic share, and $0.12 per diluted share, resulting from the release of a portion of our tax valuation allowance.

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

(All tabular amounts in thousands except per share amounts and as noted)

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that are subject to many risks and uncertainties that could cause actual results to differ significantly from expectations. For more information on forward-looking statements, refer to the "Special Note on Forward Looking Statements" at the front of this Annual Report on Form 10-K.

Our products have historically centered on fax and print servers and related technologies. Starting in 1997, our revenues began to decline as competition increased, primarily with the print server products in the Asia Pacific Region, while at the same time the Internet and other networking technologies advanced. As a result, we experienced annual operating losses beginning in 1997 through 1999. We redirected our efforts to focus on server appliances and on development efforts to integrate existing and future products with the Internet and emerging networking technologies. We introduced our new products, the FaxPress 5000 in February 1999, FaxPress 2500 in November 1999, FaxPress SBE in February 2000 and the FaxPress 7500 in September 2000. In September 2003, we launched our newest enterprise level fax servers, the FaxPress Premier Analog and FaxPress Premier Digital. Today, our analog fax servers can provide up to 16 fax channels, the digital servers up to 71 T1 fax channels, the ISDN servers up to 12 fax channels and the E1 servers up to 90 fax channels. Our current FaxPress and FaxPress Premier software versions are 8.0 and 3.0, respectively, to support our hardware.

In April 2005, we completed a review of our accounting practices with respect to the historical classification of cost of service revenues, procedures for recognizing revenue associated with extended support contracts and procedures for establishing the accrual for paid-time-off, and determined that our historical financial statements as of and for the years ended December 31, 2002 and 2003 contained certain errors in the application of generally accepted accounting principles. Consequently, we have restated our consolidated financial statements for fiscal 2002 and 2003 in this 2004 Annual Report on Form 10-K to correct for these errors. This Management's Discussion and Analysis of Financial Condition and Results of Operations reflects the restated amounts. Note 3 to the consolidated financial statements discloses the impact of the adjustments arising from the accounting errors described above on the statements of earnings and balance sheets for the restated annual periods.

Improved cash management and operating results resulted in positive operating cash flows in 2002, 2003 and 2004. Cash balances increased to $5.6 million at December 31, 2004 from $4.6 million and $3.5 million at December 31, 2003 and December 31, 2002, respectively.

From time to time, component manufacturers announce the end of life of certain of their products and at the same time introduce replacement components which are usually more efficient or cost effective. We have been informed by several of our component suppliers that new components are available to replace certain of their end-of-life components currently used in our FaxPress products. We have been replenishing, through secondary markets, and keeping approximately two years worth of these end-of-life components in an effort to guarantee a smooth supply of our FaxPress Products to our customers. We believe this will give us ample time to decide whether to re-engineer our Products with the manufacturers' suggested replacement parts, or develop new replacement products. We believe that most of these end-of-life components will be utilized in the following two years, resulting in insignificant amounts of excessive inventory, or none at all. We believe that Castelle's liquidity continues to be strong despite these purchases, as our cash reserves have increased during the periods when the parts were purchased. Even though we believe we have secured enough components for the next two years, there is no assurance that we will be able to secure additional components in the future, or be able to redesign new products in a timely manner. These end-of-life products represent $675,000 of the ending inventory balance.

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Critical Accounting Policies

We have identified the policies below as critical to our business operations and to the understanding of our results of operations. We have defined a critical accounting policy as one that is both important to the portrayal of our financial condition and results of operations and requires our management to make difficult, subjective or complex judgments. For a detailed discussion on the application of these and other accounting policies, see Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report on Form 10-K, beginning on page F-7. Note that preparation of this Annual Report on Form 10-K requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of our financial statements, and reported amounts of revenue and expenses during the reporting period. Estimates about future events and their effects cannot be made with certainty. We based our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments. These estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes.

Revenue recognition

We recognize revenue based on the provisions of Staff Accounting Bulletin No. 104 "Revenue Recognition," AICPA Statement of Position No. 97-2 ("SOP 97-2") "Software Revenue Recognition," as amended by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions," and Statement of Financial Accounting Standards ("SFAS") No. 48 "Revenue Recognition When Right of Return Exits."

The Company uses the residual method to recognize revenue when an agreement includes one or more elements to be delivered at a future date. If there is an undelivered element under the arrangement, the Company defers revenue based on vendor-specific objective evidence of the fair value of the undelivered element, as determined by the price charged when the element is sold separately. If vendor-specific objective evidence of fair value does not exist for all undelivered elements, the Company defers all revenue until sufficient evidence exists or all elements have been delivered.

Product revenue is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the fee is fixed or determinable; collection is probable; and returns can be reasonably estimated. If an acceptance period or other contingency exists, revenue is recognized upon satisfaction of the contingency, customer acceptance or expiration of the acceptance period. Shipment generally occurs and title and risk of loss is transferred when the product is delivered to a common carrier.

We enter into agreements with some of our distributors that permit limited stock rotation rights. These stock rotation rights allow the distributor to return products for credit but require the purchase of additional products of equal value. Customers who purchase products directly from us also have limited return rights, which expire 30 days from product shipment. Revenues subject to stock rotation or other return rights are reduced by our estimates of anticipated exchanges and returns.

Pursuant to our agreements with distributors, we also protect our distributors' exposure related to the impact of price reductions. Future price adjustments are estimated and accrued at the time of sale as a reduction in revenue.

We generally provide our distributors the opportunity to earn volume incentive rebates based on sales volume achieved during the fiscal quarter. These incentive rebates are accrued in the quarter incurred and recorded as a reduction in revenue.

We also provide co-op and market development funds to our distributors. These incentives are accrued at the time revenue is recognized and recorded as a reduction in revenue.

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We offer a standard trade-in discount to all of our end-user customers under which the customer, upon trade-in of any previously purchased product, is entitled to a discount from our published price list on any product included in our current product offerings. We require our customers to physically return the previously purchased products to qualify for the trade-in discount. We account for the trade-in discount as a reduction of revenue at the time the product is traded in and a new product is purchased.

Payment terms to our distributors and customers are generally thirty days, cash in advance, or by credit card.

We evaluate product sales through our distribution channels and the related reserve requirement to establish an estimate for our sales returns reserve by reviewing detailed point-of-sales and on-hand inventory reports provided to us by our channel partners. Based on a combination of historical return experience, the sales activities to end-user customers by our channel partners and the level of inventories on hand at the channel partners, we determine our returns reserve at the end of each financial period, and increases or reduce the reserve balance accordingly.

We provide standard support to our customers for an initial period of sixty days, which includes advance swap of the defective hardware and software, bug fixes, software upgrades and technical support. In addition to standard support, we also offer our customers the option to purchase extended support at the time of product purchase or anytime thereafter. Extended support covers hardware and software for a period of one year. We have established vendor-specific objective evidence with respect to the fair value of the standard support contracts based on standalone sales and renewals of our one-year extended support contracts. The fair value of our sixty day support contracts included with product sales is determined by pro-rating the related one-year extended support contracts. We recognize revenue from extended support contracts ratably over the period of the contract.

We do not sell software, which is incorporated into our hardware, separately, other than for our customers to purchase as an upgrade to their existing products when we announce a major release of the software.

Product Warranty

Hardware is warranted for one year from the date of sale and is repaired free-of-charge. Provisions for estimated warranty costs are recorded at the time products are shipped as a charge to cost of sales. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should product failure rates, material usage or service delivery cost differ from our estimates, revision to the estimated warranty liability would be required, which could affect the amount of gross profit reported.

Distributor Programs and Incentives

We enter into agreements with some of our distributors that permit limited stock rotation rights. These stock rotation rights allow the distributor to return products for credit but require the purchase of additional products of equal value. We also protect our distributors' exposure related to the impact of price reductions. We generally provide our distributors the opportunity to earn volume incentive rebates based upon the amount of sales volume achieved during the fiscal quarter. We also provide co-op and market development funds to our distributors.

If market conditions were to change, we may take actions to increase distributor incentive offerings possibly resulting in an incremental reduction of revenues at the time the incentive is offered. Moreover, if the actual incentive offerings are different from our estimates, or if the actual incentive claims are significantly higher than our historical experience, then revisions to the estimated incentive programs may be required resulting in additional reductions to revenue.

We record estimated reductions to revenues for these distributor programs and incentive offerings including special pricing agreements, promotions and other volume-based incentives.

Credit, collection and allowance for doubtful accounts

We perform ongoing customer credit evaluations based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. When credit criteria are not met, we require cash-on-delivery or payment by credit card before products are shipped. On a quarterly basis, we specifically analyze accounts receivable, historical bad debts, customer concentration, and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Such losses have generally been within our expectations. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Three customers accounted for 60%, 69% and 68% of accounts receivable at December 31, 2004, 2003 and 2002, respectively.

Inventories and related write-downs for excess and obsolete inventory

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market. We record write downs for excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based on assumptions about future product life-cycles, product demand and market conditions. If actual product life cycles, product demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

In light of the approximately two years worth of end-of-life components we have purchased to ensure a smooth supply of our FaxPress Products to our customers, our management periodically reviews the usage, supply and inventory levels of these parts to determine whether additional purchases or excessive inventory provisions are necessary. As of December 31, 2004, we have approximately $675,000 worth of end-of-life components on hand and we believe that most of these components will be utilized in the following two years, resulting in insignificant amounts of excessive inventory, or none at all.

Income taxes

We account for income taxes in accordance with the liability method. Under the liability method, deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The provision for income taxes is comprised of the current tax liability and the change in deferred tax assets and liabilities. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance against these tax assets. Significant management judgment is required in determining the provision for income taxes and any valuation allowance recorded against our deferred tax assets. The establishment or reversal of any valuation allowance is based in large part on projected future taxable income.

Results of Operations

Comparison of Years Ended December 31, 2004 and 2003

Net Sales

	Year Ended December	
	2004	2003
Net Sales:		(Restated)
Products	$ 8,011	$ 8,337
Services	2,446	1,843
Total net sales	$ 10,457	$ 10,180

	Year Ended December	
	2004	2003
Net Sales:		(Restated)
United States	$ 8,574	$ 8,222
Europe	785	704
Pacific Rim	804	883
Rest of Americas, excluding United States	294	371
Total net sales	$ 10,457	$ 10,180

Net sales increased 3% to $10.5 million in 2004 from $10.2 million in 2003. The increase of $277,000 was primarily from increased sales derived from services of $603,000, offset by a reduction in products sales of $326,000.

Products sales of $8.0 million in 2004, which represents 77% of total sales, declined by 4% as compared to $8.3 million in 2003, which represents 82% of total sales. The lower sales in 2004 are due largely to the Company's decision to divest its legacy products as part of its overall strategy to transition to its new generation of network fax servers, FaxPress Premier. We anticipate sales of our FaxPress Premier fax servers to grow as we continue to expand into Japan, Hong Kong and Mainland China markets. Product sales in 2004 also included a one-time pre-tax benefit of $126,000 from an adjustment of certain accruals related to a sales development program.

Service revenues are comprised of extended warranty and support programs as well as 60-days of maintenance included with initial product sales. Revenue related to these arrangements is recognized ratably over the period of the arrangement. Service revenues in 2004, which represents 23% of total sales, increased 33% to $2.4 million from $1.8 million in 2003, which represents 18% of total sales. The increase in service revenues was primarily due to increased sales of extended warranty contracts due to an increase in our installed customer base as well as the launch of our FaxPress Premier fax server products in the second half of 2003. We anticipate service revenue to increase as more FaxPress Premier fax servers are sold.

Domestic sales were $8.6 million in 2004 as compared to $8.2 million in 2003, representing 82% and 81%, respectively, of total net sales. The increase in sales was mostly attributable to the introduction of the new FaxPress Premier fax server products, which carry higher selling prices, an

increase in service revenues and a benefit of $126,000 from a sales development program adjustment.

International sales (excluding sales to the rest of the Americas) were $1.6 million in 2004 and 2003, representing 15% and 16%, respectively, of total net sales. Most of our international sales are denominated in U.S. dollars and thus, could be adversely affected by changes in demand resulting from fluctuations in currency exchange rates.

Sales to the rest of the Americas, excluding the United States, were $294,000 in 2004, as compared to $371,000 in 2003, representing 3% and 4% of total net sales in 2004 and 2003, respectively. The decrease in sales was mostly due to lower sales of our FaxPress fax server products.

In 2004, Ingram Micro, Tech Data and Macnica, our top three customers accounted for approximately 51% of our net sales. In 2003, the same three distributors accounted for 57% of net sales.

Cost of Sales; Gross profit

	Year Ended December 31		
	2004	2003	2002
Cost of sales:		(Restated)	(Restated)
Products	$ 2,556	$ 2,485	$ 2,833
Services	826	726	707
Total cost of sales	3,382	3,211	3,540
Gross profit	$ 7,075	$ 6,969	$ 6,180
Gross profit as % of sales	68%	68%	64%

Gross profit is equal to net sales less cost of sales. Cost of sales includes cost of materials, including components, manuals, diskettes, packaging materials and shipping. Cost of sales also includes compensation costs and overhead related to our manufacturing operations, inventory obsolescence and warranty expenses. Gross profit from service revenues in fiscal 2004 increased by $503,000 from fiscal 2003 due mostly to higher sales while cost of sales increased moderately. The higher gross profit from service revenues was offset by lower gross profit of $397,000 from product sales due to product mix. Gross profit in 2004 included the benefit of $126,000 from the sales development program adjustment.

Periodically we review obsolete and unmarketable products in our inventory and make appropriate allowances for excess and obsolete inventory. Products that are determined to be obsolete and unmarketable are physically scrapped when it is determined that such inventories are no longer usable or salable. In 2004, we identified $35,000 of unmarketable products, which were scrapped, as compared to $154,000 worth of unmarketable products scrapped in 2003.

Research and Development

	Year Ended December	
	2004	2003
		(Restated)
Research and development expenses	$ 1,722	$ 1,590
Research and development expenses as % of sales	17%	15%

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Research and development expenses represent costs associated with the development of new products and consist primarily of employee-related expenses, material costs and allocated facility costs. The higher research and development expenses in 2004 were mostly due to higher outside consulting expenses of $154,000 to enhance our current product features and $71,000 in higher compensation due to increased headcount, offset by a decrease in materials expense of $61,000. The employment of consultants is expected to continue until the short-term projects are completed. Research and development spending has supported both existing products and the development of new server appliances. We remain committed to the development of highly competitive new products and services through the efficient utilization of our engineering resources.

Sales and Marketing

	Year Ended December 31		
	2004	2003	
		(Restated)	(R
Sales and marketing expenses	$ 2,486	$ 2,398	$
Sales and marketing expenses as % of sales	24%	24%	

Sales and marketing expenses consist primarily of employee-related expenses, commissions to sales representatives, product promotion expenses, and allocated facilities expenses, including expenses associated with our regional sales and support offices. The increase in sales and marketing expenses was largely due to increased compensation expenses of $216,000 related to headcount additions, offset in part by lower advertising and promotional expenses of $129,000. Sales and marketing expenses are anticipated to remain relatively stable.

General and Administrative

Year Ended Decemb

	2004	2003 (Restated)
General and administrative expenses	$ 1,801	$ 1,902
General and administrative expenses as % of sales	17%	18%

General and administrative expenses consist primarily of employee-related expenses for administration, finance, human resources and general management, as well as consulting, outside services, legal and accounting expenses, and allocated facilities expenses. The lower expenses in 2004, as compared to 2003, were mainly attributable to lower compensation expenses of $88,000 mostly because of lower incentive payments due to performance goals that were not met. General and administrative expenses are expected to increase in fiscal 2005 in relation to Sarbanes-Oxley internal control compliance.

Interest and Other Income (Expenses)

Interest and other income (expense) consists primarily of interest income earned from our invested cash balances, interest expense on capital leases, bank service fees, and miscellaneous income and expenses. Interest and other income (expense) for 2004 was $14,000 as compared $10,000 in 2003.

Provision for Income Tax

In fiscal 2004 and 2003, we recorded non-cash tax benefits of $1.1 million and $526,000, respectively, as a result of releasing portions of our tax valuation allowance. Consequently, as of December 31, 2004, we have recorded a total of $1.5 million of deferred tax assets. We have not

reported significant income tax expenses because we have been able to utilize available Net Operating Loss ("NOL") and tax credit carryforwards to offset taxable income. Prior to December 31, 2003, the Company's NOLs were fully offset by a valuation allowance due to uncertainly surrounding the likelihood of their realization. Due to our continued profitability over the past 14 quarters and a determination that it is more likely than not that certain future tax benefits will be realized, a portion of the Company's deferred tax assets have been recognized during the fourth quarters of fiscal 2003 and 2004.

Comparison of Years Ended December 31, 2003 and 2002

Net Sales

Net sales increased 5% to $10.2 million in 2003 from $9.7 million in 2002. The increase of $460,000 resulted primarily from increased sales derived from services of $740,000 offset by a reduction in product sales of $280,000.

Products sales of $8.3 million in 2003, which represents 82% of total sales, declined by 3% as compared to $8.6 million in 2002, which represents 89% of total sales, mostly due to lower sales of our FaxPress fax servers.

Service revenues in 2003, which represents 18% of total sales, increased 67% to $1.8 million from $1.1 million in 2002, which represents 11% of total sales. The increase in service revenues was primarily due to increased sales of extended warranty contracts due to an increase in our installed customer base.

Domestic sales were $8.2 million in 2003 as compared to $7.7 million in 2002, representing 81% and 79%, respectively, of total net sales. The increase in sales was mostly attributable to the introduction of the new FaxPress Premier fax server products in the fourth quarter of 2003, which carry higher selling prices, and an increase in service revenues.

International sales (excluding sales to the rest of the Americas) were $1.6 million in 2003 as compared to $1.7 million in 2002, representing 16% and 18%, respectively, of total net sales. International sales were lower largely due to lower sales of our FaxPress server products to Europe.

Sales to the rest of the Americas, excluding the United States, were $371,000 in 2003, as compared to $347,000 in 2002, representing 4% of total net sales in both 2003 and 2002.

In 2003, Ingram Micro, Tech Data and Macnica, our top three customers accounted for approximately 57% of our net sales. In 2002, the same three distributors accounted for 56% of net sales.

Cost of Sales; Gross profit

Gross profit was $7.0 million, or 68% of net sales, in 2003, compared to $6.2 million, or 64% of net sales, in 2002. Gross profit from service revenues in fiscal 2003 increased by $721,000 from fiscal 2002 due mostly to higher sales while cost of sales was relatively flat. Continuous product cost reductions in 2003 and increased outsourcing of manufacturing contributed to the improvement in gross profit from product sales in 2003 by $68,000.

In 2003, we identified $154,000 of unmarketable products, which were scrapped, as compared to $158,000 in 2002.

Research and Development

Research and product development expenses were $1.6 million in 2003, as compared to $1.4 million in 2002, and represent 15% and 14% of net sales for those periods, respectively. The higher research and development expenses in 2003 were mostly due to additional material costs of $106,000 used in the development of our FaxPress Premier server products that were launched in September 2003, and higher compensation expense of $82,000 due to increased headcount.

Sales and Marketing

Sales and marketing expenses were $2.4 million and $2.3 million for 2003 and 2002, respectively, and represent 24% and 23% of net sales for those periods. The slight increase in sales and marketing expenses was largely due to increased promotional and travel related expenses of $235,000 and higher compensation expenses of $76,000 due to increased headcount, offset in part by lower consulting expenses of $173,000.

General and Administrative

General and administrative expenses were $1.9 million in both 2003 and 2002, and represent 18% and 20% of net sales for those periods. The slightly lower expenses in 2003 as compared to 2002 were mainly attributable to lower consulting expenses of $180,000 and legal and accounting fees of $166,000, offset partially by higher compensation expenses of $151,000 and investor relation expenses of $86,000. General and administrative expenses in 2002 included legal expenses of $128,000 and outside consulting expenses of $209,000, which were chiefly attributable to our stock repurchase and Nasdaq listing issues.

Interest and Other Income(Expenses)

Interest and other expenses for 2003 were $10,000 as compared to income of $44,000 in 2002. The decrease in interest and other income was chiefly due to a $29,000 reduction in interest income due to lower interest rates and decreased miscellaneous income of $26,000.

Provision for Income Tax

In the fourth quarter of 2003, we recorded a non-cash tax benefit of $526,000, resulting from the release of a portion of our tax valuation allowance. Prior to the fourth quarter, we had not reported significant income tax expenses because we had utilized available Net Operating Loss ("NOL") and tax credit carryforwards. These NOLs were fully reserved by a valuation allowance due to uncertainly surrounding the likelihood of their realization. Due to our continued profitability and a determination that it is more likely than not that certain future tax benefits will be realized, a portion of the deferred tax assets were recognized in the fourth quarter of fiscal 2003.

In 2002, our provision for income taxes was $6,000, representing state income taxes. The tax provision for federal income taxes was offset by utilization of our net operating loss carryforwards.

LIQUIDITY AND CAPITAL RESOURCES

	December 31, 2004	December 31, 2003
	(dollars in thousands)	
		(Restated)
Cash and cash equivalents	$ 5,599	$ 4,614
Working capital	$ 5,750	$ 4,156
Working capital ratio	3.0	2.4

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Since our initial public offering of common stock in December 1995, our principal source of funding has been cash from our operations, with some funding from capital equipment lease lines. As of December 31, 2004, we had $5.6 million of cash and cash equivalents, an increase of $985,000 from December 31, 2003. The increase in cash and cash equivalents was primarily attributable to cash provided by operating activities of $626,000 and $410,000 in proceeds from the exercise of stock options.

Even though cash and cash equivalents in 2004 improved over 2003, cash provided by operating activities declined by $492,000 primarily due to a planned increase in inventory of $608,000, mostly attributable to the purchase, net of usage, of $675,000 worth of end-of-life parts used in our FaxPress products in an effort to guarantee a smooth supply to our customers for the next two years, and the timing of accounts payable. The increase in cash provided by operating activities in 2003 as compared to 2002 was mainly due to higher earnings.

In 2004, net cash provided by financing activities was $394,000 primarily from proceeds from issuance of common stock. In the first quarter of 2003, we repurchased $48,000 of our stock from open market transactions. We acquired additional property and equipment of $35,000, $164,000 and $34,000 in 2004, 2003 and 2002, respectively. Net cash used in financing activities of $2.0 million in 2002 was largely for the repurchase of our stock and the professional fees associated with such repurchase.

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $2.25 million shares of our common stock for cash in open market, negotiated or block transactions. The timing of such transactions has depended and will depend on market conditions, other corporate strategies and has been and will be at the discretion of our management. No time limit was set for the completion of this program. As of December 31, 2003, we have repurchased from open market and negotiated transactions a total of 1.67 million shares for $1.8 million, at an average per share price of $1.10. We performed no stock repurchases during the rest of 2003 and 2004. However, we may continue to execute our buyback program as we deem necessary.

In September, 2004, we entered into a $4.0 million collateralized revolving line of credit with a bank, which is to expire in August 2005. The revolving line of credit provides for borrowings of up to $4.0 million. Borrowings under this line of credit agreement are collateralized by all of our assets and bear interest at the bank's prime rate plus 0.50%. Under the new facility we are required to maintain certain minimum cash and investment balances with the bank and meet certain other financial covenants. As of December 31, 2004, we have not drawn down on the line of credit and were in compliance with the terms of the agreement.

We lease certain of our equipment under various operating and capital leases that expire at various dates through 2006. The lease agreements frequently include renewal, escalation clauses and purchase provisions, and require us to pay taxes, insurance and maintenance costs. As of December 31, 2004, we had $32,000 outstanding under a loan and security agreement, which is subject to an interest rate of 12.8%.

We lease our headquarters in Morgan Hill, California. We have extended our building lease for a term of five years commencing on June 1, 2004 and expiring on May 31, 2009, with one conditional three-year renewal option, which if exercised, would extend the lease to May 31, 2012 commencing with rent at ninety-five percent of fair market value. As of December 31, 2004, future minimum payments under the lease were $915,000.

The following represents combined aggregate maturities for all our financing and commitments as of December 31, 2004:

Contractual Obligations	Payments Due by Period			
	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Yea

Capital (Finance) Lease Obligations	$ 32	$ 18	$ 14	--
Operating Lease Obligations	$ 915	$ 207	$ 622	$ 86
Total contractual cash obligations	$ 947	$ 225	$ 636	$ 86

We believe that our existing cash balances, anticipated cash flows from operations and available lines of credit will be sufficient to meet our anticipated capital requirements for the next 12 months. If we have a need for additional capital resources, we may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products, if any, and changes in technology in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in our inability to achieve our long-term business objectives. To the extent that additional capital is raised through the sale of additional equity or convertible debt securities, the issuance of such securities would result in additional dilution to our shareholders.

In addition, because of our dependency on a small number of distributors for a significant portion of the sales of our products, the loss of any of our major distributors or their inability to satisfy their payment obligations to us could have a significant adverse effect on our business, operating results and financial condition.

RISK FACTORS

Shareholders or investors considering the purchase of shares of the our common stock should carefully consider the following risk factors, in addition to other information in this Annual Report on Form 10-K. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations.

Our revenue and operating results have fluctuated in the past and are likely to fluctuate significantly in the future, particularly on a quarterly basis.

Our operating results may vary significantly from quarter to quarter due to many factors, some of which are outside our control. For example, the following conditions could all affect our results:

- changes in our product sales and customer mix;
- constraints in our manufacturing and assembling operations;
- shortages or increases in the prices of raw materials and components;
- changes in pricing policy by us or our competitors;
- a slowdown in the growth of the networking market;
- seasonality;
- timing of expenditures; and
- economic conditions in the United States, Europe and Asia.

Our sales often reflect orders shipped in the same quarter in which they are received. In addition, significant portions of our expenses are relatively fixed in nature, and planned expenditures are based primarily on sales forecasts. Therefore, if we inaccurately forecast demand for our products, the impact on net income may be magnified by our inability to adjust spending quickly enough to compensate for the net sales shortfall.

Other factors contributing to fluctuations in our quarterly operating results include:

- changes in the demand for our products;
- customer order deferrals in anticipation of new versions of our products;
- the introduction and acceptance of new products and product enhancements by us or our competitors;
- the effects of filling the distribution channels following introductions of new products and product enhancements;
- potential delays in the availability of announced or anticipated products;
- the mix of product and service revenue,
- the commencement or conclusion of significant development contracts;
- changes in foreign currency exchange rates; and
- the timing of significant marketing and sales promotions.

Based on the foregoing, we believe that quarterly operating results are likely to vary significantly in the future and that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be viewed as indications of future performance.

We have a history of losses and may not be able to sustain profitability.

We have experienced significant operating losses and, as of December 31, 2004, had an accumulated deficit of $20 million. Our development and marketing of current and new products will continue to require substantial expenditures. We incurred $591,000 of losses as recently as 2001 due to a slowdown in demand for our products due in part to industry-wide adverse economic conditions. We were able to recover and have been profitable since the third quarter of 2001. There can be no assurance that growth in net sales will be achieved or profitability sustained in future years.

Our common stock is listed on the Nasdaq SmallCap Market, and we have had difficulty satisfying the listing criteria to avoid the delisting of our common stock

Our common stock has been listed on the Nasdaq SmallCap Market since April 1999. In order to maintain our listing on the Nasdaq SmallCap Market, we must maintain total assets, capital and public float at specified levels, and our common stock generally must maintain a minimum bid price of $1.00 per share. If we fail to maintain the standards necessary to be quoted on the Nasdaq SmallCap Market, our common stock could become subject to delisting. There can be no assurance that we will be able to maintain the $1.00 minimum bid price per share of our common stock and thus maintain our listing on the Nasdaq SmallCap Market.

If our common stock is delisted, trading in our common stock could be conducted on the OTC Bulletin Board or in the over-the-counter market in what is commonly referred to as the "pink sheets." If this occurs, a shareholder will find it more difficult to dispose of our common stock or to obtain accurate quotations as to the price of our common stock. Lack of any active trading market would have an adverse effect on a shareholder's ability to liquidate an investment in our common stock easily and quickly at a reasonable price. It might also contribute to volatility in the market price of our common stock and could adversely affect our ability to raise additional equity or debt financing on acceptable terms or at all. Failure to obtain desired financing on acceptable terms could adversely affect our business, financial condition and results of operations.

Substantially all of our revenue comes from the sale of fax server products, and a decline in demand for those products would harm our business, operating results and financial condition.

We derive substantially all of our revenue from the sale of fax server products in 2004. We expect that our current products will continue to account for most of our sales in the near future. A decline in demand for our fax server products as a result of competition, technological change, shortages of components or other factors, or a delay in the development and market acceptance of new features and products, would have a material adverse effect on our business, operating results and financial condition.

We sell our products through a limited number of distributors, and any deterioration in our relationship with those distributors would harm our business, operating results and financial condition.

We sell our products primarily through a two-tier domestic and international distribution network. Our distributors sell our products to VARs, e-commerce vendors and other resellers. The distribution of personal computers and networking products has been characterized by rapid change, including consolidations due to the financial difficulties of distributors and the emergence of alternative distribution channels. An increasing number of companies are competing for access to these channels. Our distributors typically represent other products that are complementary to, or compete with, our products. Our distributors are not contractually committed to future purchases of our products and could discontinue carrying our products at any time for any reason. In addition, because we are dependent on a small number of distributors for a significant portion of the sales of our products, the loss of any of our major distributors or their inability to satisfy their payment obligations to us could have a significant adverse effect on our business, operating results and financial condition. We have a stock rotation policy with certain of our distributors that allows them to return marketable inventory against offsetting orders. If we reduce our prices, we credit certain distributors for the difference between the purchase price of products remaining in their inventory and our reduced price for these products. In addition, inventory levels of our products held by distributors could become excessive due to industry conditions or the actions of competitors, resulting in product returns and inventory write-downs.

The market for our products is affected by rapidly changing technology and if we fail to predict and respond to customers' changing needs, our business, operating results and financial condition may suffer.

The market for our products is affected by rapidly changing networking technology, evolving industry standards and the emergence of the Internet and other new communication technologies. We believe that our future success will depend upon our ability to enhance our existing products and to identify, develop, manufacture and introduce new products which

- conform to or support emerging network telecommunications standards;
- are compatible with a growing array of computer and peripheral devices;
- support popular computer and network operating systems and applications;
- meet a wide range of evolving user needs; and
- achieve market acceptance.

There can be no assurance that we will be successful in these efforts.

We have incurred, and expect to continue to incur, substantial expenses associated with the introduction and promotion of new products. There can be no assurance that the expenses incurred will not exceed research and development cost estimates or that new products will achieve market acceptance and generate sales sufficient to offset development costs. In order to develop new products successfully, we are dependent upon timely access to information about new technological developments and standards. There can be no assurance that we will have such access or will be able to develop new

products successfully and respond effectively to technological change or new product announcements by others.

Complex products such as those offered by us may contain undetected or unresolved hardware defects or software errors when they are first introduced or as new versions are released. Changes in our or our suppliers' manufacturing processes or the inadvertent use of defective components could adversely affect our ability to achieve acceptable manufacturing yields and product reliability. We have in the past discovered hardware defects and software errors in certain of our new products and enhancements after their introduction. Replacement of discontinued components used in our products could lead to further defects and errors. There can be no assurance that despite testing by us and by third-party test sites, errors and defects will not be found in future releases of our products, which would result in adverse product reviews and negatively affect market acceptance of these products.

The introduction of new or enhanced products requires us to manage the transition from the older products to the new or enhanced products or versions, both internally and for customers. We must manage new product introductions so as to minimize disruption in customer ordering patterns, avoid excessive levels of older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demands. We have from time to time experienced delays in the shipment of new products. There can be no assurance that we will successfully manage future product transitions.

Our success depends upon the continued contributions of our key management, marketing, product development and operational personnel.

Our success will depend, to a large extent, upon our ability to retain and continue to attract highly skilled personnel in management, marketing, product development and operations. Competition for employees in the computer and electronics industries is intense, and there can be no assurance that we will be able to attract and retain enough qualified employees. Volatility or lack of positive performance in our stock price may also adversely affect our ability to retain and continue to attract key employees, many of whom have been granted stock options. Our inability to retain and attract key employees could have a material adverse effect on our product development, business, operating results and financial condition. We do not carry key person life insurance with respect to any of our personnel.

The markets for our products are highly competitive and may become more competitive in the future.

The network enhancement products and computer software markets are highly competitive, and we believe that competition will intensify in the future. The competition is characterized by rapid change and improvements in technology along with constant pressure to reduce the prices of products. We currently compete principally in the market for network fax servers and fax-on-demand software. Both direct and indirect competition could adversely affect our business and operating results through pricing pressure, loss of market share and other factors. Any material reduction in the average selling prices of our products would adversely affect gross margins. There can be no assurance we will be able to maintain the current average selling prices of our products or the related gross margins.

The principal competitive factors affecting the market for our products include:

- product functionality;
- performance;
- quality;
- reliability;
- ease of use;
- quality of customer training and support;
- name recognition;
- price; and

- compatibility and conformance with industry standards and changing operating system environments.

Several of our existing and potential competitors have substantially greater financial, engineering, manufacturing and marketing resources than us. We also experience competition from a number of other software, hardware and service companies. In addition to our current competitors, we may face substantial competition from new entrants into the network enhancement market, including established and emerging computer, computer peripheral, communications and software companies. In the fax server market we compete with companies such as Captaris Inc., Omtool, Ltd. and Esker Software. There can be no assurance that competitors will not introduce products incorporating technology more advanced than the technology used by us in our products. In addition, certain competing methods of communications such as the Internet or electronic mail could adversely affect the market for fax products. There can be no assurance that we will be able to compete successfully or that competition will not have a material adverse effect on our business, operating results and financial condition.

We depend on sales in foreign markets, and political or economic changes in these markets could affect our business, operating results and financial condition.

Sales to customers located outside the United States accounted for approximately 18%, 19% and 21% of our net sales in 2004, 2003 and 2002, respectively. We sell our products in approximately 40 foreign countries through approximately 50 international distributors. We expect that international sales will continue to represent a significant portion of our product revenues and that we will be subject to the normal risks of international sales, such as export laws, currency fluctuations, longer payment cycles, greater difficulties in accounts receivable collections and the requirement of complying with a wide variety of foreign laws. There can be no assurance that we will not experience difficulties resulting from changes in foreign laws relating to the export of our products in the future. In addition, because we primarily invoice foreign sales in U.S. dollars, fluctuations in exchange rates could affect demand for our products by causing prices to be out of line with products priced in the local currency. Additionally, any such difficulties would have a material adverse effect on our international sales and a resulting material adverse effect on our business, operating results and financial condition. We may experience fluctuations in European sales on a quarterly basis because European sales may be weaker during the third quarter than the second quarter due to extended holiday shutdowns in July and August. There can be no assurance that we will be able to maintain the level of international sales in the future. Any fluctuations in international sales will significantly affect our operating results and financial condition.

The introduction of new products may reduce the demand for our existing products and increase returns of existing products.

From time to time, we may announce new products, product versions, capabilities or technologies that have the potential to replace or shorten the life cycles of existing products. The release of a new product or product version may result in the write-down of products in inventory if this inventory becomes obsolete. We have in the past experienced increased returns of a particular product version following the announcement of a planned release of a new version of that product. There can be no assurance that product returns will not exceed our allowance for these returns in the future and will not have a material adverse effect on our business, operating results and financial condition.

If we fail to obtain components of our products from third-party suppliers and subcontractors, our business could suffer.

Our products require components procured from third-party suppliers. Some of these components are available only from a single source or from limited sources. In addition, we subcontract a substantial portion of our manufacturing to third parties, and there can be no assurance that these subcontractors will be able to support our manufacturing requirements. We purchase components on a purchase order basis, and generally have no long-term contracts for these components. If we are unable to obtain a sufficient supply of high-quality components from our current sources, we could experience delays or reductions in product shipments. From time to time, component manufacturers announce the end of life of certain of their products and may or may not have replacement products. If we are unable to secure enough inventories of the end-of-life components or their replacements, we might not be able to deliver our products to our customers and could adversely affect our revenue and net income. Furthermore, a significant increase in the price of one or more of these components or our inability to lower component or sub-assembly prices in response to competitive price reductions could adversely affect our gross margin.

Government regulation could increase our costs of doing business and adversely affect our gross margin.

Certain aspects of the networking industry in which we compete are regulated both in the United States and in foreign countries. Imposition of public carrier tariffs, taxation of telecommunications services and the necessity of incurring substantial costs and expenditure of managerial resources to obtain regulatory approvals, or the inability to obtain regulatory approvals within a reasonable period of time, could have a material, adverse effect on our business, operating results and financial condition. This is particularly true in foreign countries where telecommunications standards differ from those in the United States. Our products must comply with a variety of equipment, interface and installation standards promulgated by communications regulatory authorities in different countries. Changes in government policies, regulations and interface standards could require the redesign of products and result in product shipment delays which could have a material, adverse impact on our business, operating results and financial condition.

We depend on proprietary technology, and inability to develop and protect this technology or license it from third parties could adversely affect our business, operating results and financial condition.

Our success depends to a certain extent upon our technological expertise and proprietary software technology. We rely upon a combination of contractual rights and copyright, trademark and trade secret laws to establish and protect our technologies. Despite the precautions taken by us, it may be possible for unauthorized third parties to copy our products or to reverse engineer or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries either do not protect our proprietary rights or offer only limited protection. Given the rapid evolution of technology and uncertainties in intellectual property law in the United States and internationally, there can be no assurance that our current or future products will not be subject to third-party claims of infringement. Any litigation to determine the validity of any third-party claims could result in significant expense and divert the efforts our technical and management personnel, whether or not any litigation is determined in favor of us. In the event of an adverse result in litigation, we could be required to expend significant resources to develop non-infringing technology or to obtain licenses to the technology that is the subject of the litigation. There can be no assurance that we would be successful in this development or that any such licenses would be available on commercially reasonable terms. We also rely on technology licensed from third parties. There can be no assurance that these licenses will continue to be available upon reasonable terms, if at all. Any impairment or termination of our relationship with third-party licensors could have a material adverse effect on our business, operating results and financial condition. There can be no assurance that our precautions will be adequate to deter misappropriation or infringement of our proprietary technologies.

We have received, and may receive in the future, communications asserting that our products infringe the proprietary rights of third parties or seeking indemnification against the alleged infringement. There can be no assurance that third parties will not assert infringement claims against us with respect to current or future products or that any assertion may not require us to enter into royalty arrangements or result in costly litigation. Any claims, with or without merit, can be time consuming and expensive to

defend. There can be no assurance that any intellectual property litigation will not have a material adverse effect on our business, operating results and financial condition.

Our stock price has been volatile, and is likely to continue to be volatile in the future.

The price of our common stock has fluctuated widely in the past. Sales of substantial amounts of our common stock, or the perception that sales could occur, could adversely affect prevailing market prices for our common stock. Our management believes past fluctuations may have been caused by the factors identified above, and that these factors may continue to affect the market price of our common stock. Additionally, stock markets have experienced extreme price volatility in recent years. This volatility has had a substantial effect on the market price of the common stock of us and other high technology companies, often for reasons unrelated to operating performance. We anticipate that prices for our common stock may continue to be volatile. Future stock price volatility may result in the initiation of securities litigation against us, which may divert substantial management and financial resources and have an adverse effect on our business, operating results and financial condition.

We may require additional capital in the future, and may be unable to obtain this capital at all or on commercially reasonable terms.

The development and marketing of products requires significant amounts of capital. If we need additional capital resources, we may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products and changes in technology in the networking industry. There can be no assurance that additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in our inability to achieve our long-term business objectives. The issuance of equity or convertible debt securities to raise additional capital would result in additional dilution to our shareholders.

Recent terrorist activity in the United States and the military action to counter terrorism could adversely impact our business.

Terrorist acts or acts of war (wherever located around the world) could significantly impact our revenue, costs and expenses, and financial condition. The terrorist attacks that took place in the United States on September 11, 2001 have created many economic and political uncertainties, some of which may materially harm our business, operating results and financial condition. The long-term effects on our business of the September 11, 2001 attacks and the ensuing war on terror are unknown. The potential for future terrorist attacks, the national and international responses to terrorist attacks or perceived threats to national security, and other actual or potential conflicts, acts of war or hostility, including the United States' activities in Iraq, have created many economic and political uncertainties that could adversely affect our business, operating results and financial condition in ways that cannot presently be predicted.

The costs of compliance with recent developments in corporate governance regulation may affect our business, operating results and financial condition in ways that presently cannot be predicted further. In the event we are unable to satisfy regulatory requirements relating to internal controls, or if these internal controls over financial reporting are not effective, our business could suffer.

Beginning with the enactment of the Sarbanes-Oxley Act of 2002, a significant number of new corporate governance requirements have been adopted or proposed through legislation and regulation by the Securities and Exchange Commission and Nasdaq National Stock Market. We may not be successful in complying with these requirements at all times in the future. Additionally, we expect these developments to increase our legal compliance and accounting costs, and to make some activities more difficult, such as stockholder approval of new stock option plans. We have incurred and expect to

continue to incur significant costs in connection with compliance with Section 404 of that law regarding internal controls over financial reporting. We expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur as a result, or the effect that these increased costs may have on our operating results.

We have identified and may from time to time identify a number of deficiencies in our disclosure controls and procedures. In connection with the audit of the consolidated financial statements for the year ended December 31, 2004, our independent registered public accounting firm, Grant Thornton LLP, determined that we had internal control deficiencies that constituted a "material weakness." Furthermore, we cannot assure you that we will be able to implement enhancements on a timely basis in order to prevent a failure of our internal controls or enable us to furnish future unqualified certifications. A material weakness or deficiency in internal control over financial reporting could materially impact our reported financial results and the market price of our stock could significantly decline. Additionally, adverse publicity related to the disclosure of a material weakness or deficiency in internal controls over financial reporting could have a negative impact on our reputation, business and stock price. Any internal control or procedure, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives.

Voting control by officers, directors and affiliates may delay, defer or prevent a change of control.

At February 28, 2005, our officers and directors and their affiliates beneficially owned approximately 25% of the outstanding shares of common stock. Accordingly, together they had the ability to significantly influence the election of our directors and other corporate actions requiring shareholder approval. Such concentration of ownership may have the effect of delaying, deferring or preventing a change in control.

Provisions in our charter documents might deter a company from acquiring us, which could inhibit your ability to receive an acquisition premium for your shares.

Our Board of Directors has authority to issue shares of preferred stock and to fix the rights, including voting rights, of these shares without any further vote or action by the shareholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock, thereby delaying, deferring or preventing a change in control. Furthermore, such preferred stock may have other rights, including economic rights, senior to the common stock, and as a result, the issuance thereof could have a material adverse effect on the market.

RECENT ACCOUNTING PRONOUNCEMENTS

In December 2003, the FASB issued a revised FASB interpretation No. 46 (FIN 46R), "Consolidation for Variable Interest Entities, and interpretation of ARB No. 51". The FASB published the revision to clarify and amend some of the original provisions of FIN 46, which was issued in January 2003, and to exempt certain entities from its requirements. A variable interest Entity ("VIE") refers to an entity subject to consolidation according to the provisions of the Interpretation. FIN 46R applies to entities whose equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support provided by any parties, including equity holders, or where the equity investors (if any) do not have a controlling financial interest. FIN 46R provides that if an entity is the primary beneficiary of a VIE, the assets, liabilities, and results of operations of the VIE should be consolidated in the entity's financial statements. In addition, FIN 46R requires that both the primary

beneficiary and all other enterprises with a significant variable interest in a VIE provide additional disclosures. The provisions of FIN 46R were effective for our fiscal 2004 first quarter. The adoption of FIN 46R did not have an impact on our financial position or results of operations.

In March 2004, the FASB issued EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective. The Company does not expect the adoption of EITF 03-1 to have a material impact on our financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," a revision of SFAS No. 123, "Accounting for Stock-Based Compensation" and superseding APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123R requires the Company to expense grants made under the Company's stock option program. That cost will be recognized over the vesting period of the plans. SFAS No. 123R is effective for interim periods beginning after June 15, 2005. The Company is evaluating the alternatives allowed under the standard, which the Company is required to adopt effective for its third quarter of fiscal 2005.

In December 2004, the FASB issued Staff Position SFAS No. 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes (FSP No. 109-1) to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 which was signed into law by the President of the United States on October 22, 2004. Companies that qualify for the recent tax law's deduction for domestic production activities must account for it as a special deduction under SFAS No. 109 and reduce their tax expense in the period or periods the amounts are deductible, according to FSP No. 109-1, effective for the Company in its fiscal year 2005. The FASB's guidance is not expected to have a material impact to the Company's financial results.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We had no holdings of derivative financial or commodity instruments at December 31, 2004. However, we are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. While much of our revenue is transacted in U.S. Dollars, certain spending is transacted in Pounds Sterling. These amounts are not currently material to our financial statements; therefore we believe that foreign currency exchange rates should not materially affect our overall financial position, results of operations or cash flows. The fair value of our money market accounts and related income would not be significantly impacted by increases or decreases in interest rates due mainly to the highly liquid nature of these investments. However, sharp declines in interest rates could seriously harm interest earnings.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

In April 2005, Castelle completed a review of its accounting practices with respect to the historical classification of cost of service revenues, procedures for recognizing revenue associated with extended support contracts and procedures for establishing the accrual for paid-time-off, and determined that its historical financial statements as of and for the years ended December 31, 2002 and 2003 contained certain errors in the application of generally accepted accounting principles. The outcome of this review has resulted in adjustments to Castelle's previously filed financial statements. Consequently, the historical financial statements and related financial information contained in Castelle's Annual Report on Form 10-K for the year ended December 31, 2003 and each of Castelle's Forms 10-Q for the year ended December 31, 2004 should no longer be relied upon and are superceded by the financial statements and financial information in the Annual Report on Form 10-K.

The consolidated financial statements and supplementary data required by this Item are set forth at the pages indicated in Item 15 of this report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On September 24, 2004, the Audit Committee of the Board of Directors dismissed PricewaterhouseCoopers LLP (PwC) as Castelle's independent registered public accounting firm. On September 24, 2004, the Audit Committee engaged Grant Thornton LLP as Castelle's new independent registered public accounting firm for the fiscal year ended December 31, 2004. The change in independent registered public accounting firm was reported in a Current Report on Form 8-K dated September 30, 2004.

PwC's reports on the consolidated financial statements of Castelle for the fiscal years 2002 and 2003 contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principle. In connection with its audits of Castelle's consolidated financial statements as of and for the fiscal years ended December 31, 2002 and 2003 and through September 24, 2004, there were no disagreements with PwC on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of PwC, would have caused PwC to make reference thereto in its reports on the consolidated financial statements for such years. During Castelle's fiscal years ended December 31, 2002 and 2003 and through September 24, 2004, there were no "reportable events," as that term is defined in Item 304(a)(1)(v) of Regulation S-K.

ITEM 9A. CONTROLS AND PROCEDURES

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to maintain "disclosure controls and procedures," which are defined to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to evaluate any change in our "internal control over financial reporting," which is defined as a process to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K and as of the periods affected by the restatement referred to elsewhere in this Form 10-K. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were not effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms due to the following:

(1) Through September 30, 2004, our historical classification of cost of service revenues did not conform to generally accepted accounting principles as such costs were classified as a component of sales and marketing expenses rather than as a component of cost of sales, due primarily to the fact that our internal financial reporting system did not track this information separately from certain sales and marketing expenses. This internal control deficiency that led to the errors in the historical classification of cost of service revenues is deemed to constitute a

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"material weakness" as defined by the Public Company Accounting Oversight Board's Auditing Standard No. 2.

(2) Through September 30, 2004, service revenues attributable to extended support contracts were overstated due to inadequate procedures in place to correctly recognize sales related to extended support contracts. The Company's independent registered public accounting firm, Grant Thornton LLP, has concluded that the internal control deficiency that led to the revenue recognition errors is

also a "material weakness" as defined by the Public Company Accounting Oversight Board's Auditing Standard No. 2.

Effective January 1, 2005, the Company established a cost center to separately capture the cost of service revenues as a component of cost of sales. During the first quarter of fiscal 2005, the Company also enhanced its internal accounting system and related controls to ensure that revenue relating to extended support contracts is recognized over the actual contract term.

In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

ITEM 9B. OTHER INFORMATION

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Identification of Directors

The information required by this Item concerning our directors is incorporated by reference from the sections captioned "Proposal 1: Election of Directors" contained in our definitive Proxy Statement (the "Proxy Statement"), related to our 2004 Annual Meeting of Shareholders to be filed by us with the Securities and Exchange Commission ("SEC") no later than April 30, 2005 or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2005.

Identification of Executive Officers

The information required by this Item concerning our executive officers is set forth in Part I of this Report.

Section 16(a) Beneficial Ownership Reporting Compliance

The information concerning compliance with Section 16(a) of the Exchange Act required by this Item is incorporated by reference to the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" contained in the Proxy Statement.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference to the section captioned "Executive Compensation" in the Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated by reference to the section captioned "Security Ownership of Certain Beneficial Owners and Management" contained in the Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

In October 2002, the Company engaged W.R. Hambrecht + Co. ("WRH + Co."), an investment bank, to manage our stock buyback program approved by the Board of Directors. Mr. Robert Hambrecht, a director of Castelle, is also a director of W.R. Hambrecht + Co. Through March 31, 2003, WRH + Co. had received an insignificant amount of compensation under this arrangement. There were no stock buyback activities from March 2003 through March 10, 2005.

Other information required by this Item is incorporated by reference from the sections captioned "Certain Transactions" and "Executive Compensation" contained in the Proxy Statement.

ITEM 14. PRINCIPAL AUDITOR FEES AND SERVICES

Information regarding principal auditor fees and service is set forth under "Ratification of Selection of Independent Auditors" in the Proxy Statement, which information is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1) Financial Statements

2) Financial Statement Schedules

The following financial statement schedule of Castelle for the years ended December 31, 2004, 2003 and 2002 is filed as part of this Form 10-K and should be read in conjunction with the Company's Financial Statements.

3) Additional Exhibits

In accordance with SEC Release No. 33-8212, Exhibits 32.1 and 32.2 are to be treated as "accompanying" this report rather than "filed" as part of the report.

31.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, executed by Scott C. McDonald, Chief Executive Officer and President of Castelle

31.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, executed by Paul Cheng, Chief Financial Officer of Castelle

32.1 Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Scott C. McDonald, Chief Executive Officer of Castelle

32.2 Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Paul Cheng, Chief Financial Officer of Castelle

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Schedules not listed above have been omitted because they are not applicable or are not required or because the required information is included in the Financial Statements or Notes thereto.

(b) Reports on Form 8-K

During the fourth quarter of 2004, Castelle filed a Form 8-K on October 27, 2004. Furnished under Item 12, "Results of Operations and Financial Condition", Castelle filed a press release regarding its financial results for its fiscal quarter ended September 30, 2004.

(c) Exhibits

		Incorporated by Reference		
Exhibit Number	Exhibit Description	Form	File No.	F
3.1	Registrant's Amended and Restated Articles of Incorporation.	SB-2/A	33-99628-LA-	
3.2	Registrant's Amended and Restated Bylaws.	10-K	000-22020	

4.1	Specimen Stock Certificate representing shares of Registrant's Common Stock.	SB-2/A	33-99628-LA-
10.1*	1995 Non-Employee Directors' Stock Option Plan, as amended, and form of Director Stock Option Agreement	SB-2/A	111-22020
10.2	Form of Indemnity Agreement between the Registrant and each of its directors and executive officers.	SB-2/A	33-99628-LA-
10.3	OEM Purchase Agreement dated May 23, 1995, by and between the Registrant and SerComm Corporation.	SB-2/A	33-99628-LA-
10.4	Distribution Agreement dated February 26, 1990, by and between the Registrant and Ingram Micro D Inc.	SB-2/A	33-99628-LA-
10.5	Distributor Contract dated June 25, 1991, as amended June 25, 1991, by and between the Registrant and Tech Data Corporation.	SB-2/A	33-99628-LA-
10.6	International Distributor Agreement dated February 24, 1994, by and between the Registrant and Macnica.	SB-2/A	33-99628-LA-
10.7*	1988 Equity Incentive Plan, as amended, and form of option agreement	S-8	333-75247
10.8	International Distributor Agreement dated April 24, 2001 by and between the Registrant and AMS Limited.	10-K	000-22020
10.9	Commercial Tenant Lease Agreement dated August 16, 2000 by and among the Registrant and Kyung S. Lee and Ieesun Kim Lee.	10-K	000-22020
10.10	First Amendment to Lease Agreement dated June 1, 2004 by and among the Registrant and by and between Kyung S. Lee and Ieesun Kim Lee.	10-Q	000-22020
10.11*	Summary of Severance Agreements with Named Executive Officers.	-	-
10.12	Employment agreement dated April 22, 2002 by and between the Registrant and Scott McDonald.	10-K	000-22020
10.13	Form of Executive Severance and Transition Benefits Agreement dated April 22, 2002 by and between the Registrant and Scott McDonald.	10-K	000-22020
10.14*	2002 Equity Incentive Plan.	10-K	000-22020
10.15	Loan and Security Agreement dated March 18, 1999 by and between the Registrant and Silicon Valley Bank.	10-K	000-22020
10.16	Loan Modification Agreement dated March 16, 2003 by and between the Registrant and Silicon Valley Bank.	10-K	000-22020

10.17	Loan Modification Agreement dated March 15, 2004 by and between the Registrant and Silicon Valley Bank.	10-K	000-22020

10.18	Loan and Security Agreement dated August 2, 2004 by and between the Registrant and Silicon Valley Bank.	10-Q	000-22020
23.1	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm		
23.2	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm		

* Indicates management contracts or compensatory plans or arrangements filed pursuant to Item 601(b)(10) of Regulation S-K

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, as amended, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized on the fifteenth day of April 2005.

By: /S/ SCOTT C. MCDONALD

Scott C. McDonald
President and Chief Executive Officer

KNOW BY ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Scott C. McDonald, as his true and lawful attorney-in-fact and agent, with full power of substitution for him, and in his name in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite and necessary to be done therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, and any of them, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Name	Title	Date
/S/ SCOTT C. MCDONALD Scott C. McDonald	President, Chief Executive Officer (principal executive officer) and Director	April 15, 2005
/S/ PAUL CHENG Paul Cheng	Vice President, Finance and Administration, Chief Financial Officer (principal accounting officer) and Secretary	April 15, 2005
/S/ DONALD L. RICH Donald L. Rich	Chairman of the Board	April 15, 2005
/S/ ROBERT H. HAMBRECHT Robert H. Hambrecht	Director	April 15, 2005
/S/ ROBERT O. SMITH Robert O. Smith	Director	April 15, 2005
/S/ PETER R. TIERNEY Peter R. Tierney	Director	April 15, 2005

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of Castelle

We have audited the accompanying balance sheet of Castelle and its subsidiary (the "Company") as of December 31, 2004 and the related statements of earnings, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Castelle and its subsidiary as of December 31, 2004 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We have also audited Schedule II for the year ended December 31, 2004. In our opinion, this schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information therein.

Grant Thornton LLP
San Francisco, California
March 3, 2005, except
for Note 3, as to which the
date is March 31, 2005

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Shareholders of Castelle

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Castelle and its subsidiary at December 31, 2003, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3, the Company has restated its financial statements for each of the two years in the period ended December 31, 2003

PricewaterhouseCoopers LLP
San Jose, California
March 29, 2004,
except for Note 3,
as to which the date is
April 13, 2005

Castelle
Consolidated Balance Sheets
(in thousands)

	December 31,	
	2004	2003
Assets		(Restat
Current assets:		
Cash and cash equivalents	$ 5,599	$ 4,
Accounts receivable, net	857	
Inventories	1,785	1,
Prepaid expenses and other current assets	130	
Deferred taxes	231	
Total current assets	8,602	7,
Property and equipment, net	203	
Other assets	50	
Deferred taxes	1,292	
Total assets	$ 10,147	$ 7,
Liabilities and Shareholders' Equity		
Current liabilities:		
Current portion of long-term debt	$ 15	$
Accounts payable	511	
Accrued liabilities	1,073	1,
Deferred revenue	1,253	
Total current liabilities	2,852	3,
Long-term debt, net of current portion	14	
Total liabilities	2,866	3,
Commitments and contingencies (Note 5)		
Shareholders' equity:		
Preferred stock, no par value:		
Authorized: 2,000 shares in 2004 and 2003		
Issued and outstanding: none in 2004 and 2003	--	
Common stock, no par value:		
Authorized: 25,000 shares		
Issued and outstanding: 3,799 shares at December 31, 2004 and 3,425 shares at December 31, 2003	27,668	27,
Accumulated deficit	(20,387)	(22,
Total shareholders' equity	7,281	4,
Total liabilities and shareholders' equity	$ 10,147	$ 7,

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Earnings
(in thousands, except per share data)

	Year Ended December 31		
	2004	2003	20
		(Restated)	(Rest
Net sales:			
Products	$ 8,011	$ 8,337	$
Services	2,446	1,843	
Total net sales	10,457	10,180	
Cost of sales:			
Products	2,556	2,485	
Services	826	726	
Total cost of sales	3,382	3,211	
Gross profit	7,075	6,969	
Operating expenses:			
Research and development	1,722	1,590	
Sales and marketing	2,486	2,398	
General and administrative	1,801	1,902	
Restructuring recovery	--	--	
	6,009	5,890	
Operating income	1,066	1,079	
Interest income, net	36	16	
Other income (expense), net	(50)	(26)	
Income before provision for (benefit from) income taxes	1,052	1,069	
Provision for (benefit from) income taxes	(1,067)	(537)	
Net income	$ 2,119	$ 1,606	$
Net income per common share - basic	$ 0.59	$ 0.49	$
Net income per common share - diluted	$ 0.48	$ 0.38	$
Shares used in per share calculation - basic	3,616	3,254	

Shares used in per share calculation - diluted	4,417	4,186	

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Shareholders' Equity
Years Ended December 31, 2004, 2003 and 2002
(in thousands)

	Common Stock		Deferred
	Shares	Amount	Compensation
Balances, December 31, 2001, restated	4,745	$ 28,977	$ (1)
Issuance of common stock through exercise of stock options	61	38	--
Repurchase and cancellation of common stock	(1,619)	(1,977)	--
Amortization of deferred compensation	--	--	1
Net income, as restated	--	--	--
Balances, December 31, 2002, restated	3,187	27,038	--
Issuance of common stock through exercise of stock options	285	268	--
Repurchase and cancellation of common stock	(47)	(48)	--
Net income, as restated	--	--	--
Balances, December 31, 2003, restated	3,425	27,258	--
Issuance of common stock through exercise of stock options	374	410	--
Net income	--	--	--
Balances, December 31, 2004	3,799	$ 27,668	$ --

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Cash Flows
Years Ended December 31, 2004, 2003 and 2002
(in thousands)

	Year Ended De	
	2004	200
Cash flows from operating activities:		(Restat
Net income	$ 2,119	$ 1
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	206	
Provision for doubtful accounts	(1)	
Allowance for sales returns and stock rotation	886	
Write-downs of excess and obsolete inventory	72	
Deferred taxes	(997)	
Compensation expense related to grant of stock options	--	
Loss on disposal of fixed assets	2	
Changes in assets and liabilities:		
Accounts receivable	(869)	
Inventories	(680)	
Prepaid expenses and other current assets	57	
Accounts payable	197	
Accrued liabilities	(663)	
Deferred revenue	297	
Net cash provided by operating activities	626	1
Cash flows from investing activities:		
Acquisition of property and equipment	(35)	
Net cash used in investing activities	(35)	
Cash flows from financing activities:		
Repayment of notes payable	(16)	
Repurchase of common stock	--	
Proceeds from issuance of common stock	410	
Net cash provided by (used in) financing activities	394	
Net increase (decrease) in cash and cash equivalents	985	1
Cash and cash equivalents, beginning of period	4,614	3
Cash and cash equivalents, end of period	$ 5,599	$ 4
Supplemental information:		
Cash paid during the period for:		
Interest	$ 5	$

The accompanying notes are an integral part of these financial statements.

Castelle
Notes to Consolidated Financial Statements

Throughout these notes to the financial statements, all referenced amounts reflect the balances and amounts on a restated basis with respect to fiscal 2003 and 2002.

1. Business and Organization of the Company

Castelle develops, manufactures, markets and supports office automation systems that allow organizations to easily implement faxing over local area networks and the Internet. Castelle's FaxPress and FaxPress Premier fax servers provide simple ways to integrate fax with email, desktop and back-end applications.

The Company distributes its products primarily through a two-tier domestic and international distribution network, with its distributors selling Castelle's products to value-added resellers, system integrators, e-commerce retailers and other resellers in the United States, Europe and the Pacific Rim. The Company also has relationships with selected original equipment manufacturers and sells software enhancements and upgrades directly to end-users.

The Company believes that its existing cash balances and anticipated cash flows from operations will be sufficient to meet its anticipated capital requirements for the next 12 months. If the Company has a need for additional capital resources, it may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third-party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for the Company's existing and new products, if any, and changes in technology in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in the Company not being able to achieve its long-term business objectives

In addition, because the Company is dependent on a small number of distributors for a significant portion of the sales of its products, the loss of any of the Company's major distributors or their inability to satisfy their payment obligations to the Company could have a significant adverse effect on the Company's business, operating results and financial condition. The Company's three largest distributors accounted for 51%, 57% and 56% of the Company's sales in 2004, 2003 and 2002, respectively. Customers accounting for more than 10% of net sales are presented in Note 9, Major Customers and Geographic Information

2. Summary of Significant Accounting Policies

Use of estimates in preparation of financial statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of consolidation

The consolidated financial statements include the accounts of Castelle and its wholly owned subsidiaries in the United States and the United Kingdom. All intercompany balances and transactions have been eliminated.

Financial instruments

Cash equivalents consist of highly liquid investments with original or remaining maturities of three months or less when purchased.

Carrying amounts of financial instruments consisting of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities included in the Company's financial statements approximate fair value due to their short maturities.

Concentrations of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables and cash equivalents. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers' financial condition. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other available information. Three customers accounted for 60%, 69% and 68% of accounts receivable at December 31, 2004, 2003 and 2002, respectively. The same three customers accounted for 51%, 57% and 56% of the Company's total sales in 2004, 2003 and 2002, respectively. Although the Company does not require collateral on accounts receivable arising from sales to large, well-established companies, it does require prepayments on certain sales to foreign and smaller companies.

With respect to cash equivalents, the Company has cash investment policies that limit the amount of credit exposure to any one issuer and restrict placement of these investments to issuers evaluated as creditworthy.

Inventories and related write-downs for excess and obsolete inventory

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market. We record write downs for excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based on assumptions about future product life-cycles, product demand and market conditions. If actual product life cycles, product demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

We have purchased approximately two years worth of end-of-life components to ensure a smooth supply of our FaxPress Products to our customers. Accordingly, our management reviews periodically the usage, supply and inventory levels of these parts to determine whether additional purchases or excessive inventory provisions are necessary. As of December 31, 2004, we have approximately $675,000 worth of end-of-life components on hand and we believe that most of these components will be utilized in the following two years, resulting in insignificant amounts of excessive inventory, or none at all.

Property and equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is provided using the straight-line method over the estimated useful lives of the respective assets, generally three to seven years. Amortization of leasehold improvements is provided on a straight-line basis over the life of the related asset or the lease term, if shorter. Gains and losses upon asset disposal are recognized in the year of disposition. Expenditures for replacements and betterments are capitalized, while expenditures for maintenance and repairs are charged against earnings as incurred.

Accounting for long-lived assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured by comparison of the carrying amount to undiscounted future net cash flows the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value.

Revenue recognition

We recognize revenue based on the provisions of Staff Accounting Bulletin No. 104 "Revenue Recognition," AICPA Statement of Position No. 97-2 ("SOP 97-2") "Software Revenue Recognition," as amended by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions," and Statement of Financial Accounting Standards ("SFAS") No. 48 "Revenue Recognition When Right of Return Exits."

The Company uses the residual method to recognize revenue when an agreement includes one or more elements to be delivered at a future date. If there is an undelivered element under the arrangement, the Company defers revenue based on vendor-specific objective evidence of the fair value of the undelivered element, as determined by the price charged when the element is sold separately. If vendor-specific objective evidence of fair value does not exist for all undelivered elements, the Company defers all revenue until sufficient evidence exists or all elements have been delivered.

Product revenue is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the fee is fixed and determinable; collection is probable; and returns can be reasonably estimated. If an acceptance period or other contingency exists, revenue is recognized upon satisfaction of the contingency, customer acceptance or expiration of the acceptance period. Shipment generally occurs and title and risk of loss is transferred when the product is delivered to a common carrier.

We enter into agreements with some of our distributors that permit limited stock rotation rights. These stock rotation rights allow the distributor to return products for credit but require the purchase of additional products of equal value. Customers who purchase products directly from us also have limited return rights, which expire 30 days from product shipment. Revenues subject to stock rotation or other return rights are reduced by our estimates of anticipated exchanges and returns.

Pursuant to our agreements with distributors, we also protect our distributors' exposure related to the impact of price reductions. Future price adjustments are estimated and accrued at the time of sale as a reduction in revenue.

We generally provide our distributors the opportunity to earn volume incentive rebates based on sales volume achieved during the fiscal quarter. These incentive rebates are accrued in the quarter incurred and recorded as a reduction in revenue.

We also provide co-op and market development funds to our distributors. These incentives are accrued at the time revenue is recognized and recorded as a reduction in revenue.

We offer a standard trade-in discount to all of our end-user customers under which the customer, upon trade-in of any previously purchased product, is entitled to a discount from our published price list on any product included in our current product offerings. We require our customers to physically return the previously purchased products to qualify for the trade-in discount. We account for the trade-in discount as a reduction of revenue at the time the product is traded in and a new product is purchased.

Payment terms to our distributors and customers are generally thirty days, cash in advance, or by credit card.

We evaluate product sales through our distribution channels and the related reserve requirement to establish an estimate for our sales returns reserve by reviewing detailed point-of-sales and on-hand inventory reports provided to us by our channel partners. Based on a combination of historical return experience, the sales activities to end-user customers by our channel partners and the level of inventories on hand at the channel partners, we determine our returns reserve at the end of each financial period, and increase or reduce the reserve balance accordingly.

We provide standard support to our customers for an initial period of sixty days, which includes advance swap of the defective hardware and software, bug fixes, software upgrades and technical support. In addition to standard support, we also offer our customers the option to purchase extended support at the time of product purchase or anytime thereafter. Extended support covers hardware and software for a period of one year. We have established vendor-specific objective evidence with respect to the fair value of the standard support contracts based on standalone sales and renewals of our one-year extended support contracts. The fair value of our sixty day support contracts included with product sales is determined by pro-rating the related one-year extended support contracts. We recognize revenue from extended support contracts ratably over the period of the contract.

Hardware is warranted for one year from the date of sale and is repaired free-of-charge. Provisions for estimated warranty costs are recorded at the time products are shipped as a charge to cost of sales. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should product failure rates, material usage or service delivery cost differ from our estimates, revision to the estimated warranty liability would be required, which could affect the amount of gross profit reported.

We do not sell software, which is incorporated into our hardware, separately, other than for our customers to purchase as an upgrade to their existing products when we announce a major release of the software.

Shipping and handling

Costs related to shipping and handling are included in cost of sales for all periods presented.

Advertising costs

Advertising costs, included in sales and marketing expenses, are expensed as incurred and were $219,000, $345,000 and $193,000 in 2004, 2003 and 2002, respectively.

Research and development expenses

Costs related to the conceptual formulation and design of both hardware and software products are expensed as research and development while costs incurred subsequent to establishing technological feasibility of software products are capitalized until general release of the product. Generally, technological feasibility is established upon completion of a working model. No significant costs subsequent to such point have been incurred, and all such costs have been expensed.

Income taxes

The Company accounts for income taxes in accordance with the liability method. Under the liability method, deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The provision for income taxes is comprised of the current tax liability and the change in deferred tax assets and liabilities. The Company establishes a valuation allowance to the extent that all or some portion of the deferred tax assets more likely than not will not be recoverable against future taxable income.

Foreign currency translation

The functional currency of the Company's foreign subsidiary is the U.S. dollar. Accordingly, all assets and liabilities are translated into U.S. dollars at the current exchange rates as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rates prevailing during the period. Cumulative gains and losses from the translation of the foreign subsidiaries' financial statements have not been material to date. Foreign exchange gains and losses resulting from foreign currency transactions were not material in any of the periods presented.

Net income per share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for that period. Diluted net income per share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential shares consist of incremental common shares issuable upon exercise of stock options.

Basic and diluted net income per share are calculated as follows (in thousands except per share amounts):

	2004	2003	2
Basic:		(Restated)	(Res
Weighted average shares	3,616	3,254	
Net income	$ 2,119	$ 1,606	$
Net income per share	$ 0.59	$ 0.49	$
Diluted:			
Weighted average shares	3,616	3,254	
Common equivalent shares from stock options	801	932	
Shares used in per share calculation	4,417	4,186	
Net income	$ 2,119	$ 1,606	$

Net income per share	$ 0.48	$ 0.38	$

The calculation of diluted shares outstanding excludes 123,000, 120,000, and 1,153,000 shares of common stock for the years ended December 31, 2004, 2003, and 2002 respectively, as their effect was antidilutive in the period.

Stock-Based Compensation

The Company accounts for its stock-based compensation plans using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Compensation cost for stock options, if any, is measured by the excess of the quoted market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock. SFAS No. 123, "Accounting for Stock-Based Compensation," established accounting and disclosure requirements using a fair-value based method of accounting for stock-based employee compensation plans.

Had compensation costs been determined consistent with SFAS No. 123, the Company's net income would have been changed to the amounts indicated below for the years ended December 31 (in thousands, except per share data):

	2004	2003 (Restated)
Net income - as reported	$ 2,119	$ 1,606
Fair value of stock-based compensation	(520)	(433)
Net income - pro forma	$ 1,599	$ 1,173
Net income per share - basic - as reported	$ 0.59	$ 0.49
Net income per share - diluted - as reported	$ 0.48	$ 0.38
Net income per share - basic - pro forma	$ 0.44	$ 0.36
Net income per share - diluted - pro forma	$ 0.36	$ 0.28

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Castelle
Notes to Consolidated Financial Statements

The Company accounts for stock-based compensation arrangements with non-employees in accordance with Emerging Issues Task Force ("EITF") Abstract No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. Accordingly, unvested options held by non-employees are subject to revaluation at each balance sheet date based on the then current fair market value.

Comprehensive income

Comprehensive income is the change in equity from transactions and other events and circumstances other than those resulting from investments by owners and distributions to owners. There are no significant components of comprehensive income excluded from net income, and therefore, no separate statement of comprehensive income has been presented.

Segment information

The Company uses one measurement of profitability of its business for internal purposes and has determined that it operates in one business segment: server appliances. The Company's sales by geographic area are included in Note 9.

Recent accounting pronouncements

In December 2003, the FASB issued a revised FASB interpretation No. 46 (FIN 46R), "Consolidation for Variable Interest Entities, an interpretation of ARB No. 51" The FASB published the revision to clarify and amend some of the original provisions of FIN 46, which was issued in January 2003, and to exempt certain entities from its requirements. A variable interest Entity refers to an entity subject to consolidation according to the provisions of the Interpretation. FIN 46R applies to entities whose equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support provided by any parties, including equity holders, or where the equity investors (if any) do not have a controlling financial interest. FIN 46R provides that if an entity is the primary beneficiary of a VIE, the assets, liabilities, and results of operations of the VIE should be consolidated in the entity's financial statements. In addition, FIN 46R requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE provide additional disclosures. The provisions of FIN 46R were effective for the Company's fiscal 2004 first quarter. The adoption of FIN 46R did not have a material impact on the Company's financial position or results of operations.

In March 2004, the FASB issued EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which provides new guidance for assessing impairment losses on debt and equity investments. Additionally, EITF Issue No. 03-1 includes new disclosure requirements for investments that are deemed to be temporarily impaired. In September 2004, the FASB delayed the accounting provisions of EITF Issue No. 03-1; however, the disclosure requirements remain effective. The Company does not expect the adoption of EITF 03-1 to have a material impact on our financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," a revision of SFAS No. 123, "Accounting for Stock-Based Compensation" and superseding APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS No. 123R requires the Company to expense grants made under the Company's stock option program. That cost will be recognized over the vesting period of the grants. SFAS No. 123R is effective for interim periods beginning after June 15, 2005.. The Company is evaluating the alternatives allowed under the standard, which the Company is required to adopt effective for its third quarter of fiscal 2005.

In December 2004, the FASB issued Staff Position SFAS No. 109-1, Application of FASB Statement No. 109, Accounting for Income Taxes (FSP No. 109-1) to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004 which was signed into law by the President of the United States on October 22, 2004. Companies that qualify for the recent tax law's deduction for domestic production activities must account for it as a special deduction under SFAS No. 109 and reduce their tax expense in the period or periods the amounts are deductible, according to FSP No. 109-1, effective for the Company in fiscal year 2005. The FASB's guidance is not expected to have a material impact to the Company's financial results.

3. Restatement of Previously Issued Financial Statements

In March and April 2005, the Company conducted a review of its accounting practices with respect to the historical classification of cost of service revenues, procedures for recognizing revenue associated with extended support contracts and procedures for establishing the accrual for paid-time-off, and determined that its historical financial statements as of and for the years ended December 31, 2003 and 2002 contained certain errors in the application of generally accepted accounting principles as described below:

o Classification of cost of service revenues

The Company has concluded that its historical classification of cost of service revenues did not conform to generally accepted accounting principles. Historically, such costs were improperly included as a component of sales and marketing expenses on the Company's consolidated statements of earnings; however under generally accepted accounting principles, such costs are required to be classified as cost of service revenues. Accordingly, the accompanying consolidated statements of earnings for the years ended December 31, 2003 and 2002 reflect the reclassification of $729,000 and $711,000, respectively, out of sales and marketing and into cost of service revenues. The reclassifications had no impact on previously reported sales, net income, earnings per share or cash flows from operations for the respective periods. The misclassification, however, did result in cost of sales being understated, and gross profit and operating expenses being overstated by equal amounts.

o Revenue recognition related to extended support contracts

The Company has determined that service revenues attributable to extended support contracts were overstated by approximately $34,000 and $39,000 for the years ended December 31, 2003 and 2002, respectively. These amounts should have been deferred and recognized as service revenues in subsequent periods. Accordingly, the accompanying consolidated statements of earnings for the years ended December 31, 2003 and 2002 reflect reductions to previously reported service revenues of $34,000 and $39,000, respectively. The error that led to these revenue overstatements in 2003 and 2002 also affected 2001, resulting in revenue being understated in 2001. Consequently, opening retained earnings as of January 1, 2002 have been adjusted to reflect the impact of the error on 2001. This adjustment decreased previously reported accumulated deficit by $27,000 with a corresponding decrease to deferred revenue. The accompanying balance sheets reflect the aggregate impact of the restatement adjustments on deferred revenue as of the periods presented.

- Accrual for paid-time off

  The Company has also determined that its accrual for paid-time-off was overstated as of December 31, 2003 and 2002. This error resulted in the overstatement of expenses by $7,000 and $15,000 for the years ended December 31, 2003 and 2002, respectively. Accordingly, the accompanying consolidated statements of earnings for the years ended December 31, 2003 and 2002 reflect reductions to previously reported operating expenses of $7,000 and $15,000, respectively. The accompanying balance sheets reflect the aggregate impact of the restatement adjustments on accrued liabilities as of the periods presented.

The following tables set forth the previously reported amounts and the restated amounts reflected in the accompanying financial statements:

Castelle
Reconciliation of Statements of Earning
(amounts in thousands, except per share d

	Year-ended December 31, 2003 as previously reported	adjustments	Year-ended December 31, 2003 as restated	Year-ended December 31, 2002 as previously reported
Sales:				
Products	$ 8,337	--	$ 8,337	$ 8,617
Services	1,877	(34)	1,843	1,142
Net sales	10,214	(34)	10,180	9,759
Cost of sales:				
Products	2,485	--	2,485	2,836
Services	--	726	726	--
Total cost of sales	2,485	726	3,211	2,836

Gross Profit	7,729	(760)	6,969	6,923
Operating expenses:				
Research and development	1,590	--	1,590	1,383
Sales and marketing	3,131	(733)	2,398	3,016
General and administrative	1,902	--	1,902	1,943
Restructuring charges	--	--	--	(40)
Total operating expenses	6,623	(733)	5,890	6,302
Operating income	1,106	(27)	1,079	621
Other income (expense), net	(10)	--	(10)	44
Income before provision for (benefit from) income taxes	1,096	(27)	1,069	665
Provision for (benefit from) income taxes	(537)	--	(537)	6
Net income	$ 1,633	(27)	$ 1,606	$ 659
Net income per common share:				
Basic	$ 0.50	($0.01)	$ 0.49	$ 0.15
Diluted	$ 0.39	($0.01)	$ 0.38	$ 0.14

Castelle
Summary of Adjustments to Consolidated Balanc
(amounts in thousands)

	December 31, 2003 as previously reported	Restatement adjustments	December 31, 2003 as restated	December 31 2002 as previousl reported
Balance sheet accounts:				
Current liabilities:				
Accrued liabilities	$ 1,759	($22)	$ 1,737	$ 1,696
Deferred revenue	909	46	955	592
Total current liabilities	2,998	24	3,022	2,668
Total liabilities	3,027	24	3,051	2,712
Accumulated deficit	(22,482)	(24)	(22,506)	(24,115)
Total shareholders' equity	4,776	(24)	$ 4,752	$ 2,923
Total liabilities and				

shareholders' equity	$ 7,803	--	$ 7,803	$ 5,635

4. Balance Sheet Detail (in thousands)

Accounts Receivable, net:

	December 31, 2004	December 31, 2003
Accounts receivable	$ 1,295	$ 1,354
Less: allowance for sales returns	(408)	(442)
Less: allowance for doubtful accounts	(30)	(39)
Total accounts receivable, net	$ 857	$ 873

Inventories:

	December 31, 2004	December 31, 2003
Raw materials	$ 1,202	$ 610
Work in process	118	--
Finished goods	465	567
Total inventories	$ 1,785	$ 1,177

Property and equipment:

	December 31, 2004	December 31, 2003
Production, test and demonstration equipment	$ 422	$ 420
Computer equipment	1,151	1,175
Office equipment	105	100
Leasehold improvements	446	442
	2,124	2,137
Less accumulated depreciation and amortization	(1,921)	(1,761)

Total property and equipment	$ 203	$ 376

The Company recorded depreciation and amortization related to property and equipment of $206,000, $213,000 and $206,000 in 2004, 2003 and 2002, respectively.

As of December 31, 2004 and 2003, the Company had $75,000 and $100,000, respectively, of equipment under capital leases. Accumulated amortization associated with these capital leases was $61,000 and $65,000 at December 31, 2004 and 2003, respectively.

Accrued liabilities:

	December 31, 2004	December 31, 2003
		(Restated)
Accrued compensation	$ 429	$ 462
Accrued sales and marketing	123	378
Accrued professional fees	73	136
Other accruals	448	761
Total accrued liabilities	$ 1,073	$ 1,737

5. Commitments and Contingencies

Lease Commitments

The Company has entered into a noncancelable operating lease that expires in 2009 and other capital leases that expire at various dates ending in 2006, and is responsible for certain maintenance costs, taxes and insurance under the leases. The lease on the Company's headquarters facility was extended for a term of five years commencing on June 1, 2004 and expiring on May 31, 2009, with one conditional three-year renewal option, which if exercised, would extend the lease to May 31, 2012 commencing with rent at ninety-five percent of fair market value. Future minimum payments under noncancelable operating leases are as follows (in thousands):

Year Ending December 31,	
2005	$ 207
2006	207
2007	207
2008	207
2009	87

	$ 915

Rent expense, including the facility lease and equipment rental, was $162,000 $288,000, and $298,000, for 2004, 2003 and 2002, respectively.

The Company leases certain of its equipment under various capital leases that expire at various dates through 2006. The lease agreements frequently include renewal and escalation clauses and purchase provisions and require the Company to pay taxes, insurance and maintenance costs. As of December 31, 2004, the Company had a loan and security agreement of $32,000, which is subject to an interest rate of 12.8%. As of December 31, 2004, future minimum lease payments are as follows (in thousands):

Year Ending December 31,	
2005	18
2006	14
Total minimum lease payments	32
Less amount representing interest	(3)
Present value of capital lease obligations	29
Less current portion	(15)
Long-term portion of capital lease obligations	$ 14

Product Warranties and Guarantor Arrangements

We offer warranties on certain products and record a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and our estimate of the level of future costs. Warranty costs are reflected in the Statement of Earnings as a Cost of Sales. If actual warranty costs are different from our estimated costs, or if the warranty claims were to be significantly higher than our historical experience, then revisions to the estimated warranty liability may be required and the warranty expense could change from current levels. A

reconciliation of the changes in our warranty liability during the periods presented is as follows (in thousands):

	December 31, 2004	December 31, 2003
Warranty accrual at the beginning of the year	$ 24	$ 34
Accruals for warranties issued during the year	2	15
Settlements made in kind during the year	(13)	(25)
Warranty accrual at the end of the year	$ 13	$ 24

As permitted under California law, the Company has agreements whereby the Company indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer insurance policy that limits the Company's exposure and enables the Company to recover a portion of any future amounts paid. As a result of the Company's insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal.

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company's business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to the Company's products. The term of these indemnification agreements is generally perpetual following execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements.

6. Bank Borrowings

On August 2, 2004, we secured from Silicon Valley Bank a new revolving line of credit to replace the previous credit facility. The new revolving line of credit provides for borrowings of up to $4.0 million and has a one-year term. Borrowings under this line of credit agreement are collateralized by all of our assets and bear interest at the bank's prime rate plus 0.50%. Under the new facility we are required to maintain certain minimum cash and investment balances with the bank and meet certain other financial covenants. As of December 31, 2004, we have not drawn down on the line of credit and were in compliance with the terms of the agreement.

7. Common Stock

Stock Repurchase Program

In the fourth quarter of 2002, the Company's Board of Directors authorized the Company, from time to time, to repurchase at market prices, up to $2.25 million of its common stock for cash in open market, negotiated or block transactions. The timing of such transactions will depend on market conditions, other corporate strategies and will be at the discretion of the management of

the Company. No time limit was set for the completion of this program. At the time of the approval by the Board of Directors, the Company had approximately 4.8 million shares of common stock outstanding. During the fourth quarter of 2002, the Company repurchased from open market and negotiated transactions a total of approximately 1.62 million shares for approximately $1.8 million, at an average per share price of $1.10. During the first quarter of 2003, the Company repurchased from open market transactions a total of 46,500 shares for $48,000, at an average per share price of $1.04. The Company has not repurchased any of its common stock since then. The Company intends to continue to execute its buyback program as it deems necessary.

2002 Equity Incentive Plan

In December 2002, the shareholders of the Company approved the adoption of the 2002 Equity Incentive Plan ("2002 Plan"). A total of 850,000 shares of common stock have been reserved for issuance under the 2002 Plan. The 2002 Plan provides for awards to employees, directors, consultants and independent advisors. The adoption of the 2002 Plan was necessitated by the use or expiration of all but an insignificant amount of authorized shares under the prior option plans, (the 1995 Non-employee Directors' Stock Option Plan ("Directors Plan") and the 1988 Incentive Stock Plan ("1988 Plan")). Under the 2002 Plan, the Board of Directors may grant either the right to purchase shares or options to purchase shares of the Company's common stock at prices not less than the fair market value at the date of grant for incentive stock options and 85% of the fair market value at the date of grant for non-qualified options and purchase rights. Options granted under the 2002 Plan as well as those granted under the prior option plans generally become exercisable, and the Company's right to repurchase shares issued and sold pursuant to stock purchase rights generally lapses, at a rate of one-quarter of the shares under option or purchased under stock purchase rights at the end of the first year and thereafter ratably over the next three years. Awards under the 2002 Plan and the prior option plans generally expire seven years from the date of grant. No additional option grants will be made under any prior option plan. As of December 31, 2004, 400,205 options have been granted under the 2002 Plan, while 903,000 options are outstanding under the prior plans.

The following table summarizes option activity under the Company's stock option plans (in thousands):

		Outstanding Options	
	Available for Grant	Number Outstanding	Weighted Average Exercise Price
Balances, January 1, 2002	275	1,404	$ 1.08
Options granted	(405)	405	$ 0.71
Options cancelled	151	(175)	$ 1.08
Options expired	(21)	--	
Options exercised	--	(61)	$ 0.63

Balances, December 31, 2002	--	1,573	$ 1.00
Additional shares reserved	850	--	
Options granted	(305)	305	$ 2.94
Options cancelled	1	(3)	$ 2.05
Options exercised	--	(285)	$ 0.94
Balances, December 31, 2003	546	1,590	$ 1.38
Options granted	(96)	96	$ 3.45
Options cancelled	10	(19)	$ 1.92
Options exercised	--	(374)	$ 1.10
Balances, December 31, 2004	460	1,293	$ 1.61

At December 31, 2004, 2003 and 2002, 993,000, 1,078,000, and 1,087,000 options, respectively, were exercisable at a weighted average exercise price of $1.34, $1.15 and, $1.10, respectively.

Options to purchase common stock outstanding and currently exercisable by exercise price at December 31, 2004, are as follows (in thousands, except years and per share data):

Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.00-$0.50	10	4.3	$0.34	10	$0.34
$0.51-$0.75	226	4.1	$0.70	164	$0.70
$0.76-$1.00	436	3.2	$0.91	425	$0.91
$1.01-$1.25	88	3.6	$1.12	88	$1.12
$1.26-$1.50	67	2.0	$1.33	66	$1.33
$1.51-$1.75	40	0.7	$1.60	40	$1.61
$1.76-$2.00	30	5.2	$1.94	30	$1.94
$2.00-$2.50	37	4.9	$2.38	20	$2.38
$2.51-$3.00	172	5.8	$2.77	100	$2.78
$3.01-$5.00	187	6.4	$3.45	50	$3.86
	1,293	4.2	$1.61	993	$1.34

The fair value of each option grant is estimated on the date of grant using the Black-Scholes model with the following assumptions for 2004, 2003 and 2002:

	2004	2003	2002
Risk-free interest rate	3.68%-4.73%	3.32%-4.48%	3.86%-5.43%
Expected life	4.7 years	4.1 years	6.9 years
Expected dividends	-	-	-
Volatility	192%	201%	146%

The weighted average fair value of options granted in 2004, 2003 and 2002 was $3.45, $2.95, and $0.71 per share, respectively.

Option Grants to Non-employees

In addition to the options granted under the plans detailed above, Castelle has granted options to purchase common stock to consultants under special arrangements.

There were no grants to non-employees in 2002, 2003, or 2004. Under EITF 96-18, the unvested options are revalued at each balance sheet date to reflect their current fair value. Compensation expense is reflected in results of operations over the vesting period. In connection with its grant of options to non-employees, the Company recorded charges of $1,000 in 2002 and nothing in 2003 or 2004.

Options to purchase 27,000, 27,000, and 33,000 shares of common stock were held by non-employees at December 31, 2004, 2003 and 2002, respectively, of which 27,000, 27,000, and

33,000 were exercisable for aggregate total exercise proceeds of $44,000, $44,000, and $50,000, respectively.

8. Income Taxes

The provision (benefit) for income taxes is as follows (amounts in thousands).

	Year Ended December 31, 2004	2003	
Current			
Federal	$ (70)	$ 5	
State	1	1	
Total Current	$ (69)	$ 6	$
Deferred			
Federal	$ (849)	$ (464)	

State	(149)	(79)	
Total Deferred	$ (998)	$ (543)	
Total provision (benefit) for income taxes	$ (1,067)	$ (537)	$

The Company's tax provision (benefit) differs from the provision computed using statutory income tax rates as follows (in thousands):

	2004	2003	
Federal tax provision at statutory rate	$ 353	$ 386	$
Permanent difference due to non-deductible expenses	10	12	
State tax provision, net of federal benefit	39	1	
Utilization of net operating loss carryovers	(33)	(187)	
Change in valuation allowance	(1,436)	(689)	
General business credits	--	(60)	
	$ (1,067)	$ (537)	$

The components of the net deferred tax assets are as follows (in thousands):

	December 31,	
	2004	2003
Inventory allowances and adjustments	$ 72	$ 77
Accounts receivable allowances	12	16
Other liabilities and allowances	369	526
Net operating loss carryforwards	4,538	4,584
Tax credit carryforwards	1,633	1,615
Depreciation and amortization	478	396
Valuation allowance	(5,579)	(6,688)
Total net deferred tax assets	$ 1,523	$ 526

Significant management judgment is required in determining the provision for income taxes, and in particular, any valuation allowance recorded against the Company's deferred tax assets. During 2004 and 2003, the Company recorded tax benefits of $1,067,000 and $537,000, respectively. This portion of the valuation allowance was reversed because the Company determined that it was more likely than not that certain future tax benefits will be realized as a result of projected future income.

At December 31, 2004, the Company had net operating loss carryforwards of approximately $12,955,000 and $2,296,000 available to offset future federal and California taxable income, respectively. These loss carryforwards will expire in varying amounts beginning in 2005 through 2021. In addition, at December 31, 2004, the Company had federal and California Research and Development credit carryforwards of approximately $1,152,000 and $728,000, respectively. The federal Research and Development credits expire in varying amounts beginning in 2007. The California Research and Development credits carry-forward indefinitely.

For federal and state income tax purposes, the amount of benefit from the Company's net operating loss and credit carryforwards may be impaired or limited if the Company incurs a cumulative ownership change of more than 50%, as defined, over a three year period.

The Company's profit before provision for income taxes for all periods presented was derived substantially from domestic operations.

9. Retirement Plan

The Company has a voluntary 401(k) plan covering substantially all employees. The plan provides for employer contributions at the discretion of the Board of Directors. In 2004, 2003 and 2002, the Company made no contributions to the plan.

10. Major Customers and Geographic Information

Revenues by geographic area are determined by the location of the customer and are summarized as follows (in thousands):

	Year Ended December 31,		
	2004	2003	
		(Restated)	(
United States	$ 8,574	$ 8,222	$
Europe	785	704	
Pacific Rim	804	883	
Rest of Americas, excluding United States	294	371	
Total revenues	$ 10,457	$ 10,180	$

Customers that individually accounted for greater than 10% of net sales are as follows (in thousands):

Year Ended December 31,

Customer	2004 Amount	2004 Percentage	2003 Amount	2003 Percentage	2002 Amount	2002 Perce
A	$ 2,186	21%	$ 2,200	22%	$ 2,657	
B	$ 2,451	23%	$ 2,899	28%	$ 2,257	

11. Restructuring

In the second quarter of 2002, a non-recurring benefit of $40,000 arising from the reversal of a portion of the previously recorded restructuring charge was included in the results of operations, following the completion of the Company's 2001 restructuring program for less than previously anticipated.

12. Litigation

From time to time and in the ordinary course of business, the Company is involved in various legal proceedings and third party assertions of patent or trademark infringement claims against the Company in the form of letters and other forms of communication. The Company is not currently involved in any litigation which, in management's opinion, would have a material adverse effect on its business, operating results, cash flows or financial condition; however, there can be no assurance that any such proceeding will not escalate or otherwise become material to the Company's business in the future.

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Supplemental Financial Information

Supplemental Data (unaudited)

The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related Notes thereto included elsewhere in this Annual Report on Form 10-K.

Quarterly Results of Operations (unaudited)

The following table sets forth certain consolidated quarterly financial data for the eight quarters ended December 31, 2004. This information is unaudited, but in our opinion, has been prepared on the same basis as the audited consolidated financial statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the unaudited interim results. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

The consolidated quarterly financial data presented below reflects the restatement of the periods through September 30, 2004 to reflect the adjustment for certain errors noted by the Company during the fourth quarter of fiscal 2004. For a description of the restatement items and the effect on annual periods for fiscal 2003 and 2002, see Note 3 to the Company's consolidated financial statements.

	Year 2004, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
	(Restated)	(Restated)	(Restated)	
Net sales (1)	$2,539	$2,691	$2,685	$2,542
Gross profit (2)	1,702	1,883	1,804	1,686
Operating income (3)	228	272	236	330
Net income (4)	129	146	130	1,714(5)
Net income per share, basic (4)	0.04	0.04	0.04	0.46(5)
Net income per share, diluted (4)	0.03	0.03	0.03	0.39(5)

(1) Net sales in the 2004 quarters ended March 31, June 30 and September 30 have been restated to reduce service revenues by $19,000, $26,000 and $13,000, respectively, as compared to previously reported net sales in relation to the extended support contract adjustments.

(2) Gross profit and operating expenses for the quarters ended March 31, June 30 and September 30, 2004 have been restated to reduce such balances by equal amounts of $198,000, $216,000 and $207,000, respectively, as compared to previously reported amounts, as a result of the reclassification of cost of service revenues from operating expenses to cost of sales.

(3) Operating income for the quarters ended March 31, June 30, and September 30, 2004 has been increased by an additional $1,000 in each of the three quarters, as compared to previously reported amounts to correct the overstatement of the Company's paid-time-off accrual.

(4) The restatement adjustments referred to above reduced previously reported net income by $18,000, $25,000 and $12,000 in 2004 for the quarters ended March 31, June 30 and September 30, respectively. Both basic and diluted net income per share as restated decreased by $0.01 for the quarter ended June 30 as compared to the amounts previously reported. Basic and diluted net income per share as restated did not change from the amounts previously reported in 2004 for the quarters ended March 31 and September 30.

(5) Includes a non-cash tax benefit of $1.4 million, or $0.37 per basic share, and $0.31 per diluted share, resulting from the release of a portion of our tax valuation allowance.

Year 2003, Quarter Ended			
Mar 31	Jun 30	Sep 30	Dec 31

	(Restated)	(Restated)	(Restated)	(Restated)
	(in thousands, except per share data)			
Net sales(1)	$2,495	$2,501	$2,561	$2,623
Gross profit(2)	1,626	1,752	1,814	1,777
Operating income(3)	252	232	238	357
Net income(4)	239	220	238	909(5
Net income per share, basic(4)	0.07	0.07	0.07	0.27(5
Net income per share, diluted(4)	0.06	0.05	0.05	0.21(5

(1) Net sales in the 2003 quarters ended March 31, June 30, September 30 and December 31 have been restated to reflect the reduction of service revenues by $5,000, $10,000, $5,000 and $14,000, respectively, as compared to previously reported amounts in relation to the extended support contract adjustments.

(2) Gross profit and operating expenses for the quarters ended March 31, June 30, September 30 and December 31, 2003 have been restated to reduce such balances by equal amounts of $172,000, $177,000, $193,000 and $187,000, respectively, as compared to previously reported amounts, as a result of the reclassification of cost of service revenues from operating expenses to cost of sales.

(3) Operating income has been increased by $1,000 in the quarter ended March 31, 2003 and $2,000 in each of the remaining quarters of 2003, as compared to previously reported amounts, to correct the overstatement of the Company's paid-time-off accrual.

(4) The restatement adjustments referred to above reduced previously reported net income by $4,000, $8,000, $3,000 and $12,000 for the quarters ended March 31, June 30, September 30 and December 31, respectively. Basic net income per share as restated decreased by $0.01 for the quarter ended March 31 and did not change for the quarters ended June 30, September 30 or December 31, as compared to the amounts previously reported. Diluted net income per share as restated decreased by $0.01 for the quarters ended June 30 and September 30 and did not change for the quarters ended March 31 or December 31, as compared to amounts previously reported.

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Supplemental Financial Information

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(5) Includes a non-cash tax benefit of $526,000, or $0.16 per basic share, and $0.12 per diluted share, resulting from the release of a portion of our tax valuation allowance.

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Valuation and Qualifying Accounts
(in thousands)

	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductio
Year Ended December 31, 2002:			
Deducted from asset accounts:			
Allowance for doubtful accounts	$ 96	$ (21)	$
Allowance for sales returns and stock rotation	$ 630	$ 660	$ (6
Valuation allowance for deferred tax asset	$ 7,946	$ --	$ (2
Year Ended December 31, 2003:			
Deducted from asset accounts:			
Allowance for doubtful accounts	$ 70	$ 5	$ (
Allowance for sales returns and stock rotation	$ 634	$ 524	$ (7
Valuation allowance for deferred tax asset	$ 7,689	$ --	$ (1,0
Year Ended December 31, 2004:			
Deducted from asset accounts:			
Allowance for doubtful accounts	$ 39	$ (1)	$
Allowance for sales returns and stock rotation	$ 442	$ 886	$ (9
Valuation allowance for deferred tax asset	$ 6,688	$ --	$ (1,1

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Exhibit Number	Description
10.11	Summary of Severance Agreement with Named Executive Officers
23.1	Consent of Independent Registered Public Accounting Firm - Grant Thornton LLP
23.2	Consent of Independent Registered Public Accounting Firm - PricewaterhouseCoopers LLP
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer
32.1	Certification Pursuant to 8 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer
32.2	Certification Pursuant to 8 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer