LANTRONIX INC
Form 10-K/A
October 12, 2004

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

FORM 10-K/A
AMENDMENT NO. 2

(MARK ONE)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED JUNE 30, 2004

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

FOR THE TRANSITION PERIOD FROM ________ TO ________

COMMISSION FILE NUMBER 1-16027

LANTRONIX, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	33-0362767
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

15353 BARRANCA PARKWAY, IRVINE, CALIFORNIA 92618
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

(949) 453-3990
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
COMMON STOCK, $0.0001 PAR VALUE	THE NASDAQ MARKET

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 definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes [ ] No [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

The aggregate market value of the registrant's Common Stock held by non-affiliates based upon the closing sales price of the Common Stock on December 31, 2003, as reported by the Nasdaq National Market, was approximately $31,192,000. Shares of Common Stock held by each current executive officer and director and by each person who is known by the registrant to own 5% or more of the outstanding Common Stock have been excluded from this computation in that such persons may be deemed to be affiliates of the registrant. Share ownership information of certain persons known by the registrant to own greater than 5% of the outstanding common stock for purposes of the preceding calculation is based solely on information on Schedule 13G filed with the Commission and is as of December 31, 2003. This determination of affiliate status is not a conclusive determination for other purposes.

As of August 31, 2004, there were 58,154,919 shares of the Registrant's common stock outstanding.

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EXPLANATORY NOTE

Amendment No. 2

This Amendment No. 2 to Form 10-K corrects cover page clerical error, changing FOR THE FISCAL YEAR ENDED JUNE 30, 2003 to FOR THE FISCAL YEAR ENDED JUNE 30, 2004.

Amendment No. 1

This Amendment to our annual report on Form 10-K for the year ended June 30, 2004 filed on September 28, 2004 is being filed for the purposes of (i) revising the total operating expenses for the 2000 Income Statement on page 15 from $21,826 to $21,836, and the working capital amount for 2002 on page 16 from $39,164 to $40,317 (ii) revising the percent variance in the gross profit table on page 22 from 8.5% to 81.8% (iii) revising the liquidity and capital resources section on page 30 to reflect a change in the decrease in contract manufacturer receivable from $745,000 to $777,000 (iv) revising the Consolidated Statement of Cash Flows amortization of purchased intangible assets and impairment of goodwill and purchased intangible assets for 2002 and the supplemental disclosure of income taxes paid for 2004 on page F-5 (v) revising the property and equipment table for 2003 on page F-14 (vi) revising the June 30, 2003 note receivable from officers on page F-14 from $110,000 to $104,000 (vii) revising the stock based compensation amount for year ended June 30, 2003 on page F-22 from $1.3 million to $1.5 million (viii) revising the income tax reconciliation table on page F-24 and (ix) revising Schedule II for years ended June 30, 2003 and 2004 on page S-2.

In connection with these amendments, we are including the certifications required by (i) 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, and (ii) Rule 13a-15(e) and 15d-15(e) promulgated pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, as exhibits 32.1, 31.1, 31.2, respectively. We have included the document in its entirety in this Amendment No. 1 to Form 10-K to reflect such changes.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the Lantronix, Inc. Annual Meeting of Stockholders scheduled to be held on November 18, 2004 are incorporated by reference into Part II and Part III of this Amendment No. 1 to Form 10-K ("Form 10-K").

Certain exhibits filed in connection with the Lantronix, Inc. Registration Statement on Form S-1, originally filed May 19, 2000, and Registration Statement on Form S-1, originally filed June 14, 2001, are incorporated by reference into Part IV of this Form 10-K.

LANTRONIX, INC.
ANNUAL REPORT ON FORM 10-K/A
Amendment No. 1
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

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FORWARD-LOOKING STATEMENTS

THIS DOCUMENT CONTAINS STATEMENTS THAT ARE NOT HISTORICAL FACTS BUT ARE FORWARD-LOOKING STATEMENTS RELATING TO SUCH MATTERS AS ANTICIPATED FINANCIAL PERFORMANCE, BUSINESS PROSPECTS, TECHNOLOGICAL DEVELOPMENTS, NEW PRODUCTS, ENGINEERING AND DEVELOPMENT ACTIVITIES AND SIMILAR MATTERS. SUCH STATEMENTS ARE GENERALLY IDENTIFIED BY THE USE OF FORWARD-LOOKING WORDS AND PHRASES, SUCH AS "INTENDED," "EXPECTS," "ANTICIPATES" AND "IS (OR ARE) EXPECTED (OR ANTICIPATED)." THESE FORWARD-LOOKING STATEMENTS INCLUDE BUT ARE NOT LIMITED TO STATEMENTS CONCERNING INDUSTRY TRENDS, ANTICIPATED DEMAND FOR OUR PRODUCTS, THE IMPACT OF PENDING LITIGATION, OUR STRATEGY, THE POSSIBILITY OF FUTURE INVESTMENTS OR ACQUISITIONS, FUTURE CUSTOMER AND SALES DEVELOPMENTS, MANUFACTURING FORECASTS, INCLUDING THE POTENTIAL BENEFITS OF OUR CONTRACT MANUFACTURERS SOURCING AND SUPPLYING RAW MATERIALS, COMPONENTS AND INTEGRATED CIRCUITS, THE POSSIBILITY OF AN EXPANDING ROLE FOR ORIGINAL EQUIPMENT MANUFACTURERS IN OUR BUSINESS, THE FUTURE COST AND POTENTIAL BENEFITS OF OUR RESEARCH AND DEVELOPMENT EFFORTS, AND LIQUIDITY AND CASH RESOURCES FORECASTS. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE DISCUSSED IN SUCH FORWARD-LOOKING STATEMENTS, AND OUR STOCKHOLDERS SHOULD CAREFULLY REVIEW THE CAUTIONARY STATEMENTS SET FORTH IN THIS FORM 10-K, INCLUDING FACTORS THAT MAY AFFECT FUTURE RESULTS. WE MAY FROM TIME TO TIME MAKE ADDITIONAL WRITTEN AND ORAL FORWARD-LOOKING STATEMENTS, INCLUDING STATEMENTS CONTAINED IN OUR FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION AND IN OUR REPORTS TO STOCKHOLDERS. WE DO NOT UNDERTAKE TO UPDATE ANY FORWARD-LOOKING STATEMENTS THAT MAY BE MADE FROM TIME TO TIME BY US OR ON OUR BEHALF.

PART I

ITEM 1. BUSINESS

OVERVIEW

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

We have a history of providing devices that enable information technology ("IT") equipment to network using standard protocols for connectivity, including fiber optic, Ethernet and wireless. Our first device was a terminal server that

allowed "dumb" terminals to connect to a network. Building on the success of our terminal servers, we introduced a complete line of print servers in 1991 that enabled users to inexpensively share printers over a network. Over the years, we have continually refined our core technology and have developed additional innovative networking solutions that expand upon the business of providing our customers network connectivity. With the expansion of networking and the Internet, our technology focus is increasingly broader, so that our device solutions provide a product manufacturer with the ability to network their products within the industrial, service and consumer markets.

We provide three broad categories of products: "device networking solutions," that enable almost any electronic product to be connected to a network; "IT management solutions," that enable multiple pieces of hardware, usually IT-related network hardware such as servers, routers, switches, and similar pieces of equipment to be managed over a network; and "non-core" products and services that include visualization solutions, legacy print server's, software revenues, and other miscellaneous products. The expansion of our business in the future is directed at the first two of these categories, device networking and IT management solutions.

Today, our solutions include fully integrated hardware and software devices, as well as software tools, to develop related customer applications. Because we deal with network connectivity, we provide hardware solutions to extremely broad market segments, including industrial, medical, commercial, financial, governmental, retail and building automation, and many more. Our technology is used to provide networking capabilities to products such as medical instruments, manufacturing equipment, bar code scanners, building HVAC systems, elevators, process control equipment, vending machines, thermostats, security cameras, temperature sensors, card readers, point of sale terminals, time clocks, and virtually any product that has some form of standard data control capability. Our current product offerings include a wide range of hardware devices of varying size, packaging and, where appropriate, software solutions that allow our customers to network-enable virtually any electronic product.

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

Our products are sold to distributors, OEMs, VARs, and systems integrators, as well as directly to end-users. One customer, Ingram Micro Inc., accounted for approximately 14%, 11% and 12% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Another customer, Tech Data Corporation, accounted for approximately 9%, 10% and 11% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Accounts receivable attributable to these two domestic customers accounted for approximately 13% and 16% of total accounts receivable at June 30, 2004 and 2003, respectively.

Our common stock is currently traded on The Nasdaq SmallCap Market under the symbol LTRX.

Our worldwide headquarters are located in Irvine, California and we have offices in Milford, Connecticut and worldwide, including; Germany; France; Hong Kong and Japan. We also have employees working from home offices in other areas of the world including the United Kingdom and Netherlands. During the first quarter of fiscal 2004, we closed our European administrative operations handled by our Switzerland office. Since September 2003, European operations have been managed from our Irvine, California facility.

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

OUR STRATEGY

Our business strategy is based on our proven capability to develop fully integrated networking solutions that increase the value of our customers' products by making it easy to take advantage of features that can be made

available when these products are network-enabled. This strategy is accomplished by providing our customers with hardware and software that connects products and systems to a network, and intelligently manages and controls them. Through our 15 years of networking expertise, knowledge of industry trends, and our capability to develop solutions based on open industry standards, we have been able to anticipate our customers' networking technology requirements and offer solutions that enable them to achieve their connectivity objectives. By providing a complete solution of hardware and integrated software, we have been able to provide "turnkey" solutions, eliminating the need for our customers to build expensive design and manufacturing expertise in-house. This results in savings to the customer both in terms of financial investment and time.

Our fully integrated hardware, software, and application development tools have enabled us to become a technology and industry leader. We focus on the following key areas:

- Device Networking Solutions - We offer an array of embedded and external device networking solutions that enable integrators and manufacturers of electronic and electro-mechanical products to add network connectivity, manageability, and control to their products. Our customers' products originate from a wide variety of applications, such as blood analyzers that relay critical patient information directly to a hospital's information system, to simple devices such as timeclocks or audio/visual equipment, to improve how these products are managed and controlled.

- IT Management Solutions - We offer off-the-shelf equipment that enables IT professionals to remotely manage network infrastructure equipment and large groups of servers. Our terminal and console management systems solutions provide a comprehensive solution for the remote command and control of today's network infrastructure.

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

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

PRODUCTS

DEVICE NETWORKING SOLUTIONS

We provide manufacturers, integrators, and users with complete device networking solutions that include the technology required for products to be connected, managed and controlled over networks using standard protocols for connectivity,

including fiber optic, Ethernet and wireless. As common, everyday products such as lighting, security and audio/visual systems leverage the power of network connectivity, manufacturers and users are realizing the benefits of networking. Our device networking solutions dramatically shorten a manufacturer's development time to implement network connectivity, provide competitive advantages with new features, and greatly reduce engineering and marketing risks. Our hardware solutions include embedded modules (completed boards or intelligent connectors with electronic components and the necessary connectors and software that is mounted within a customer's product), and external hardware modules (with single, multi- or wireless ports), as well as the related real-time operating system and application software that is required to make the devices effective. We also offer application- and industry-specific solutions such as industrial device servers.

Our device servers allow a wide range of equipment to be quickly network-enabled without the need for intermediary gateways, workstations, or PCs. This distributed computing approach significantly improves reliability and up-time. Our device servers also eliminate the high cost of ownership associated with networking, which frequently would otherwise require using PCs and workstations to perform connectivity and remote management functions. Our device servers contain high-performance processors capable of not only controlling the attached device, but also of accumulating data and status. Such data can then be formatted by the device server and presented to users via the built in web server, SNMP, e-mail, etc. Device servers are easy to manage using any standard Web browser, due to a built-in HTTP server.

In February 2003, we announced the release of our XPort device server, which represents a significant improvement in technology, and a reduction in physical size and price for this type of functionality. The thumb-sized XPort is a self-contained network communications server and miniaturized web site enclosed within a rugged RJ-45 connector package, which can be embedded in virtually any electronic product. Products incorporating XPort have their own address on the World Wide Web and can be accessed from any web browser, including a wireless PC or Internet-enabled cell phone, from anywhere in the world. The XPort can serve up Internet-standard web pages, initiate e-mails for notifications or alerts, and run other applications as defined by the product manufacturer. XPort eliminates the complexity for a product manufacturer to

create network connectivity, because the XPort device includes a complete, integrated solution with a 10/100 Base-T Ethernet connection, a reliable and proven operating system, an embedded web server, flexible firmware, a full TCP/IP protocol stack, and optional 256-bit standards-based (AES) encryption. We believe the relatively low price of the XPort, as well as the speed and ease with which a manufacturer can design the device into their products, will make a customer's products more attractive, by providing network connectivity.

In March 2004, we introduced WiPort, a wireless (and wired) device server, with substantially the same functionality as XPort, but with an 802.11 wireless configuration, for embedded application to products and situations where a wired Ethernet environment is not available or practical. In August 2004, we introduced WiBox, an external wireless web server that is planned for transition to volume production in the second and third quarters of fiscal 2005.

IT MANAGEMENT SOLUTIONS

Our IT management solutions provide IT professionals with the tools they need to remotely manage computers and associated systems.

IT professionals use our multiport device solutions (including our terminal and console servers) to monitor and run their systems to ensure the performance and availability of critical business information systems, network infrastructure, and telecommunications equipment. The equipment they manage includes routers, switches, servers, phone switches and public branch exchanges that are often located in remote or inaccessible locations.

Our console servers provide system administrators and network managers a way to connect with their remote equipment through a universal interface called a console port, helping them work more efficiently without having to leave their desk or office. With remote access, system downtime, and its impact on business, is minimized. Our console servers provide IT professionals with peace-of-mind through extensive security features in some cases, and in some cases, provisions for dial-in access via modem. These solutions are provided in various configurations, and can manage up to 48 devices from one console server.

NON-CORE BUSINESSES: VISUALIZATION SOLUTIONS, PRINT SERVERS AND OTHER LEGACY PRODUCTS

We offer visualization solutions that provide switching and optical extension of high performance video, audio, keyboard and mouse over long distances within a building or campus environment. Products include FiberLynx video display extenders and keyboard, video, mouse ("KVM") switches, KVM extension systems, and matrix hubs. These products provide a valuable solution for extending and sharing audio, video, keyboard and mouse signals among many users and over large distances without loss of resolution. KVM products enable a single keyboard, monitor and mouse to be switched between multiple computers, providing immediate access and control from a single location. The customers for these devices are typically companies needing to isolate users from the core computing center for security reasons, or have other needs requiring high speed video sources to be shared among many users. Our visualization solutions can be found in government agencies and at customers involved with large scale simulation and display applications.

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

We acquired a line of low-cost products which we market under the "Stallion" brand. Stallion products' range includes a variety of network servers and a range of multiport serial I/O cards. Various other small categories of our legacy business are included in this category, such as software revenues and other product lines we have discontinued or that are being de-emphasized.

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The following are approximate revenues for these categories, the definitions of which have been modified slightly as of June 30, 2004, and previous years' data has been modified to conform to the new definitions:

NET REVENUES FOR THE

PRODUCT FAMILY	PRIMARY PRODUCT FUNCTION	2004	2003
Device networking solutions	Enable almost any electronic product to become network enabled.	$ 27.5	$ 24
IT management solutions	Allow the user to control equipment by way of the Internet using a wide range of network protocols. This category includes console servers.	$ 12.6	$ 13
Non-core products	Includes visualization solutions, legacy print servers, software and other miscellaneous products	$ 8.8	$ 11

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

CUSTOMERS

Distributors

Our principal customers are our distributors, who are the source of our highest percentage of net revenues. Distributors resell our products to a wide variety of customers including consumers, corporate customers, VARs, etc. We sell to a group of ten major distributors, who operate, in some cases, from multiple warehouses. Our major distributors in the U.S. include: Ingram Micro, Tech Data, KMJ Communications and Arrow Electronics, Inc. In Europe, we distribute directly from a public warehouse located in Belgium which serves, in part, the following major distributors: transtec AG (a related party due to common ownership by our largest shareholder), Sphinx Computer Vertriebs GmbH, Powercorp PTY, LTD, Jade Communications, LTD, Astradis Elecktronik GmbH, and Atlantik Systems GmbH.

OEM Manufacturers

We have established a broad range of OEM electro-mechanical manufacturing customers in various industries such as industrial automation, medical, security, building automation, consumer and audio/visual. Our OEM customers typically lack the expertise or resources to develop hardware and software required to introduce network solutions to their end-users in a timely manner. To shorten the development cycle to add network connectivity to a product, OEMs can use our external devices to network-enable their installed base of products, while board-level embedded modules are typically used in new product designs. Our capabilities and solutions enable OEMs to focus on their core competencies, resulting in reduced research and development costs, fewer integration problems, and faster time to market.

Our module products, including XPort, are particularly useful and adaptable by OEM customers to enable network connectivity to a wide variety of electro-mechanical products. In addition to the features it provides, the advantage is low cost, and the fact that the device can be adapted for use in a wide range of products without the necessity for lengthy engineering processes by the OEM, or the time delays that activity might introduce.

End-User Businesses

We have established a broad range of end-user customers in various businesses such as airports, retail, universities/education, manufacturing, healthcare/hospitals and financial/banking. End-user businesses require

solutions that are simple to install, setup, and operate, and can provide immediate results. Generally, these customers have requirements to connect a diverse range of products and equipment, without modifying existing software and systems.

Our external device solutions enable end-users to quickly, securely and easily connect their devices and equipment to networks, extending the life of existing investments. In support of these customers, we provide a number of programs including telephone-based sales and technical support as well as a wide array of Internet-based resources. In many cases, the customer simply has to call in to obtain assistance in identifying which networking device would be most appropriate for its need. After buying the devices from us or one of our distributors, a customer often only has to plug a cable from the device to be managed to our external device, and then plug our device into their network.

SALES AND MARKETING

We maintain both an inside and a field sales force. We are also represented by manufacturers' representatives, VARs and other resellers throughout the world who call on engineering design and product management teams. We develop marketing programs, products, tools and services specifically geared to meet the needs of our targeted customers. Our sales and marketing force consisted of 82 employees as of June 30, 2004 and 83 employees as of June 30, 2003.

We believe that our multi-channel approach provides several advantages. We can engage the customers and end-users through their channel of choice, making our solution available from a variety of sources.

Our device networking solutions are principally sold to manufacturers by our worldwide OEM sales force and through our group of manufacturers' representatives. We have continued to expand our use of manufacturers' representatives and other resellers, leveraging their established relationships to bring our device networking solutions to a greater number of customers within the OEM market.

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

Net revenues generated from sales in the Americas, Europe and other geographic areas including Asia and Japan for the year ended June 30, 2004 were $33.8 million, $11.3 million and $3.8 million, respectively, compared to $37.4 million, $10.4 million and $1.6 million for the year ended June 30, 2003 and $47.7 million, $8.2 million and $1.7 million for the year ended June 30, 2002,

respectively. Although the U.S. represents our largest geographic marketplace, approximately 31%, 24% and 17% for the years ended June 30, 2004, 2003 and 2002, respectively of our net sales came from sales to customers outside the U.S. Gross margin on sales of our products in foreign countries, and sales of product that include components obtained from foreign suppliers, can be adversely affected by international trade regulations, including tariffs and antidumping duties, and by fluctuations in foreign currency exchange rates. Information concerning our sales by geographic region can be found in Note 15 to the Audited Consolidated Financial Statements.

MANUFACTURING

Our manufacturing strategy is to produce reliable, high quality products at competitive prices and to achieve on-time delivery to our customers. To achieve this strategy, we generally contract with others for the manufacturing of our products. This practice enables us to concentrate our resources on design, engineering and marketing where we believe we have greater competitive advantages.

We have agreements with multiple contract manufacturers. Our contract manufacturers are located in and around Irvine, Sacramento and Lake Forest, California; Dongguan, China; Tsao Tuen, Nan-to, Taiwan; and Penang, Malaysia. Under these agreements, the manufacturers source and supply most raw materials, components and integrated circuits in accordance with our pre-determined specifications and forecasts, and perform final assembly, functional testing and quality control. We believe that this arrangement decreases our working capital requirements and provides better raw material and component pricing, enhancing our gross and operating margins. Please see "Risk Factors" for a discussion of the risks associated with contract manufacturing.

RESEARCH AND DEVELOPMENT

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

resources. We employed 60 employees in our research and development organization as of June 30, 2004, and 47 employees as of June 30, 2003. Our research and development expenses were $7.8 million, $9.4 million and $8.7 million for the years ended June 30, 2004, 2003 and 2002, respectively.

INDUSTRY PARTNERS

In keeping with our business strategy, we have engaged a portfolio of partners, consortia, and standards committees in an effort to provide the most complete networking solutions to our customers. We are an active member of several leading professional and industry associations. Membership in these associations provides us with a voice in the development of future standards that are vital to our customers.

SOFTWARE DEVELOPER RELATIONS

Recruiting and informing third-party software developers is an integral part of our ongoing strategy. We encourage, enable, and support programmers to develop vertical applications using our hardware, firmware and software products. With their help and investment in creating additional applications and

markets for our products, we secure a defensible market position and loyal customers in the process.

COMPETITION

The markets in which we compete are dynamic and highly competitive. We expect competition to intensify in the future. Our current and potential competitors include the following:

- companies with network-enabling technologies, such as Avocent, Echelon, Moxa, Digi International, Cyclades, Quatech, Wind River, Rabbit, MRV (formerly known as iTouch), Rose Electronics, Raritan, Equinox and Zilog;

- companies with equipment for IT management solutions, such as Cyclades, Moxa, Digi International, Sena, Logical Solutions, Cisco, MRV, DPAC Technologies and Perle; and

- companies with significant networking expertise and research and development resources, including Cisco Systems, IBM and Lucent Technologies.

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

- product quality, technological innovation, compatibility with standards and protocols, reliability, functionality, ease of use, and compatibility;

- prices of the products; and

- potential customers' awareness and perception of our products and of network-enabling technologies.

Much of our technology can be reproduced by our competitors without royalties or license fees and could compete with our offerings. In addition, there is a risk that our customers or new entrants to the market could develop and market their own solutions without paying a fee to us.

INTELLECTUAL PROPERTY RIGHTS

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

Trade secret and copyright laws afford us only limited protection. We cannot be certain that the steps we have taken in this regard will be adequate to deter misappropriation of our proprietary information or that we will be able to detect unauthorized use and take appropriate steps to enforce our intellectual property rights. An adverse change in the laws protecting intellectual property could harm our business. In addition, we believe that our success will depend principally upon continuing innovation, technical expertise, knowledge of networking, storage and applications, and to a lesser extent, on our ability to protect our proprietary technology. Furthermore, there can be no

assurance that our current or future competitors will not develop technologies that are substantially equivalent to ours.

LIMITATIONS ON OUR RIGHTS TO INTELLECTUAL PROPERTY

Gordian, Inc. ("Gordian") developed certain intellectual property used in our micro serial server line of products. These products represented and continue to represent a significant portion of our net revenues. Under the terms of an agreement dated February 29, 1989, Gordian owned the rights to the intellectual property developed under the agreement and required us to pay royalties based upon gross margin of products sold under the agreement. For the year ended June 30, 2002, we paid Gordian approximately $1.2 million for royalties. No royalties were paid to Gordian for the years ended June 30, 2004 and 2003 as a result of a new Gordian agreement as described below. Our agreement with Gordian was to terminate at the end of the sales life of the products.

On May 30, 2002, we signed a new intellectual property agreement with Gordian. The new agreement gives us joint ownership of the Gordian intellectual property that is embodied in the products Gordian has designed for us since 1989. This new agreement provides that we will be able to use the intellectual property to support, maintain and enhance our products. This new agreement extinguishes our obligations to pay royalties for each unit of a Gordian-designed product that we sell as of the effective date.

As part of the new agreement, we paid Gordian $6.0 million in three installments. We paid $3.0 million concurrent with the signing of the new agreement, $2.0 million on July 1, 2002, and we made the third and final payment of $1.0 million on July 1, 2003. We also agreed to purchase $1.5 million of engineering and support services from Gordian over the 18-month period that ended November 2003. We are amortizing the intellectual property rights acquired by this new agreement over the remaining life cycles of our products designed by Gordian, or approximately three years. We recorded $1.8 million, $2.5 million and $212,000 of amortization expense in cost of revenues for the years ended June 30, 2004, 2003 and 2002, respectively.

UNITED STATES AND FOREIGN GOVERNMENT REGULATION

Many of our products and the industries in which they are used are subject to federal, state or local regulation in the United States. In addition, our products are exported worldwide. Therefore, we are subject to the regulation of foreign governments. For example, wireless communication is highly regulated in both the United States and elsewhere. Our products currently employ encryption technology; the export of some encryption software is restricted. At this time our activities comply with existing laws, but we cannot determine whether future, more restrictive laws, if enacted, would adversely affect us. Information regarding risks attendant to our foreign operations is set forth in Part I, Item 7 under the heading "Risk Factors" of this Annual Report on Form 10-K.

EMPLOYEES

As of June 30, 2004, we had 198 full-time employees consisting of 60 employees in research and development, 82 in sales and marketing departments, 21 in operations departments, and 35 general and administrative employees. We have not experienced any work stoppages and we believe that our relationship with our employees is good. None of our employees are currently represented by a labor union.

BACKLOG

Normally, we manufacture our products in advance of receiving firm product

orders from our customers based upon our forecasts of worldwide customer demand. Most customer orders are placed on an as-needed basis and may be canceled or rescheduled by the customer without significant penalty. Accordingly, backlog as of any particular date is not necessarily indicative of our future sales. Because most of our business is on an as-needed basis and varies slightly, only because of short-term customer requests, we do not track backlog as a metric of our operations. We have no customer orders extending more than several months into the future.

AVAILABILITY OF THIS REPORT

Our annual report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Section 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available free of charge on our web site at www.lantronix.com shortly after we electronically file such material with the SEC. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The SEC also maintains a web site at www.sec.gov that contains reports, proxy, and information statements, and other information regarding issues that file electronically. We assume no obligation to update or revise forward looking statement in this annual report, whether as a result of new information, future events or otherwise, unless we are required to do so by law.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following table lists the names, ages and positions held by all our executive officers as of August 31, 2004. There are no family relationships between any director or executive officer and any other director or executive officer of Lantronix. Executive officers serve at the discretion of the Board of Directors.

NAME	AGE	POSITION
Marc Nussbaum	48	President and Chief Executive Officer
James Kerrigan	68	Chief Financial Officer
Katherine McDermott	44	Vice President of Finance and Secretary

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

JAMES KERRIGAN has served as our Chief Financial Officer since May 2002 (on an Interim basis until February 2003). From March 2000 to October 2000, he was Chief Financial Officer of Motiva, a privately-owned company that developed,

marketed and sold collaboration software systems. From January 1998 to February 1999, he was Chief Financial Officer of Who?Vision Systems, Inc., an incubator company that developed biometric fingerprint devices and software. From April 1995 to March 1997, Mr. Kerrigan was Chief Financial Officer of Artios, Inc., a privately-owned company that designs, manufactures, and sells prototyping hardware and software to the packaging industry. Previously, Mr. Kerrigan has served as chief financial officer for other larger, public companies. He has a BS degree in engineering and a MBA degree from Northwestern University.

KATHERINE MCDERMOTT has served as our Vice President of Finance since March 2001 and our Secretary since August 2004. Ms. McDermott joined Lantronix in March 2000 as Corporate Controller. From 1988 through 1999, Ms. McDermott served in a number of senior level finance positions with Bausch & Lomb, Inc., a global health care company. Her most recent positions included Corporate Audit Manager, Plant Controller, and Controller of a wholly owned subsidiary. From 1982 to 1988, Ms. McDermott held various financial positions at a division of General Motors. Ms. McDermott holds a BBA degree in Business Administration from St. Bonaventure University in New York, where she graduated cum laude. She also earned a MBA degree, with a concentration in Finance and Economics, from the Simon School of Business Administration at the University of Rochester.

ITEM 2. PROPERTIES

We lease a building in Irvine, California that comprises our corporate headquarters and includes administration, sales, marketing, research and development, warehouse and order fulfillment functions. We have smaller sales offices in Milford, Connecticut; Germany; France; Hong Kong and Japan. The foregoing leases comprise an aggregate of approximately 60,000 square feet of which our Irvine facility represents the majority of our square footage. Our Irvine facility has a lease term expiring in July 2005.

During the year ended June 30, 2004, we completed facility and organizational restructuring activities that we began in fiscal 2003. In September 2003, we ceased operational activities in Cham, Switzerland, the headquarters of Lantronix International AG, which is our wholly owned subsidiary; now, we support international sales and shipping from our Irvine, California headquarters. In March 2004, we sold our Premise software unit and closed our Redmond, Washington facility. We continue to make payments on our lease obligations for facilities we no longer occupy including our facilities located in Naperville, Illinois, Redmond Washington, Hillsboro, Oregon and Ames, Iowa. The liability for these lease obligations are included in our restructuring reserve at June 30, 2004.

ITEM 3. LEGAL PROCEEDINGS

Government Investigation

The SEC is conducting a formal investigation of the events leading up to our restatement of our financial statements on June 25, 2002. The Department of Justice is also conducting an investigation concerning events related to the restatement.

Class Action Lawsuits

On May 15, 2002, Stephen Bachman filed a class action complaint entitled Bachman v. Lantronix, Inc., et al., No. 02-3899, in the U.S. District Court for

the Central District of California against us and certain of our current directors and former officers alleging violations of the Securities Exchange Act of 1934 and seeking unspecified damages. Subsequently, six similar actions were filed in the same court. Each of the complaints purports to be a class action lawsuit brought on behalf of persons who purchased or otherwise acquired our common stock during the period of April 25, 2001 through May 30, 2002, inclusive. The complaints allege that the defendants caused us to improperly recognize revenue and make false and misleading statements about our business. Plaintiffs further allege that the defendants materially overstated our reported financial results, thereby inflating our stock price during our securities offering in July 2001, as well as facilitating the use of our common stock as consideration in acquisitions. The complaints have subsequently been consolidated into a single action and the court has appointed a lead plaintiff. The lead plaintiff filed a consolidated amended complaint on January 17, 2003. The amended complaint now purports to be a class action brought on behalf of persons who purchased or otherwise acquired our common stock during the period of August 4, 2000 through May 30, 2002, inclusive. The amended complaint continued to assert that we and the individual officer and director defendants violated the 1934 Act, and also includes alleged claims that we and our officers and directors violated the Securities Act of 1933 arising from our Initial Public Offering in August 2000. We filed a motion to dismiss the additional allegations on March 3, 2003. The Court granted the motion, with leave to amend, on December 31, 2003. Plaintiffs filed their second amended complaint February 6, 2004, and we filed a motion to dismiss the additional allegations in the second amended complaint on March 10, 2004. On August 19, 2004, the Court granted in part and denied in part the motion to dismiss. On September 13, 2004, plaintiffs filed their third amended complaint. We have not yet answered the third amended complaint and discovery has not yet commenced.

Derivative Lawsuit

On July 26, 2002, Samuel Ivy filed a shareholder derivative complaint entitled Ivy v. Bernhard Bruscha, et al., No. 02CC00209, in the Superior Court of the State of California, County of Orange, against certain of our current directors and former officers. On January 7, 2003, the plaintiff filed an amended complaint. The amended complaint alleges causes of action for breach of fiduciary duty, abuse of control, gross mismanagement, unjust enrichment, and improper insider stock sales. The complaint seeks unspecified damages against the individual defendants on our behalf, equitable relief, and attorneys' fees.

We filed a demurrer/motion to dismiss the amended complaint on February 13, 2003. The basis of the demurrer is that the plaintiff does not have standing to bring this lawsuit since plaintiff has never served a demand on our Board that the Board take certain actions on our behalf. On April 17, 2003, the Court overruled our demurrer. All defendants have answered the complaint and generally denied the allegations. Discovery has commenced, but no trial date has been established.

Employment Suit Brought by Former Chief Financial Officer and Chief Operating Officer Steven Cotton

On September 6, 2002, Steven Cotton, our former CFO and COO, filed a complaint entitled Cotton v. Lantronix, Inc., et al., No. 02CC14308, in the Superior Court of the State of California, County of Orange. The complaint alleges claims for breach of contract, breach of the covenant of good faith and fair dealing, wrongful termination, misrepresentation, and defamation. The complaint seeks unspecified damages, declaratory relief, attorneys' fees and costs.

We filed a motion to dismiss on October 16, 2002, on the grounds that Mr. Cotton's complaints are subject to the binding arbitration provisions in Mr. Cotton's employment agreement. On January 13, 2003, the Court ruled that five of

the six counts in Mr. Cotton's complaint are subject to binding arbitration. The court is staying the sixth count, for declaratory relief, until the underlying facts are resolved in arbitration. No arbitration date has been set.

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

On October 17, 2002, Richard Goldstein and several other former shareholders of Synergetic filed a complaint entitled Goldstein, et al v. Lantronix, Inc., et al in the Superior Court of the State of California, County of Orange, against us and certain of our former officers and directors. Plaintiffs filed an amended complaint on January 7, 2003. The amended complaint alleges fraud, negligent misrepresentation, breach of warranties and covenants, breach of contract and negligence, all stemming from our acquisition of Synergetic. The complaint seeks an unspecified amount of damages, interest, attorneys' fees, costs, expenses, and an unspecified amount of punitive damages. On May 5, 2003, we answered the complaint and generally denied the allegations in the complaint. Discovery has commenced but no trial date has been established.

Patent Infringement Litigation

On August 10, 2004, Digi International served a complaint on us alleging that certain of our products infringe Digi's U.S. Patent No. 6,446,192. Digi filed the complaint in the U.S. District Court in Minnesota. The complaint seeks both monetary and non-monetary relief. We are still analyzing all of the allegations of the complaint. On August 30, 2004, we served and filed an answer and counterclaim seeking to invalidate U.S. Patent No. 6,446,192 for failure to meet the applicable statutory requirements in Part II of Title 35 of the United States Code including, without limitation, 35 U.S.C. Sec. 102, 103 and 112, as conditions for patentability. The counterclaim seeks both monetary and non-monetary relief.

We filed, on May 3, 2004, a complaint against Digi, alleging that certain of Digi's products infringe on our U.S. Patent No. 6,571,305, in the U.S. District Court for the Central District of California. The complaint seeks both monetary and non-monetary relief from Digi's infringement. Digi has filed an answer and counterclaim alleging invalidity of the patent. The Counterclaim seeks both monetary and non-monetary relief.

Other

From time to time, we are subject to other legal proceedings and claims in the ordinary course of business. We are currently not aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business, prospects, financial position, operating results or cash flows.

The pending lawsuits involve complex questions of fact and law and likely will continue to require the expenditure of significant funds and the diversion of other resources to defend. Management is unable to determine the outcome of its outstanding legal proceedings, claims and litigation involving us, our subsidiaries, directors and former officers and cannot determine the extent to which these results may have a material adverse effect on our business, results of operations and financial condition taken as a whole. The results of litigation are inherently uncertain, and adverse outcomes are possible. We are unable to estimate the range of possible loss from outstanding litigation, and

no amounts have been provided for such matters in the consolidated financial statements.

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

No matters were submitted to a vote of our security holders during the fourth quarter of fiscal year ended June 30, 2004.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

PRICE RANGE OF COMMON STOCK

Our common stock was traded on The Nasdaq National Market under the symbol "LTRX" from our initial public offering on August 4, 2000 through October 22, 2002. On October 23, 2002 our listing was changed to The Nasdaq SmallCap Market. The number of holders of record of our common stock as of August 31, 2004 was approximately 97. The following table sets forth, for the period indicated, the high and low per share closing prices for our common stock:

FISCAL YEAR 2003	HIGH	LOW
First Quarter	$1.03	$0.38
Second Quarter	0.92	0.36
Third Quarter	1.08	0.67
Fourth Quarter	0.91	0.49

FISCAL YEAR 2004	HIGH	LOW
First Quarter	$1.41	$0.78
Second Quarter	1.32	0.89
Third Quarter	1.86	1.06
Fourth Quarter	2.09	1.18

We believe that a number of factors, including but not limited to quarterly fluctuations in results of operations, may cause the market price of our common stock to fluctuate significantly. See "Management's Discussion and Analysis-Risk Factors."

DIVIDEND POLICY

We have never declared or paid cash dividends on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future, and we intend to retain any future earnings for use in the expansion of our business and for general corporate purposes. Pursuant to a line of credit we entered into in January 2002 and have amended on several occasions including July 24, 2004, we are restricted from paying any dividends.

EQUITY COMPENSATION PLANS

The information required by this item regarding equity compensation plans is incorporated by reference to the information set forth in Item 12 of this Annual Report on Form 10-K. Item 12 of this Annual Report on Form 10-K

incorporates by reference the information contained in the sections captioned "Election of Directors" and "Security Ownership of Certain Beneficial Owners and Management" in Lantronix's definitive Proxy Statement for the Annual Meeting of Stockholders to be held November 18, 2004 (the Proxy Statement), a copy of which will be filed with the Securities and Exchange Commission before the meeting date.

RECENT SALES OF UNREGISTERED SECURITIES

We have not issued unregistered securities since July 1, 2003. Also, we have not repurchased any of our common stock during the fourth quarter of fiscal 2004.

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included below. In March 2004, we completed the sale of our Premise business unit that was originally purchased in January 2002. Accordingly, the information set forth in the table below reflects the Premise business unit as a discontinued operation. The consolidated statements of operations data for the years ended June 30, 2004, 2003 and 2002 and the balance sheet data as of June 30, 2004 and 2003, are derived from the audited consolidated financial statements included elsewhere in this report. The consolidated statements of operations data for the years ended June 30, 2001 and 2000, and the balance sheet data as of June 30, 2002, 2001 and 2000, are derived from the audited consolidated financial statements not included elsewhere in this report. The historical results are not necessarily indicative of results to be expected for future periods.

	YEARS ENDED J		
	2004	2003	2002
	(IN THOUSANDS, EXCEPT		
CONSOLIDATED STATEMENTS OF OPERATIONS DATA:			
Net revenues	$ 48,885	$ 49,389	$ 57,59
Cost of revenues	25,026	36,264	40,28
Gross profit	23,859	13,125	17,31
Operating expenses:			
Selling, general and administrative	23,293	28,660	40,53
Research and development	7,813	9,430	8,68
Stock-based compensation	347	1,453	2,86
Amortization of goodwill and purchased intangible assets	148	602	96
Impairment of goodwill and purchased intangible assets	-	2,353	50,44
Restructuring (recovery) charges	(2,093)	5,600	3,47
Litigation settlement costs	-	1,533	1,91

In-process research and development	-	-	
Total operating expenses	29,508	49,631	108,87
Income (loss) from operations	(5,649)	(36,506)	(91,56
Minority interest	-	-	
Interest income (expense), net	50	248	1,54
Other income (expense), net	(5,333)	(926)	(76
Income (loss) before income taxes and cumulative effect of accounting changes	(10,932)	(37,184)	(90,77
Provision (benefit) for income taxes	(325)	250	(6,66
Income (loss) from continuing operations before cumulative effect of accounting changes	(10,607)	(37,434)	(84,10
Loss from discontinued operations	(5,047)	(10,115)	(3,44
Income (loss) before cumulative effect of accounting changes	(15,654)	(47,549)	(87,55
Cumulative effect of accounting changes:			
Change in revenue recognition policy, net of income tax benefit of $176	-	-	
Adoption of new accounting standard, SFAS No. 142	-	-	(5,90
Net income (loss)	$(15,654)	$(47,549)	$(93,45
Basic income (loss) per share from continuing operations before Cumulative effect of accounting changes	$ (0.19)	$ (0.69)	$ (1.6
Loss from discontinued operations	(0.09)	(0.19)	(0.0
Income (loss) before cumulative effect of accounting changes	(0.28)	(0.88)	(1.7
Cumulative effect of accounting changes per share:			
Change in revenue recognition policy, net of income tax benefit of $176	-	-	
Adoption of new accounting standard, SFAS No. 142	-	-	(0.1
Basic net income (loss) per share	$ (0.28)	$ (0.88)	$ (1.8
Diluted income (loss) per share from continuing operations before cumulative effect of accounting changes	$ (0.19)	$ (0.69)	$ (1.6
Loss from discontinued operations	(0.09)	(0.19)	(0.0
Income (loss) before cumulative effect of accounting changes	(0.28)	(0.88)	(1.7
Cumulative effect of accounting changes per share:			
Change in revenue recognition policy, net of income tax benefit of $176	-	-	
Adoption of new accounting standard, SFAS No. 142	-	-	(0.1
Diluted net income (loss) per share	$ (0.28)	$ (0.88)	$ (1.8
Weighted average shares (basic)	56,862	54,329	51,40
Weighted average shares (diluted)	56,862	54,329	51,40

	AS OF JUNE 30,				
	2004	2003	2002	2001	2000
CONSOLIDATED BALANCE SHEET DATA:					
Cash and cash equivalents	$ 9,128	$ 7,328	$ 26,491	$ 15,367	$ 1,988
Marketable securities	3,050	6,750	6,963	1,973	-
Working capital	12,087	17,312	40,317	36,963	11,042
Goodwill, net	9,488	9,488	7,218	42,273	-
Purchased intangible assets, net	2,056	4,275	11,891	13,328	586
Total assets	37,250	54,947	103,812	116,861	20,210
Retained earnings (accumulated deficit)	(156,078)	(140,424)	(92,875)	582	8,427
Total stockholders' equity	24,791	37,717	82,157	99,496	12,547

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

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

OVERVIEW

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

Our products are sold to distributors, OEMs, VARs, and systems integrators, as well as directly to end-users. One customer, Ingram Micro Inc., accounted for approximately 14%, 11% and 12% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Another customer, Tech Data Corporation, accounted for approximately 9%, 10% and 11% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Accounts receivable attributable to these two domestic customers accounted for approximately 13% and 16% of total accounts receivable at June 30, 2004 and 2003, respectively.

One international customer, transtec AG, which is a related party due to common ownership by our largest stockholder and former Chairman of our Board of Directors, Bernhard Bruscha, accounted for approximately 3%, 4% and 5% of our

net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. We also had an agreement with transtec AG for the provision of technical support services at the rate of $7,500 per month which has now been terminated. Included in selling, general and administrative expenses is $90,000 for the year ended June 30, 2002 for these support services. No support services were incurred for the years ended June 30, 2004 and 2003.

We have completed a number of acquisitions and investments the purpose of which was to expand our product offerings, increase our technology base and provide a foundation for future growth.

In October 2001, we completed the acquisition of Synergetic Micro Systems, Inc. ("Synergetic"), a provider of high performance embedded network communication solutions that complement our external device products. In connection with the acquisition, we paid cash consideration of $2.7 million and issued an aggregate of 2,234,715 shares of our common stock in exchange for all outstanding shares of Synergetic common stock and reserved 615,705 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Synergetic.

In January 2002, we completed the acquisition of Premise, a developer of client-side software applications that complement our device networking products by providing superior management and control capabilities for devices that have been network and internet enabled. Prior to the acquisition, we held shares of Premise representing 19.9% ownership and, in addition, held convertible promissory notes of $1.2 million with interest accrued there-on at the rate of 9.0%. The convertible promissory notes were converted into equity securities of Premise at the closing of the transaction. We issued an aggregate of 1,063,371 shares of our common stock in exchange for all remaining outstanding shares of Premise common stock and reserved 875,000 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Premise. In connection with the acquisition, we recorded a one-time charge for purchased in-process research and development ("IPR&D") expenses of $1.0 million in our fourth fiscal quarter ended June 30, 2002. In January 2003, we issued an

additional 1,063,372 shares of our common stock to the former shareholders of Premise stock in exchange for a release of all claims relating to the acquisition. We also accelerated the vesting of options held by certain former Premise shareholders and released all shares that had been held in the acquisition escrow. See "Discontinued Operations" section below.

In August 2002, we completed the acquisition of Stallion, a provider of terminal servers and multiport products. In connection with the acquisition, we paid $1.2 million in cash consideration, of which $200,000 was paid upon the execution of the Letter of Intent dated May 9, 2002, and established a cash escrow account in the amount of $867,000 at the acquisition date to be used in lieu of our common stock, in the event that we were unable to issue registered shares by October 31, 2002. In accordance with the terms of the agreement, we were not able to issue registered shares by October 31, 2002; accordingly, the cash escrow amount of $867,000 was released on November 1, 2002. In addition, we issued two-year notes in the principal amount of $867,000 accruing interest at a rate of 2.5% per annum. The notes were paid to the holders in August 2004.

In September and October 2001, we made a strategic investment in Xanboo, a privately-held company that develops technology that allows users to control, command and view their home or business remotely over the Internet. We paid an aggregate of $3.0 million for convertible promissory notes, which converted in

January 2002, in accordance with their terms, into Xanboo preferred stock. In addition, we purchased $4.0 million of Xanboo preferred stock in January 2002. Our ownership interest in Xanboo was 14.9%, 15.3% and 15.8% at June 30, 2004, 2003 and 2002, respectively. Our investment in Xanboo is accounted for using the equity method of accounting based on our ability through representation on Xanboo's board of directors to exercise significant influence over its operations. Our losses in Xanboo aggregating $413,000, $1.3 million and $526,000 for the years ended June 30, 2004, 2003 and 2002, respectively, have been recognized as other expense in the accompanying consolidated statement of operations. We periodically review our investments for which fair value is less than cost to determine if the decline in value is other than temporary. If the decline in value is judged to be other than temporary, the cost basis of the security is written down to fair value. We generally believe an other-than-temporary decline has occurred when the fair value of the investment is below the carrying value for two consecutive quarters, absent evidence to the contrary. On the basis of events occurring during the quarter ended June 30, 2004, we performed an analysis and recorded a charge in the amount of $5.0 million, representing a write-off of all remaining value of this non-marketable equity security. This charge is included within the consolidated statements of operations as other expense.

Discontinued operations

In August 2001, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 144 supersedes FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of;" however, it retains the fundamental provisions of that statement related to the recognition and measurement of the impairment of long-lived assets to be "held and used." SFAS No. 144 also supersedes the accounting and reporting provisions of Accounting Principles Board ("APB") Opinion No. 30, "Reporting the Results of Operation's - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", for the disposal of a segment of a business. Under SFAS No. 144, a component of a business that is held for sale is reported in discontinued operations if (i) the operations and cash flows will be, or have been, eliminated from the ongoing operations of the company and, (ii) the company will not have any significant continuing involvement in such operations.

In March 2004, we sold substantially all of the net assets of our Premise business unit for $1.0 million. Additionally, we incurred $383,000 of disposal costs.

Impairment of goodwill and purchased intangible assets related to discontinued operations

During the second quarter of fiscal 2004, we identified indicators of an other than temporary impairment as it related to our Premise acquisition of goodwill and purchased intangible assets. We performed an assessment of the value of our goodwill and purchased intangible assets in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" and SFAS No. 144. We identified certain conditions including continued losses and the inability to achieve significant revenue from the existing home automation and media management software markets as indicators of asset impairment. These conditions led to operating results and forecasted future results that were substantially less than had been anticipated. We revised our projections and determined that the projected results utilizing a discounted cash flow valuation technique would not fully support the carrying values of the goodwill and purchased intangible assets associated with the Premise acquisition. Based on this assessment, we recorded an impairment charge of $2.2 million during the second quarter of fiscal 2004 to write-off the value of the Premise goodwill. Additionally, during

the second quarter of fiscal 2004, we recorded a $790,000 impairment charge of the Premise purchased intangible assets of which $14,000 and $776,000 were charged to operating expenses and cost of revenues, respectively. As a result of the sale of the Premise business unit, the goodwill and purchased intangibles, net of Premise at June 30, 2003 have been included as part of discontinued operations.

During the third quarter of fiscal 2004, we sold the assets related to our Premise business unit to an undisclosed buyer for $1.0 million cash. After paying all related transaction fees, resolving our lease commitments, and paying other restructuring costs related to the transaction, the transaction had a then-favorable impact on our cash balance of approximately $250,000. For the years ended June 30, 2004, 2003 and 2002, the impact of the Premise business unit resulted in a $5.0 million, $10.1 million and $3.4 million loss, respectively, recorded as discontinued operations in our consolidated statement of operations.

The loss from discontinued operations for the year ended June 30, 2004 of $5.0 million includes a negative gross profit of $822,000, primarily due to the $776,000 purchased intangible asset impairment charge, $2.0 million of operating expenses, $590,000 of restructuring charges, a $2.3 million impairment charge of Premise goodwill charged to operating expenses, and a gain on the sale of Premise of $592,000.

The loss from discontinued operations for the year ended June 30, 2003 of $10.1 million includes a negative gross profit of $1.2 million primarily due to the $846,000 purchased intangible asset impairment charge, $3.4 million of operating expenses, $111,000 of restructuring charges, a $4.4 million impairment charge of Premise goodwill, and a $1.1 million legal settlement with the former shareholders of Premise.

The loss from discontinued operations for the year ended June 30, 2002 of $3.4 million includes a negative gross profit of $174,000, $1.9 million of operating expenses, $383,000 impairment charge of Premise purchased intangible assets charged to operating expenses, and a $1.0 million IPR&D charge as a result of the Premise acquisition.

Critical Accounting Policies and Estimates

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

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

financial statements:

Revenue Recognition

We do not recognize revenue until all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; our price to the buyer is fixed or determinable; and collectibility is reasonably assured. Commencing July 1, 2000, we adopted a new accounting policy for revenue recognition such that recognition of revenue and related gross profit from sales to distributors are deferred until the distributor resells the product. Net revenue from certain smaller distributors for which point-of-sale information is not available, is recognized one month after the shipment date. This estimate approximates the timing of the sale of the product by the distributor to the end-user. When product sales revenue is recognized, we establish an estimated allowance for future product returns based on historical returns experience; when price reductions are approved, we establish an estimated liability for price protection payable on inventories owned by product resellers. Should actual product returns or pricing adjustments exceed our estimates, additional reductions to revenues would result. Revenue from the licensing of software is recognized at the time of shipment (or at the time of resale in the case of software products sold through distributors), provided we have vendor-specific objective evidence of the fair value of each element of the software offering and collectibility is probable. Revenue from post-contract customer support and any other future deliverables is deferred and recognized over the support period or as contract elements are delivered. Our products typically carry a ninety day to two year warranty. Although we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, use of materials or service delivery costs that differ from our estimates. As a result, additional warranty reserves could be required, which could reduce gross margins. Additionally, we sell extended warranty services which extend the warranty period for an additional one to three years. Warranty revenue is recognized evenly over the warranty service period.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our allowance for doubtful accounts is based on our assessment of the collectibility

of specific customer accounts, the aging of accounts receivable, our history of bad debts and the general condition of the industry. If a major customer's credit worthiness deteriorates, or our customers' actual defaults exceed our historical experience, our estimates could change and impact our reported results. We also maintain a reserve for uncertainties relative to the collection of officer notes receivable. Factors considered in determining the level of this reserve include the value of the collateral securing the notes, our ability to effectively enforce collection rights and the ability of the former officers to honor their obligations.

Inventory Valuation

Our policy is to value inventories at the lower of cost or market on a part-by-part basis. This policy requires us to make estimates regarding the market value of our inventories, including an assessment of excess and obsolete inventories. We determine excess and obsolete inventories based on an estimate of the future sales demand for our products within a specified time horizon,

generally three to twelve months. The estimates we use for demand are also used for near-term capacity planning and inventory purchasing and are consistent with our revenue forecasts. In addition, specific reserves are recorded to cover risks in the area of end of life products, inventory located at our contract manufacturers, deferred inventory in our sales channel and warranty replacement stock.

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

Valuation of Deferred Income Taxes

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

Goodwill and Purchased Intangible Assets

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including IPR&D. Goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual impairment tests. The amounts and useful lives assigned to intangible assets impact future amortization and the amount assigned to IPR&D is expensed immediately. If the assumptions and estimates used to allocate the purchase price are not correct, purchase price adjustments or future asset impairment charges could be required.

Impairment of Long-Lived Assets

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

Strategic Investments

We have made strategic investments in privately held companies for the promotion of business and strategic investments. Strategic investments with less than a 20% voting interest are generally carried at cost. We will use the equity method to account for strategic investments in which we have a voting interest of 20% to 50% or in which we otherwise have the ability to exercise significant influence. Under the equity method, the investment is originally recorded at cost and adjusted to recognize our share of net earnings or losses of the

investee, limited to the extent of our investment in the investee. From time to time we are required to estimate the amount of our losses of the investee. Our estimates are based on historical experience. The value of non-publicly traded securities is difficult to determine. We periodically review these investments for other-than-temporary declines in fair value based on the specific identification method and write down investments to their fair value when an

other-than-temporary decline has occurred. We generally believe an other-than-temporary decline has occurred when the fair value of the investment is below the carrying value for two consecutive quarters, absent evidence to the contrary. Fair values for investments in privately held companies are estimated based upon the values of recent rounds of financing. Although we believe our estimates reasonably reflect the fair value of the non-publicly traded securities held by us, had there been an active market for the equity securities, the carrying values might have been materially different than the amounts reported. Future adverse changes in market conditions or poor operating results of companies in which we have such investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's current carrying value and which could require a future impairment charge. During the fourth quarter of 2004, we wrote-off $5.0 million representing the remaining balance of our investment in Xanboo. Subsequent to the write-off of Xanboo, there are no other strategic investments as of June 30, 2004.

Restructuring Charge

Over the last several quarters we have undertaken, and we may continue to undertake, significant restructuring initiatives, which have required us to develop formalized plans for exiting certain business activities. We have had to record estimated expenses for lease cancellations, contract termination expenses, long-term asset write-downs, severance and outplacement costs and other restructuring costs. Given the significance of, and the timing of the execution of such activities, this process is complex and involves periodic reassessments of estimates made at the time the original decisions were made. Through December 31, 2002, the accounting rules for restructuring costs and asset impairments required us to record provisions and charges when we had a formal and committed plan. Beginning January 1, 2003, the accounting rules now require us to record any future provisions and changes at fair value in the period in which they are incurred. In calculating the cost to dispose of our excess facilities, we had to estimate our future space requirements and the timing of exiting excess facilities and then estimate for each location the future lease and operating costs to be paid until the lease is terminated and the amount, if any, of sublease income. This required us to estimate the timing and costs of each lease to be terminated, including the amount of operating costs and the rate at which we might be able to sublease the site. To form our estimates for these costs, we performed an assessment of the affected facilities and considered the current market conditions for each site. Our assumptions on future space requirements, the operating costs until termination or the offsetting sublease revenues may turn out to be incorrect, and our actual costs may be materially different from our estimates, which could result in the need to record additional costs or to reverse previously recorded liabilities. Our policies require us to periodically evaluate the adequacy of the remaining liabilities under our restructuring initiatives. As management continues to evaluate the business, there may be additional charges for new restructuring activities as well as changes in estimates to amounts previously recorded.

Settlement Costs

From time to time, we are involved in legal actions arising in the ordinary course of business. We cannot assure you that these actions or other third party assertions against us will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows. As facts concerning contingencies become known, we reassess our position and make appropriate adjustments to the financial statements. There are many uncertainties associated with any litigation. If our initial assessments regarding the merits of a claim prove to be wrong, our results of operations and financial condition could be materially and adversely affected. In addition, if further information becomes available that causes us to determine a loss in any of our pending litigation, is probable and we can reasonably estimate a range of loss associated with such litigation, then we would record at least the minimum estimated liability. However, the actual liability in any such litigation may be materially different from our estimates, which could result in the need to record additional costs. We record our legal expenses as incurred; reimbursement of legal expenses from insurance or other sources are recorded upon receipt.

Recent Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51," ("FIN 46"). FIN 46 requires certain variable interest entities ("VIE") to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new VIEs created or acquired after January 31, 2003. For VIEs created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period ending March 15, 2004. We reviewed our investments and other arrangements and determined that none of our investee companies are VIE's.

In May 2003, the FASB issued SFAS No. 150, "Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity" ("SFAS No. 150") which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the

beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 did not have a material impact on our financial position, results of operations or cash flows.

Cumulative effect of an accounting change

Under the transitional provisions of SFAS No. 142, effective as of July 1, 2002, we completed our initial assessment and concluded that goodwill arising from the acquisition of United States Software Corporation ("USSC"), having a

carrying amount of approximately $5.9 million as of July 1, 2001, may be impaired. We engaged an independent valuation company to perform a review of the value of our goodwill related to USSC. Based on the independent valuation, which utilized a discounted cash flow valuation technique, we recorded a $5.9 million charge for the impairment of our USSC goodwill. This amount is reflected as the cumulative effect of adopting the new accounting standard effective July 1, 2001.

The following discussion of results of operations includes discussion of continuing operations only. Certain amounts in the 2003 and 2002 consolidated financial statements have been reclassified to conform with current year presentation.

CONSOLIDATED RESULTS OF OPERATIONS

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

	YEAR ENDED J	
	2004	2003
Net revenues	100.0%	100.0
Cost of revenues	51.2	73.4
Gross profit	48.8	26.6
Operating expenses:		
Selling, general and administrative	47.6	58.0
Research and development	16.0	19.1
Stock-based compensation	0.7	2.9
Amortization of purchased intangible assets	0.3	1.2
Impairment of goodwill and purchased intangible assets	-	4.8
Restructuring (recovery) charges	(4.3)	11.3
Litigation settlement costs	-	3.1
Total operating expenses	60.4	100.5
Loss from operations	(11.6)	(73.9
Interest income (expense), net	0.1	0.5
Other income (expense), net	(10.9)	(1.9
Loss before income taxes and cumulative effect of an accounting change	(22.4)	(75.3
Provision (benefit) for income taxes	(0.7)	0.5
Loss from continuing operations before cumulative effect of an accounting change	(21.7)	(75.8
Loss from discontinued operations	(10.3)	(20.5

Loss before cumulative effect of an accounting change	(32.0)	(96.3
Cumulative effect of adoption of new accounting standard, SFAS No. 142	-	-
Net loss	(32.0)%	(96.3)

COMPARISON OF THE YEARS ENDED JUNE 30, 2004 AND 2003

Net Revenues by Product Category

	YEAR ENDED JUNE 30,					
PRODUCT CATEGORIES	2004	% OF NET REVENUE	2003	% OF NET REVENUE	$ VARIANCE	% VARIANCE
Device networking	$27,481	56.2%	$24,523	49.6%	$ 2,958	12.1%
IT management	12,555	25.7%	13,034	26.4%	(479)	(3.7)%
Non-core	8,849	18.1%	11,832	24.0%	(2,983)	(25.2)%
TOTAL	$48,885	100.0%	$49,389	100.0%	$ (504)	(1.0)%

The overall decrease in net revenues was primarily attributable to a decrease in net revenues of our non-core and IT management product lines offset by an increase in our device networking product line. Our increase in device networking products included increases from our newly introduced XPort product. The decrease in our IT management product line is primarily due to delays in

introducing certain new products. During the fourth quarter of fiscal 2004, we introduced a new line of console servers and we have substantially increased our marketing and sales efforts in our IT management solutions product family. The decrease in our non-core product line was primarily attributable to a decrease in our legacy print server, industrial controller board and Stallion product lines. We are no longer investing in the development of these product lines and expect net revenues related to these product lines to continue to decline in the future as we focus our investment on device networking and IT management products.

Net Revenues by Region

YEAR ENDED

GEOGRAPHIC REGION	JUNE 30, 2004	% OF NET REVENUE	2003	% OF NET REVENUE	$ VARIANCE	% VARIANCE
Americas	$ 33,847	69.3%	$37,391	75.7%	$(3,544)	(9.5)%
Europe	11,252	23.0%	10,366	21.0%	886	8.5 %
Other	3,786	7.7%	1,632	3.3%	2,154	132.0 %
TOTAL	$ 48,885	100.0%	$49,389	100.0%	$ (504)	(1.0)%

The overall decrease in net revenues is primarily due to a decrease in the Americas region. The decrease in net revenues in the Americas region is primarily attributable to our exit of the industrial controller board product line, which was sold entirely in the Americas as well as our decrease in the IT management product family net revenues. The increase in Europe is primarily due to the addition of new customers including three new distributors and several channel customers. The increase in other is primarily due to the signing of several new customers and our increased sales efforts in the Asia Pacific region.

Gross Profit

	YEAR ENDED JUNE 30, 2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Gross profit	$23,859	48.8%	$13,125	26.6%	$ 10,734	81.8%

Gross profit represents net revenues less cost of revenues. Cost of revenues consists primarily of the cost of raw material components, subcontract labor assembly from outside manufacturers, amortization of purchased intangible assets, impairment of purchased intangible assets, establishing or relieving inventory reserves for excess and obsolete products or raw materials, overhead and warranty costs. Cost of revenues for the years ended June 30, 2004 and 2003 included $2.1 million and $3.6 million of amortization of purchased intangible assets, respectively. Cost of revenues for the year ended June 30, 2003 includes a $3.1 million impairment charge of purchased intangible assets, in accordance with SFAS No. 144. No impairment charge was recorded for the year ended June 30, 2004. At June 30, 2004, the unamortized balance of purchased intangible assets that will be amortized to future cost of revenues was $2.0 million, of which $1.4 million will be amortized in fiscal 2005 and $557,000 in fiscal 2006.

In May 2002, we signed a new agreement with Gordian to acquire a joint interest in the intellectual property that is evident in our products designed

by Gordian and to extinguish our obligation to pay royalties on future sales of our products. We paid $6.0 million for this intellectual property and are amortizing this asset to cost of revenues over the remaining life of our products designed by Gordian, or approximately 3 years. Effective May 30, 2002, upon the signing of the new agreement, royalty expenses have been replaced by an amortization of the prepaid royalties and entitlement to the intellectual property that was part of the agreement. Amortization expense related to the new Gordian agreement, included in amortization of purchased intangible assets of $2.1 million, totaled $1.8 million for the year ended June 30, 2004. Amortization expense related to the new Gordian agreement, included in amortization of purchased intangible assets of $3.6 million totaled $2.5 million for the year ended June 30, 2003. The increase in gross profit is primarily attributable to a lower inventory reserve provision in fiscal 2004 compared to fiscal 2003, an overall reduction in payroll and payroll related costs due to the closing of our Milford, Connecticut facility in February 2003, an increase in our capitalized inventory overhead and a decrease in the amortization of purchased intangible assets due to the impairment write-down of $3.1 million during the fourth quarter of fiscal 2003. These decreases were offset by an increase in our warranty expense.

Selling, General and Administrative

	YEAR ENDED JUNE 30,					
	2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Selling, general and administrative	$23,293	47.6%	$28,660	58.0%	$ (5,367)	(18.7)

Selling, general and administrative expenses consist primarily of personnel-related expenses including salaries and commissions, facility expenses, information technology, trade show expenses, advertising, insurance proceeds, and professional legal and accounting fees. Selling, general and administrative expense decreased primarily due to reductions in headcount and facility costs as a result of our fiscal 2003 restructurings, decrease in legal and other professional fees, improvement in our accounts receivable resulting in a reduction of our allowance for doubtful accounts, offset by an increase in our directors and officers liability insurance. The legal fees primarily relate to our defense of the shareholders and various other lawsuits and the SEC investigation. Legal fees incurred in defense of the shareholder suits are reimbursable to the extent provided in our directors and officers liability insurance policies, and subject to the coverage limitations and exclusions contained in such policies. For the years ended June 30, 2004 and 2003, we have been reimbursed $3.0 million and $1.4 million of these expenses. Management expects to receive additional reimbursements from insurance sources for legal fees in fiscal 2005.

Research and Development

	YEAR ENDED JUNE 30,					
	2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Research and development	$ 7,813	16.0%	$9,430	19.1%	$ (1,617)	(17.1)%

Research and development expenses consist primarily of personnel-related costs of employees, as well as expenditures to third-party vendors for research and development activities. Research and development expenses decreased primarily due to our fiscal 2003 restructurings which resulted in the consolidation of our research and development activities primarily to our Irvine, California facility.

Stock-based compensation

	YEAR ENDED JUNE 30,					
	2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Stock-based compensation	$ 347	0.7%	$1,453	2.9%	$ (1,106)	(76.1)%

Stock-based compensation expense generally represents the amortization of deferred compensation. We recorded no deferred compensation for the year ended June 30, 2004 and recorded a reduction to deferred compensation as a result of employee stock option forfeitures in the amount of $197,000. Deferred compensation represents the difference between the fair value of the underlying common stock for accounting purposes and the exercise price of the stock options at the date of grant as well as the fair market value of the vested portion of non-employee stock options utilizing the Black-Scholes option pricing model. Deferred compensation also includes the value of employee stock options assumed in connection with our acquisitions calculated in accordance with current accounting guidelines. Deferred compensation is presented as a reduction of stockholders' equity and is amortized ratably over the respective vesting periods of the applicable options, which is generally four years.

Included in cost of revenues is stock-based compensation of $48,000 and $89,000 for the years ended June 30, 2004 and 2003, respectively. Stock-based compensation decreased primarily due to the restructuring plan whereby options for which deferred compensation has been recorded were forfeited by terminated

employees. Additionally, the decrease is due to the acceleration of approximately $239,000 of stock-based compensation in January 2003 as a result of our completion of a stock option exchange program whereby employees holding options to purchase our common stock were given the opportunity to cancel certain of their existing options in exchange for the opportunity to receive new options. At June 30, 2004, a balance of $103,000 remains and will be amortized as follows: $86,000 in fiscal 2005 and $17,000 in fiscal 2006.

Amortization of purchased intangible assets

	YEARS ENDED JUNE 30,					
	2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARI
Amortization of purchased intangible assets	$ 148	0.3%	$ 602	1.2%	$ (454)	(7

Purchased intangible assets primarily include existing technology, patents and non-compete agreements and are amortized on a straight-line basis over the estimated useful lives of the respective assets, ranging from one to five years. We obtained independent appraisals of the fair value of tangible and intangible assets acquired in order to allocate the purchase price. In addition, approximately $2.1 million and $3.6 million of amortization of purchased intangible assets have been classified as cost of revenues for the years ended June 30, 2004 and 2003, respectively. During the fourth fiscal quarter of 2004, we completed our annual impairment assessment and determined that no impairment was indicated as the estimated fair values exceeded their respective carrying values. The overall decrease is primarily due to the impairment charge of $2.4 million recorded during the year ended June 30, 2003. At June 30, 2004, the unamortized balance of purchased intangible assets that will be amortized to future operating expense was $67,000 which will be amortized in fiscal 2005.

Impairment of goodwill and purchased intangible assets

During the fourth quarter of fiscal 2003, we performed an assessment of the value of our purchased intangible assets in accordance with SFAS No. 144. As a result of industry conditions, continued lower market valuations and reduced estimates in information technology capital equipment spending in the future and other factors impacting expected future cash flows, we determined that there were indicators of impairment to the carrying value of our purchased intangible assets recorded as part of our acquisitions. We engaged an independent valuation company to perform a review of the value of our purchased intangible assets. In accordance with SFAS No. 144, we utilized a cash flow estimation approach, comparing the discounted expected future cash flows to the carrying value of the subject assets. Based on the independent valuations, during the fourth quarter of fiscal 2003 we recorded a $5.4 million impairment charge of which $2.4

million and $3.1 million were charged to operating expenses and cost of revenues, respectively.

Restructuring (recovery) charges

On September 12, 2002 and again on March 14, 2003, we announced a restructuring plan to prioritize our initiatives around the growth areas of our business, focus on profit contribution, reduce expenses and improve operating efficiency. These restructuring plans included a worldwide workforce reduction, consolidation of excess facilities and other charges. We recorded restructuring costs totaling $5.6 million which were classified as operating expenses in the consolidated statements of operations for the year ended June 30, 2003. The restructuring plans resulted in the reduction of approximately 58 regular employees worldwide. We recorded workforce reduction charges of approximately $1.2 million related to severance and fringe benefits for the terminated employees. We recorded charges of approximately $4.4 million related to consolidation of excess facilities, relating primarily to lease terminations, non-cancelable lease costs, write-off of leasehold improvements and termination of a contractual obligation.

During the year ended June 30, 2004, approximately $2.1 million of restructuring charges were recovered related to a favorable settlement of a contractual obligation, consolidation of excess facilities and workforce reductions which were previously accrued for in fiscal 2003. The remaining restructuring reserve is related to facility closures in Naperville, Illinois; Hillsboro, Oregon; Redmond, Washington and Ames, Iowa. Payments under the lease obligations will end in fiscal 2007.

Litigation settlement costs

On August 23, 2002, a complaint entitled Dunstan v. Lantronix, Inc., et al., was filed in the Circuit Court of the State of Oregon, County of Multnomah, against us and certain of our current and former officers and directors by the co-founders of USSC. The parties participated in mediation on June 30, 2003, and subsequently reached an agreement to settle the dispute. The agreement called for us to release to the plaintiffs approximately $400,000 in cash and 49,038 shares of our common stock that had been held in an escrow since December 2000 as part of the acquisition of USSC. The agreement also called for us to issue to the plaintiffs additional shares of our common stock worth approximately $1.5 million, which was recorded in our results of operations as litigation settlement costs for the year ended June 30, 2003. Accordingly, 1,726,703 shares were issued following a fairness determination by the state court in Oregon. In exchange, the plaintiffs released all claims against all defendants. No litigation settlement costs related to this matter were incurred during the year ended June 30, 2004.

Interest Income (Expense), Net

	YEAR ENDED JUNE 30,			
	% OF NET	% OF NET	$	%

	2004	REVENUES	2003	REVENUES	VARIANCE	VARIANCE
Interest income (expense), net	$ 50	0.1%	$ 248	0.5%	$ (198)	(79.8)%

Interest income (expense), net consists primarily of interest earned on cash, cash equivalents and marketable securities. The decrease is primarily due to lower average investment balances and interest rates. Additionally, the decrease in the average investment balance is due to increased legal and other professional fees, settlement of litigation and contractual obligations, cash portions of settlements with prior owners of some of the businesses we have acquired, the settlement of the Milford lease obligation included in our restructuring charge, the purchase of a joint interest in intellectual property from Gordian, our acquisition of Stallion and to fund current operations.

Other Income (Expense), Net

	YEAR ENDED JUNE 30,					
	2004	% OF NET REVENUES	2003	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Other income (expense), net	$(5,333)	(10.9)%	$(926)	(1.9)%	$ 4,407	475.9%

The increase in other expense is due to our decision to write-off our investment in Xanboo. We periodically review our investments for which fair value is less than cost to determine if the decline in value is other than temporary. If the decline in value is judged to be other than temporary, the cost basis of the security is written down to fair value. We generally believe an other-than-temporary decline has occurred when the fair value of the investment is below the carrying value for two consecutive quarters, absent evidence to the contrary. On the basis of events occurring during the quarter ended June 30, 2004, we performed an analysis and recorded a charge in the amount of $5.0 million, representing a write-off of all remaining value of this non-marketable equity security. This charge is included within the consolidated statements of operations as other expense.

Provision (Benefit) for Income Taxes

We utilize the liability method of accounting for income taxes as set forth in FASB Statement No. 109, "Accounting for Income Taxes." Our effective tax rate was 3% for the year ended June 30, 2004, and 0% for the year ended June 30, 2003. The federal statutory rate was 34% for both periods. Our effective tax rate associated with the income tax expense for the year ended June 30, 2004, was lower than the federal statutory rate primarily due to the increase in valuation allowance. Our effective tax rate associated with the income tax benefit for the year ended June 30, 2003, was lower than the federal statutory rate primarily due to the increase in valuation allowance and amortization of stock-based compensation for which no benefit was provided. In 2003, the Internal Revenue Service ("IRS") completed its audit of our federal income tax returns for the fiscal years ended June 30, 1999, 2000 and 2001. As a result, we were required to pay approximately $776,000 in tax and interest to the IRS and

the California Franchise Tax Board. We accrued $1.3 million for this liability in prior fiscal periods. Based on the final resolution of their examination and related state impact of the IRS examination, we recorded a reduction in our tax contingency reserve of approximately $500,000. We have paid $662,000 of this liability through June 30, 2004 and $114,000 was paid during the quarter ended September 30, 2004.

COMPARISON OF THE YEARS ENDED JUNE 30, 2003 AND 2002

Net Revenues

NET REVENUES BY PRODUCT CATEGORY

	YEAR ENDED JUNE 30,					
PRODUCT CATEGORIES	2003	% OF NET REVENUE	2002	% OF NET REVENUE	$ VARIANCE	% VARIANCE
Device networking	$24,523	49.6%	$ 28,607	49.8%	$ (4,084)	(14.3)%
IT management	13,034	26.4%	16,528	28.7%	(3,494)	(21.1)%
Non-core	11,832	24.0%	12,456	21.5%	(624)	(5.0)%
TOTAL	$49,389	100.0%	$ 57,591	100.0%	$ (8,202)	(14.3)%

The overall decrease in net revenues by product is primarily attributable to logistical issues surrounding the restructuring of our Milford, Connecticut operations, whereby we began to outsource our manufacturing to three contract manufacturers, our discontinuance of certain product offerings as well as the overall decrease in industry technology spending year to year.

NET REVENUES BY REGION

	YEAR ENDED JUNE 30,					
GEOGRAPHIC REGION	2003	% OF NET REVENUE	2002	% OF NET REVENUE	$ VARIANCE	% VARIANCE
Americas	$37,391	75.7%	$47,691	82.8%	$ (10,300)	(21.6)%
Europe	10,366	21.0%	8,249	14.3%	2,117	25.7%
Other	1,632	3.3%	1,651	2.9%	(19)	(1.2)%
TOTAL	$49,389	100.0%	$57,591	100.0%	$ (8,202)	(14.2)%

Our net revenues derived from customers located in the Americas decreased primarily due to logistical issues surrounding the restructuring of our Milford, Connecticut operations, whereby we began to outsource our manufacturing to three contract manufacturers, our discontinuance of certain product offerings as well as the overall decrease in industry technology spending year to year. The increase in the Europe region was primarily due to a concentrated effort to improve sales through a stronger sales structure.

Gross Profit

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Gross profit	$13,125	26.6%	$17,310	30.1%	$ (4,185)	(24.2)%

Gross profit represents net revenues less cost of revenues. Cost of revenues consists primarily of the cost of raw material components, subcontract labor assembly from outside manufacturers, amortization of purchased intangible assets, establishing inventory reserves for excess and obsolete products or raw materials and overhead costs. As part of an agreement with Gordian, an outside research and development firm, a royalty charge was included in cost of revenues and was calculated based on the related products sold. Gordian royalties were $1.2 million for the year ended June 30, 2002. No royalties were paid for the year ended June 30, 2003 as a result of a new Gordian agreement as described below. Cost of revenues for the years ended June 30, 2003 and 2002 consisted of $3.6 million and $2.2 million of amortization of purchased intangible assets, respectively. Cost of revenues for the years ended June 30, 2003 and 2002 also includes a $3.1 million and $6.4 million impairment charge of purchased intangible assets, respectively, in accordance with SFAS No. 144.

In May 2002, we signed a new agreement with Gordian to acquire a joint interest in the intellectual property that is evident in our products designed by Gordian and to extinguish our obligation to pay royalties on future sales of our products. We paid $6.0 million for this intellectual property and are amortizing this asset to cost of revenues over the remaining life of our products designed by Gordian, or approximately 3 years. Effective May 30, 2002, upon the signing of the new agreement, royalty expenses have been replaced by an amortization of the prepaid royalties and entitlement to the intellectual property that was part of the agreement. Amortization expense related to the new Gordian agreement, included in amortization of purchased intangible assets of $3.6 million, totaled $2.5 million for the year ended June 30, 2003. Amortization expense related to the new Gordian agreement, included in amortization of purchased intangible assets of $2.2 million, totaled $212,000 for the year ended June 30, 2002.

The overall decrease in gross profit is primarily attributable to a decrease in net revenues, an increase in the amortization of purchased intangible assets relating to technology acquired in our acquisitions, an increase in production expenses related to the closing of our Milford, Connecticut facility and an increase in our reserves for excess and obsolete inventory and warranty.

Selling, General and Administrative

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Selling, general and administrative	$28,660	58.0%	$40,538	70.4%	$ (11,878)	(29.3)

Selling, general and administrative expenses consist primarily of personnel-related expenses including salaries and commissions, facilities expenses, information technology, trade show expenses, advertising, and professional legal and accounting fees. Selling, general and administrative expense decreased primarily due to reductions in headcount and facility costs as a result of our restructurings in the second quarter of fiscal 2002 and the first and third quarters of fiscal 2003, as well as a favorable settlement of a contractual service obligation and a reduction in our allowance for doubtful accounts. These decreases are partially offset by increases in legal and other professional fees. The legal fees primarily relate to our defense of the shareholder lawsuits, government investigations, and the defense of the intellectual property lawsuit, which was settled during the second quarter of fiscal 2003. Legal fees incurred in defense of the shareholder suits are reimbursable to the extent provided in our directors and officers liability insurance policies, and subject to the coverage limitations and exclusions contained in such policies. For the year ended June 30, 2003, we have been reimbursed $1.4 million of these expenses. There were no reimbursements for the year ended June 30, 2002.

Research and Development

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Research and development	$9,430	19.1%	$8,680	15.1%	$ 750	8.6%

Research and development expenses consist primarily of personnel-related costs of employees, as well as expenditures to third-party vendors for research and development activities. Research and development expenses increased primarily due to increased personnel-related costs including the acquisitions of Synergetic and Stallion and third-party expenses related to new product development.

Stock-based compensation

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Stock-based compensation	$1,453	2.9%	$2,863	5.0%	$ (1,410)	(49.2)%

Stock-based compensation expense generally represents the amortization of deferred compensation. We recorded approximately $73,000 of deferred compensation for the year ended June 30, 2003. Additionally, we recorded deferred compensation forfeitures of $2.6 million for the year ended June 30, 2003. Deferred compensation represents the difference between the fair value of the underlying common stock for accounting purposes and the exercise price of the stock options at the date of grant as well as the fair market value of the vested portion of non-employee stock options utilizing the Black-Scholes option pricing model. Deferred compensation also includes the value of employee stock options assumed in connection with our acquisitions calculated in accordance with current accounting guidelines. Deferred compensation is presented as a reduction of stockholders' equity and is amortized ratably over the respective vesting periods of the applicable options, which is generally four years.

Included in cost of revenues is stock-based compensation of $89,000 and $117,000 for the years ended June 30, 2003 and 2002, respectively. The decrease in stock-based compensation for the year ended June 30, 2003 is primarily attributable to the restructuring plan whereby options for which deferred compensation has been recorded are forfeited for terminated employees.

Amortization of purchased intangible assets

	YEARS ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	VARI
Amortization of purchased intangible assets	$ 602	1.2%	$ 960	1.7%	$ (358)	(3

Purchased intangible assets primarily include existing technology, customer agreements, patents and trademarks and are amortized on a straight-line basis over the estimated useful lives of the respective assets, ranging from one to five years. We obtained independent appraisals of the fair value of tangible and intangible assets acquired in order to allocate the purchase price. The increase in amortization of purchased intangible assets included in cost of revenues is primarily due to the amortization of the intellectual property

agreement with Gordian signed in May 2002, and existing technology recorded as part of the Stallion acquisition in August 2002, offset by the impairment write-down of $6.4 million during the fourth quarter of fiscal 2002 as well as the $3.1 million impairment during the fourth quarter of fiscal 2003. The decrease in amortization of purchased intangible assets is primarily due to the impairment write-down of $4.0 million during the fourth quarter of fiscal 2002 as well as the $2.4 million impairment write-down during the fourth quarter of fiscal 2003.

Impairment of goodwill and purchased intangible assets

We performed the first of the required annual impairment tests of goodwill under the guidelines of SFAS No. 142 effective as of June 1, 2002. As a result of industry conditions, lower market valuations and reduced estimates of information technology capital equipment spending in the future, we determined that there were indicators of impairment to the carrying value of goodwill related to the acquisitions of Lightwave and Synergetic which had carrying values of $39.7 million and $13.9 million, respectively, as of June 30, 2002. During the fourth quarter of fiscal 2002, we engaged an independent valuation company to perform a review of the value of our goodwill and based on the independent valuation we recorded a $46.4 million impairment charge of our goodwill.

Additionally, during the fourth quarter of fiscal 2002, we performed a review of the value of our purchased intangible assets in accordance with SFAS No. 144. As a result of industry conditions, lower market valuations and reduced estimates of information technology capital equipment spending in the future, we determined that there were indicators of impairment to the carrying value of our purchased intangible assets related to our acquisitions. During the fourth quarter of fiscal 2002, we engaged an independent valuation company to perform a review of the value of our purchased intangible assets and based on the independent valuation we recorded a $9.8 million impairment charge of which $4.0 million and $5.8 million were charged to operating expenses and cost of revenues, respectively. Additionally, we recorded an impairment charge of $665,000 to cost of revenues related to intellectual property not associated with an acquisition.

During the fourth quarter of fiscal 2003, we performed an assessment of the value of our purchased intangible assets in accordance with SFAS No. 144. As a result of industry conditions, continued lower market valuations and reduced estimates in information technology capital equipment spending in the future and other factors impacting expected future cash flows, we determined that there were indicators of impairment to the carrying value of our purchased intangible assets recorded as part of our acquisitions. We engaged an independent valuation company to perform a review of the value of our purchased intangible assets. In accordance with SFAS No. 144, we utilized a cash flow estimation approach, comparing the discounted expected future cash flows to the carrying value of the subject assets. Based on the independent valuations, during the fourth quarter of fiscal 2003 we recorded a $5.4 million impairment charge of which $2.3 million and $3.1 million were charged to operating expenses and cost of revenues, respectively.

Restructuring charges

On September 12, 2002 and March 14, 2003, we announced restructuring plans to prioritize our initiatives around the growth areas of our business, focus on profit contribution, reduce expenses, and improve operating efficiency. These restructuring plans included a worldwide workforce reduction, consolidation of excess facilities and other charges. We recorded restructuring costs totaling $5.6 million, which were classified as operating expenses in the consolidated statement of operations for the year ended June 30, 2003. These restructuring

plans resulted in the reduction of approximately 58 regular employees worldwide. We recorded workforce reduction charges of approximately $1.2 million related to severance and fringe benefits for the terminated employees. We recorded charges of approximately $4.4 million related to the consolidation of excess facilities, relating primarily to lease terminations, non-cancelable lease costs, write-off of leasehold improvements and termination of a contractual obligation.

On February 6, 2002, we announced a restructuring plan to prioritize our initiatives around the growth area of our business, focus on profit contribution, reduce expenses, and improve operating efficiency. This restructuring plan included a worldwide workforce reduction, consolidation of excess facilities and other charges. As of June 30, 2002, we recorded restructuring costs totaling $3.5 million. Through June 30, 2003, the February 2002 restructuring plan has resulted in the reduction of approximately 50 regular employees worldwide and we incurred actual workforce reduction charges of approximately $1.9 million related to severance and fringe benefits. Included in the workforce reduction charge was a non-cash stock-based compensation charge in the amount of $595,000 associated with the modification of stock options that were outstanding at the termination date. Property, equipment and other assets that were disposed of or removed from operations resulted in a charge of $1.6 million and consisted primarily of computer software and related equipment, production, engineering and office equipment, and furniture and fixtures.

Litigation settlement costs

On August 23, 2002, a complaint entitled Dunstan v. Lantronix, Inc., et al., was filed in the Circuit Court of the State of Oregon, County of Multnomah, against us and certain of our current and former officers and directors by the co-founders of USSC. The parties participated in mediation on June 30, 2003, and subsequently reached an agreement to settle the dispute. The agreement called for us to release to the plaintiffs approximately $400,000 in cash and 49,038 shares of our common stock that had been held in an escrow since December 2000 as part of the acquisition of USSC. The agreement also called for us to issue to the plaintiffs additional shares of our common stock worth approximately $1.5 million, which was recorded in our results of operations as litigation settlement costs for the year ended June 30, 2003. Accordingly, 1,726,703 shares were issued following a fairness determination by the state court in Oregon. In exchange, the plaintiffs released all claims against all defendants.

We received an informal notice from several holders of our unregistered shares of common stock that were issued in connection with the acquisition of Lightwave. The shares were issued to the holders in a private transaction not registered under the Securities Act of 1933, and therefore could not be sold by the stockholders without a valid registration statement. The stockholders alleged that we failed to honor their rights to have the shares registered and that they were therefore precluded from selling the shares. Effective July 26, 2002, we settled with the stockholders of Lightwave in the amount of $2.0 million in exchange for 240,000 shares of our common stock held in escrow and 208,335 additional shares issued to the former owners of Lightwave on the acquisition date. This settlement resulted in a net charge to our results of operations of approximately $1.9 million for the year ended June 30, 2002 and has been recognized as litigation settlement costs.

Interest Income (Expense), Net

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Interest income (expense), net	$ 248	0.5%	$1,548	2.7%	$ (1,300)	(84.0)%

Interest income (expense), net consists primarily of interest earned on cash, cash equivalents and marketable securities. The decrease is primarily due to lower average investment balances and interest rates. Additionally, the decrease in the average investment balance is due to increased expenditures for legal and other professional fees resulting from our financial statement restatements in fiscal 2002 and defense of our lawsuits. Also, the decrease is due to the settlement of the Milford lease obligation included in our restructuring charge, the purchase of a joint interest in intellectual property from Gordian, our acquisition of Stallion and to fund current operations.

Other Income (Expense), Net

	YEAR ENDED JUNE 30,					
	2003	% OF NET REVENUES	2002	% OF NET REVENUES	$ VARIANCE	% VARIANCE
Other income (expense), net	$(926)	(1.9)%	$(760)	(1.3)%	$ (166)	(21.8)%

The increase for the year ended June 30, 2003 is primarily attributable to our share of the losses from our investment in Xanboo.

Provision (Benefit) for Income Taxes

We utilize the liability method of accounting for income taxes as set forth in FASB Statement No. 109, "Accounting for Income Taxes." Our effective tax rate was 0% for the year ended June 30, 2003, and 7% for the year ended June

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30, 2002. The federal statutory rate was 34% for both periods. Our effective tax rate associated with the income tax expense for the year ended June 30, 2003, was lower than the federal statutory rate primarily due to the increase in valuation allowance, as well as the amortization of stock-based compensation for which no current year tax benefit was provided. Our effective tax rate associated with the income tax benefit for the year ended June 30, 2002, was lower than the federal statutory rate primarily due to foreign losses and amortization of stock-based compensation for which no benefit was provided.

LIQUIDITY AND CAPITAL RESOURCES

Since inception, we have financed our operations through the issuance of common stock and through net cash generated from operations. We consider all highly liquid investments purchased with original maturities of 90 days or less to be cash equivalents. Cash and cash equivalents, consisting of money-market funds and commercial paper, totaled $9.1 million at June 30, 2004. Marketable securities are income yielding securities which can be readily converted to cash. Marketable securities consist of obligations of U.S. Government agencies, state, municipal and county government notes and bonds and totaled $3.1 million at June 30, 2004.

Our operating activities used cash of $2.9 million for the year ended June 30, 2004. We incurred a net loss of $15.7 million of which $10.6 million is from continuing operations and $5.1 million is from discontinued operations, which includes the following adjustments: depreciation of $1.7 million, amortization of purchased intangible assets of $2.2 million, amortization of stock-based compensation of $395,000, equity losses from unconsolidated businesses of $413,000, revaluation of a strategic investment of $5.0 million, offset by a recovery in the restructuring reserve of $1.6 million and a deferred tax liability of $600,000. The revaluation of a strategic investment is due to the write-off of our remaining investment in Xanboo due to an other-than temporary impairment. The restructuring reserve recovery is primarily due to the favorable settlement of a contractual obligation. The changes in our operating assets consist of a decrease in accounts receivable of $708,000, decrease in contract manufacturer receivable of $777,000, decrease in prepaid expenses and other current assets of $1.1 million, decrease in net assets of discontinued operations of $3.4 million, increase in warranty reserve of $577,000, increase in other current liabilities of $732,000, which was reduced by a decrease in accounts payable of $725,000, decrease in our liability to Gordian of $1.0 million and a decrease in restructuring reserve of $932,000. The reduction in accounts receivable is primarily due to improved collections from our distributors and European customers. The decrease in contract manufacturer receivables is due to improved collections. The decrease in our prepaid and other current assets is primarily due to the Gordian payment whereby we maintained a time deposit for $1.0 million as well as the maturity of additional time deposits totaling $682,000. Net assets of discontinued operations are due to the sale of the Premise business unit in March 2004. The increase in the warranty reserve is primarily due to the increase in historical actual warranty costs. The increase in other current liabilities is primarily due to an increase in accrued payroll and an increase in general liabilities such as audit fees, legal fees and inventory purchases. The decrease in accounts payable is due to the timing of payments to our suppliers. The decrease in the balance due to Gordian is due to payments in accordance with the agreement. The decrease in the restructuring reserve is due to payments on lease obligations and workforce reductions. Our operating activities used cash of $17.6 million for the year ended June 30, 2003.

Cash provided by investing activities was $3.5 million for the year ended June 30, 2004 compared with a $2.1 million usage of cash for the year ended June 30, 2003. We received $4.3 million in proceeds from the sales of marketable securities. We used $552,000 to purchase marketable securities. We also used $248,000 to purchase property and equipment.

Cash provided by financing activities was $1.2 million for the year ended June 30, 2004 primarily related to the purchases by the employee stock purchase plan and $500,000 in borrowings under our line of credit. Cash provided by financing activities was $345,000 for the year ended June 30, 2003.

In January 2002, we entered into a two-year line of credit with a bank in an amount not to exceed $20.0 million. Borrowings under the line of credit bear

interest at either (i) the prime rate or (ii) the LIBOR rate plus 2.0%. We are required to pay a $100,000 facility fee which was reduced to $62,500 and was paid. We were also required to pay a quarterly unused line fee of .125% of the unused line of credit balance. Since establishing the line of credit, we have twice reduced the amount of the line, modified customary financial covenants and adjusted the interest rate to be charged on borrowings to the prime rate plus .50% and eliminated the LIBOR option. Effective July 25, 2003, we further modified this line of credit, reducing the revolving line to $5.0 million and adjusting the customary affirmative and negative covenants. We are also required to maintain certain financial ratios as defined in the agreement. The agreement has an annual revolving maturity date that renews on the effective date. The agreement was renewed on July 24, 2004 with an amendment to a financial ratio. We are required to pay a $12,500 facility fee for the renewal. Our borrowing base at June 30, 2004, was $3.2 million. In March 2004, we borrowed $500,000 against this line of credit. Additionally, we have used letters of credit available under our line of credit totaling approximately $1.0 million in place of cash to fund deposits on leases, tax account deposits and security deposits. As a result, our available line of credit at June 30, 2004 was $1.6 million. We are currently in compliance with the revised financial covenants of the July 24, 2004 amended line of credit. Pursuant to the line of credit, we are restricted from paying any dividends.

The following table summarizes our contractual payment obligations and commitments:

	Fiscal Years			
	2005	2006	2007	TOTAL
Convertible note payable	$ 867	$ -	$ -	$ 867
Bank line of credit	500	-	-	500
Operating leases	1,562	437	162	2,161
Total	$2,929	$ 437	$ 162	$3,528

In March 2004, we completed the sale of substantially all of the net assets of the Premise business unit with a net book value of approximately $25,000 for $1.0 million. Additionally, we incurred $383,000 of disposal costs.

At June 30, 2004, we had purchase obligations which consists of our finished goods purchases from our contract manufacturers and raw materials from our suppliers in the amount of approximately $5.5 million.

Additionally, in the first fiscal quarter of 2005, our convertible note will become due. If the notes are not converted to our common stock we will be required to pay up to $867,000. On August 22, 2004, the notes were not converted into our common stock and were paid.

Net cash requirements in the first fiscal quarter of 2005 may represent an

increase from the average net cash usage of the previous quarters. During the first quarter of fiscal 2005, we expect to use approximately $2.2 to $2.8 million in cash. This increase is primarily the result of payment of our convertible note as discussed above. Additionally, we expect to incur higher expenses for this quarter in marketing, sales and research and development that are related to our product launches, as well as the tax payment also discussed above. We expect to return to a more normal range of cash usage of approximately $1.0 million in the second quarter of fiscal 2005.

At June 30, 2004, approximately $2.9 million of our net tangible assets (primarily cash held in foreign bank accounts) were located outside the United States. Such assets are unrestricted with regard to foreign liquidity needs, however, our ability to utilize such assets to satisfy liquidity needs outside of such foreign locations are subject to approval by the foreign location board of directors. We believe that our existing cash, cash equivalents and marketable securities and any available borrowings under our line of credit facility will be adequate to meet our anticipated cash needs through at least the next twelve months. Our future capital requirements will depend on many factors, including the timing and amount of our net revenues, research and development and infrastructure investments, and expenses related to on-going government investigations and pending litigation, which will affect our ability to generate additional cash. If cash generated from operations and financing activities is insufficient to satisfy our working capital requirements, we may need to borrow funds through bank loans, sales of securities, or other means. There can be no assurance that we will be able to raise any such capital on terms acceptable to us, if at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to operate our business.

RISK FACTORS

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing our company. Our business operations may be impaired by additional risks and uncertainties of which we are unaware or that we currently consider immaterial.

Our business, results of operations or cash flows may be adversely affected if any of the following risks actually occur. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

VARIATIONS IN QUARTERLY OPERATING RESULTS, DUE TO FACTORS INCLUDING CHANGES IN DEMAND FOR OUR PRODUCTS AND CHANGES IN OUR MIX OF NET REVENUES, COULD CAUSE OUR STOCK PRICE TO DECLINE.

Our quarterly net revenues, expenses and operating results have varied in the past and might vary significantly from quarter to quarter in the future. We therefore believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance, and you should not rely on them to predict our future performance or the future performance of our stock price. Our short-term expense levels are relatively fixed and are based on our expectations of future net revenues. If we were to experience a reduction in net revenues in a quarter, we would likely be unable to adjust our short-term expenditures. If this were to occur, our operating results for that quarter would be harmed. If our operating results in future quarters fall below the expectations of market analysts and investors, the price of our common stock

would likely fall. Other factors that might cause our operating results to fluctuate on a quarterly basis include:

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

WE ARE CURRENTLY ENGAGED IN MULTIPLE SECURITIES CLASS ACTION LAWSUITS, A STATE DERIVATIVE SUIT, A LAWSUIT BY OUR FORMER CFO AND COO STEVEN V. COTTON, A LAWSUIT BY FORMER SHAREHOLDERS OF OUR SYNERGETIC SUBSIDIARY, AND PATENT INFRINGEMENT LITIGATION ANY OF WHICH, IF IT RESULTS IN AN UNFAVORABLE RESOLUTION, COULD ADVERSELY AFFECT OUR BUSINESS, RESULTS OF OPERATIONS OR FINANCIAL CONDITION.

From time to time, we are subject to other legal proceedings and claims in the ordinary course of business.

We are currently involved in significant litigation, including multiple security class action lawsuits, a state derivative lawsuit, litigation with a former executive officer and patent infringement litigation. The pending lawsuits involve complex questions of fact and law and likely will continue to require the expenditure of significant funds and the diversion of other resources to defend. We do not know what the outcome of outstanding legal proceedings will be and cannot determine the extent to which these resolutions might have a material adverse effect on our business, results of operations and financial condition taken as a whole. The results of litigation are inherently uncertain, and adverse outcomes are possible. For a more detailed description of pending litigation, see Part 3, Item 1 on page 13.

WE MIGHT BECOME INVOLVED IN LITIGATION OVER PROPRIETARY RIGHTS, WHICH COULD BE COSTLY AND TIME CONSUMING.

Substantial litigation regarding intellectual property rights exists in our industry. There is a risk that third-parties, including current and potential competitors, current developers of our intellectual property, our manufacturing partners, or parties with which we have contemplated a business combination will claim that our products, or our customers' products, infringe on their intellectual property rights or that we have misappropriated their intellectual property. In addition, software, business processes and other property rights in our industry might be increasingly subject to third-party infringement claims as the number of competitors grows and the functionality of products in different industry segments overlaps. Other parties might currently have, or might eventually be issued, patents that infringe on the proprietary rights we use. Any of these third parties might make a claim of infringement against us. For example, Digi International, ("Digi") has just filed a lawsuit alleging that we infringe their '192 patent. We have filed suit alleging that Digi infringes our '305 patent. Please refer to Part I, Item 3 on page 13 for more information.

From time to time in the future we could encounter other disputes over rights and obligations concerning intellectual property. We cannot assume that we will prevail in intellectual property disputes regarding infringement, misappropriation or other disputes. Litigation in which we are accused of

infringement or misappropriation might cause a delay in the introduction of new products, require us to develop non-infringing technology, require us to enter into royalty or license agreements, which might not be available on acceptable terms, or at all, or require us to pay substantial damages, including treble damages if we are held to have willfully infringed. In addition, we have obligations to indemnify certain of our customers under some circumstances for infringement of third-party intellectual property rights. If any claims from third-parties were to require us to indemnify customers under our agreements, the costs could be substantial, and our business could be harmed. If a successful claim of infringement were made against us and we could not develop non-infringing technology or license the infringed or similar technology on a timely and cost-effective basis, our business could be significantly harmed.

WE HAVE ELECTED TO USE A CONTRACT MANUFACTURER IN CHINA, WHICH INVOLVES SIGNIFICANT RISKS.

One of our contract manufacturers is based in China. There are significant risks of doing business in China, including:

- Delivery times are extended due to the distances involved, requiring more lead-time in ordering and increasing the risk of excess inventories.

- We could incur ocean freight delays because of labor problems, weather delays or expediting and customs problems.

- China does not afford the same level of protection to intellectual property as domestic or many other foreign countries. If our products were reverse-engineered or our intellectual property was otherwise pirated-reproduced and duplicated without our knowledge or approval, our revenues would be reduced.

- China and U.S foreign relations have, historically, been subject to change. Political considerations and actions could interrupt our expected supply of products from China.

INABILITY, DELAYS IN DELIVERIES OR QUALITY PROBLEMS FROM OUR COMPONENT SUPPLIERS COULD DAMAGE OUR REPUTATION AND COULD CAUSE OUR NET REVENUES TO DECLINE AND HARM OUR RESULTS OF OPERATIONS.

Our contract manufacturers and we are responsible for procuring raw materials for our products. Our products incorporate components or technologies that are only available from single or limited sources of supply. In particular, some of our integrated circuits are available from a single source. From time to time in the past, integrated circuits we use in our products have been phased out of production. When this happens, we attempt to purchase sufficient inventory to meet our needs until a substitute component can be incorporated into our products. Nonetheless, we might be unable to purchase sufficient components to meet our demands, or we might incorrectly forecast our demands, and purchase too many or too few components. In addition, our products use components that have in the past been subject to market shortages and substantial price fluctuations. From time to time, we have been unable to meet

our orders because we were unable to purchase necessary components for our products. We rely on a number of different component suppliers. Because we do not have long-term supply arrangements with any vendor to obtain necessary components or technology for our products, if we are unable to purchase components from these suppliers, product shipments could be prevented or delayed, which could result in a loss of sales. If we are unable to meet existing orders or to enter into new orders because of a shortage in components, we will likely lose net revenues and risk losing customers and harming our reputation in the marketplace.

THE MARKET FOR OUR PRODUCTS IS NEW AND RAPIDLY EVOLVING. IF WE ARE NOT ABLE TO DEVELOP OR ENHANCE OUR PRODUCTS TO RESPOND TO CHANGING MARKET CONDITIONS, OUR NET REVENUES WILL SUFFER.

Our future success depends in large part on our ability to continue to enhance existing products, lower product cost and develop new products that maintain technological competitiveness. The demand for network-enabled products is relatively new and can change as a result of innovations or changes. For example, industry segments might adopt new or different standards, giving rise to new customer requirements. Any failure by us to develop and introduce new products or enhancements directed at new industry standards could harm our business, financial condition and results of operations. These customer requirements might or might not be compatible with our current or future product offerings. We might not be successful in modifying our products and services to address these requirements and standards. For example, our competitors might develop competing technologies based on Internet Protocols, Ethernet Protocols or other protocols that might have advantages over our products. If this were to happen, our net revenue might not grow at the rate we anticipate, or could decline.

IF OUR RESEARCH AND DEVELOPMENT EFFORTS ARE NOT SUCCESSFUL, OUR NET REVENUES COULD DECLINE AND OUR BUSINESS COULD BE HARMED.

For the year ended June 30, 2004, we incurred $7.8 million in research and development expenses, which comprised 16.0% of our net revenues. If we are unable to develop new products as a result of this effort, or if the products we develop are not successful, our business could be harmed. Even if we do develop new products that are accepted by our target markets, we do not know whether the net revenue from these products will be sufficient to justify our investment in research and development.

IF A MAJOR CUSTOMER CANCELS, REDUCES, OR DELAYS PURCHASES, OUR NET REVENUES MIGHT DECLINE AND OUR BUSINESS COULD BE ADVERSELY AFFECTED.

Our top five customers accounted for 38% of our net revenues for the year ended June 30, 2004. One customer, Ingram Micro, Inc., accounted for approximately 14%, 11% and 12% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Another customer, Tech Data, accounted for approximately 9%, 10% and 11% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Accounts receivable attributable to these two domestic customers accounted for approximately 13% and 16% of total accounts receivable at June 30, 2004 and 2003, respectively. The number and timing of sales to our distributors have been difficult for us to predict. While our distributors are customers in the sense they buy our products, they are also part of our product distribution system. To some extent, the business lost for some reason to a distributor would likely be replaced by sales to other customer/distributors in a reasonable period, rather than a total loss of that

business such as from a customer who used our products in their business.

The loss or deferral of one or more significant sales in a quarter could harm our operating results. We have in the past, and might in the future, lose one or more major customers. If we fail to continue to sell to our major customers in the quantities we anticipate, or if any of these customers terminate our relationship, our reputation, the perception of our products and technology in the marketplace and the growth of our business could be harmed. The demand for our products from our OEM, VAR and systems integrator customers depends primarily on their ability to successfully sell their products that incorporate our device networking solutions technology. Our sales are usually completed on a purchase order basis and we have no long-term purchase commitments from our customers.

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

THE AVERAGE SELLING PRICES OF OUR PRODUCTS MIGHT DECREASE, WHICH COULD REDUCE OUR GROSS MARGINS.

In the past, we have experienced some reduction in the average selling prices and gross margins of products and we expect that this will continue for our products as they mature. In the future, we expect competition to increase, and we anticipate this could result in additional pressure on our pricing. Our average selling prices for our products might decline as a result of other reasons, including promotional programs and customers who negotiate price reductions in exchange for longer-term purchase commitments. We also may not be able to increase the price of our products in the event that the prices of components or our overhead costs increase. Changes in exchange rates between currencies might change in such a way or over a period such that we cannot adjust prices to maintain gross margins. If these were to occur, our gross margins would decline. In addition, we may not be able to reduce the cost to manufacture our products to keep up with the decline in prices.

UNDETECTED PRODUCT ERRORS OR DEFECTS COULD RESULT IN LOSS OF NET REVENUES, DELAYED MARKET ACCEPTANCE AND CLAIMS AGAINST US.

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

THERE IS A RISK THAT THE SEC COULD LEVY FINES AGAINST US, OR DECLARE US TO BE OUT OF COMPLIANCE WITH THE RULES REGARDING OFFERING SECURITIES TO THE PUBLIC.

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

WE INCORPORATE SOFTWARE LICENSED FROM THIRD PARTIES INTO SOME OF OUR PRODUCTS AND ANY SIGNIFICANT INTERRUPTION IN THE AVAILABILITY OF THESE THIRD-PARTY SOFTWARE PRODUCTS OR DEFECTS IN THESE PRODUCTS COULD REDUCE THE DEMAND FOR, OR PREVENT THE SALE OR USE OF, OUR PRODUCTS.

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

WE PRIMARILY DEPEND ON FIVE THIRD-PARTY MANUFACTURERS TO MANUFACTURE SUBSTANTIALLY ALL OF OUR PRODUCTS, WHICH REDUCES OUR CONTROL OVER THE MANUFACTURING PROCESS. IF THESE MANUFACTURERS ARE UNABLE OR UNWILLING TO MANUFACTURE OUR PRODUCTS AT THE QUALITY AND QUANTITY WE REQUEST, OUR BUSINESS COULD BE HARMED AND OUR STOCK PRICE COULD DECLINE.

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

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

- lack of guaranteed production capacity or product supply; and

- reliance on third-party manufacturers to maintain competitive manufacturing technologies.

Our agreements with these manufacturers provide for services on a purchase order basis. If our manufacturers were to become unable or unwilling to continue to manufacture our products in required volumes, at acceptable quality,

quantity, yields and costs, or in a timely manner, our business would be seriously harmed. As a result, we would have to attempt to identify and qualify substitute manufacturers, which could be time consuming and difficult, and might result in unforeseen manufacturing and operations problems. Moreover, if we shift products among third-party manufacturers, we may incur substantial expenses, risk material delays, or encounter other unexpected issues. For example, in the third quarter of fiscal 2003 we encountered product shortages related to the transition to a third-party manufacturer. This product shortage contributed to our net revenues falling below our publicly announced estimates.

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

BECAUSE WE ARE DEPENDENT ON INTERNATIONAL SALES FOR A SUBSTANTIAL AMOUNT OF OUR NET REVENUES, WE FACE THE RISKS OF INTERNATIONAL BUSINESS AND ASSOCIATED CURRENCY FLUCTUATIONS, WHICH MIGHT ADVERSELY AFFECT OUR OPERATING RESULTS.

Net revenues from international sales represented 31%, 24% and 17% of net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Net revenues from Europe represented 23%, 21% and 14% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. Our revenues in Japan and the People's Republic of China are increasing, as well.

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

- unexpected changes in regulatory requirements, taxes, trade laws and tariffs;
- reduced protection for intellectual property rights in some countries;
- differing labor regulations;
- compliance with a wide variety of complex regulatory requirements;
- changes in a country's or region's political or economic conditions;
- greater difficulty in staffing and managing foreign operations; and

- increased financial accounting and reporting burdens and complexities.

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

OUR EXECUTIVE OFFICERS AND TECHNICAL PERSONNEL ARE CRITICAL TO OUR BUSINESS, AND WITHOUT THEM WE MIGHT NOT BE ABLE TO EXECUTE OUR BUSINESS STRATEGY.

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

THERE IS A RISK THAT OUR OEM CUSTOMERS WILL DEVELOP THEIR OWN INTERNAL EXPERTISE IN NETWORK-ENABLING PRODUCTS, WHICH COULD RESULT IN REDUCED SALES OF OUR PRODUCTS.

For most of our existence, we primarily sold our products to distributors, VARs and system integrators. Although we intend to continue to use all of these sales channels, we have begun to focus more heavily on selling our products to OEMs. Selling products to OEMs involves unique risks, including the risk that OEMs will develop internal expertise in network-enabling products or will otherwise provide network functionality to their products without using our device networking solutions. If this were to occur, our stock price could decline in value and you could lose part or all of your investment.

NEW PRODUCT INTRODUCTIONS AND PRICING STRATEGIES BY OUR COMPETITORS COULD ADVERSELY AFFECT OUR ABILITY TO SELL OUR PRODUCTS AND COULD REDUCE OUR MARKET SHARE OR RESULT IN PRESSURE TO REDUCE THE PRICE OF OUR PRODUCTS.

The market for our products is intensely competitive, subject to rapid change and is significantly affected by new product introductions and pricing strategies of our competitors. We face competition primarily from companies that network-enable devices, semiconductor companies, companies in the automation industry and companies with significant networking expertise and research and

development resources. Our competitors might offer new products with features or functionality that are equal to or better than our products. In addition, since we work with open standards, our customers could develop products based on our technology that compete with our offerings. We might not have sufficient engineering staff or other required resources to modify our products to match our competitors. Similarly, competitive pressure could force us to reduce the price of our products. In each case, we could lose new and existing customers to our competition. If this were to occur, our net revenues could decline and our business could be harmed.

WE CARRY INVENTORY AND THERE IS A RISK WE MAY BE UNABLE TO DISPOSE OF THEM.

Our products and therefore our inventories are subject to technological risk. At any time either new products may enter the market or prices of competitive products may be introduced with more attractive features or at lower prices than ours. There is a risk that we may be unable to sell our inventory in a timely manner to avoid their becoming obsolete. As of June 30, 2004, our inventories including raw materials, finished goods and inventory at distributors, were valued at $12.7 million and we had excess and obsolete inventory reserves of $6.0 million against these inventories. As of June 30, 2003, our inventories, including raw materials, finished goods and inventory at distributors were valued at $14.0 million and we had reserved $8.0 million against these inventories. In the event we are required to substantially discount our inventory or are unable to sell our inventory in a timely manner, we would be required to increase our reserves and our operating results could be substantially harmed.

OUR INTELLECTUAL PROPERTY PROTECTION MIGHT BE LIMITED.

We have not historically relied on patents to protect our proprietary rights, although we are now building a patent portfolio. We rely primarily on a combination of laws, such as copyright, trademark and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights. Despite any precautions that we have taken:

- laws and contractual restrictions might not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies;

- other companies might claim common law trademark rights based upon use that precedes the registration of our marks;

- other companies might assert other rights to market products using our trademarks;

- policing unauthorized use of our products and trademarks is difficult, expensive and time-consuming, and we might be unable to determine the extent of this unauthorized use;

- courts may determine that our software programs use open source software in such a way that deprives the entire programs of intellectual property protection; and

- current federal laws that prohibit software copying provide only limited protection from software pirates.

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We do not use derivative financial instruments for speculative or trading purposes. We place our investments in instruments that meet high credit quality standards, as specified in our investment policy. Information relating to quantitative and qualitative disclosure about market risk is set forth below and in "Management's Discussion and Analysis of

Financial Condition and Results of Operations-Liquidity and Capital Resources."

INTEREST RATE RISK

Our exposure to interest rate risk is limited to the exposure related to our cash, cash equivalents, marketable securities and our credit facilities, which is tied to market interest rates. As of June 30, 2004 and 2003, we had cash and cash equivalents of $9.1 million and $7.3 million, respectively, which consisted of cash and short-term investments with original maturities of ninety days or less, both domestically and internationally. As of June 30, 2004 and 2003, we had marketable securities of $3.1 million and $7.0 million, respectively, consisting of obligations of U.S. Government agencies, state,

municipal and county government notes and bonds. We believe our marketable securities will decline in value by an insignificant amount if interest rates increase, and therefore would not have a material effect on our financial condition or results of operations.

FOREIGN CURRENCY RISK

We sell products internationally. As a result, our financial results could be harmed by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

INVESTMENT RISK

As of June 30, 2003, we had a net investment of $5.4 million, in Xanboo, a privately held company which can still be considered in the start-up or development stage. We performed an analysis and recorded a charge in the amount of $5.0 million, representing a write-off of all remaining value of this non-marketable equity security. This charge was included within the consolidated statements of operations as other expense.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and supplementary data required by this item are incorporated by reference from Part IV, Item 15 of this Form 10-K and are presented beginning on page F-1.

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

Not Applicable.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) as of the end of our fiscal year. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures

are sufficiently effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission's rules and instructions for Form 10-K.

(b) Changes in internal controls.

There have been no changes in our internal control over financial reporting identified in connection with our evaluation as of the end of our fiscal year that occurred during such quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We are aware that any system of controls, however well designed and operated, can only provide reasonable, and not absolute, assurance that the objectives of the system are met, and that maintenance of disclosure controls and procedures is an ongoing process that may change over time.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

(a) The information required by Item 10 of this Annual Report on Form 10-K with respect to identification of directors is incorporated by reference from the information contained in the section captioned "Election of Directors" in Lantronix's definitive Proxy Statement for the Annual Meeting of Stockholders to be held November 18, 2004 (the Proxy Statement), a copy of which will be filed with the Securities and Exchange Commission before the meeting date. For information with respect to the executive officers of Lantronix, see "Executive Officers of the Registrant" included in Part I, Item 4 of this report.

(b) For information regarding our Directors Code of Ethics and compliance with Section 16(a) of the Securities Exchange Act of 1934, we direct you to the sections entitled Proposal I - Election of Directors, Audit Committee, Code of Ethics and Complaint Procedures and Section 16(a) Beneficial Ownership Reporting Compliance, respectively, in the Proxy Statement we will deliver to our stockholders in connection with our Annual Meeting of Stockholders to be held on November 18, 2004. We are incorporating the information contained in those sections of our Proxy Statement, herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the section captioned "Executive Compensation and Related Information" in the Proxy Statement, which we will deliver to our stockholders in connection with our Annual Meeting of Stockholders to be held on November 18, 2004.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by Item 12 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the sections captioned "Election of Directors" and "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement which we will deliver to our stockholders in connection with our Annual Meeting of Stockholders to be held on November 18, 2004.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Except as set forth below, the information required by Item 13 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the sections captioned "Election of Directors" and "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement which we will deliver to our stockholders in connection with our Annual Meeting of Stockholders to be held on November 18, 2004.

Howard Slayen, a member of our Board of Directors also serves as our nominee to the Xanboo Board of Directors. Marc Nussbaum our Chief Executive Officer also served as a nominee to the Xanboo Board of Directors prior to his resignation from the Xanboo board in August 2003.

One international customer, transtec AG, which is a related party due to common ownership by our largest stockholder and former Chairman of our Board of Directors, Bernhard Bruscha, accounted for approximately 3%, 4% and 5% of our net revenues for the years ended June 30, 2004, 2003 and 2002, respectively. We also had an agreement with transtec AG for the provision of technical support services at the rate of $7,500 per month, which has now been terminated. Included in selling, general and administrative expenses are $90,000 for the year ended June 30, 2002. No similar expenses were recorded for the years ended June 30, 2004 and 2003.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

The information under the caption "Fees Paid to Independent Auditors," appearing in the Proxy Statement which we will deliver to our stockholders in connection with our Annual Meeting of Stockholders to be held on November 18, 2004, is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENTS, SCHEDULE AND REPORTS ON 8-K.

(a) 1. Consolidated Financial Statement

The following financial statement schedule of the Company and related Report of Independent Registered Public Accounting Firm is filed as part of this Form 10-K.

Report of Independent Registered Public Accounting Firm. . . . .
Consolidated Balance Sheets as of June 30, 2004 and 2003 . . . .
Consolidated Statements of Operations for the years ended June 30, 2004, 2003 and 2002 . . . . .
Consolidated Statements of Stockholders' Equity for the years ended June 30, 2004, 2003 and 2002
Consolidated Statements of Cash Flows for the years ended June 30, 2004, 2003 and 2002 . . . . .
Notes to Consolidated Financial Statements . . . .

2. Financial Statement Schedule

The following financial statement schedule of the Company and related Report of Independent Registered Public Accounting Firm is filed as part of this Form 10-K.

		PAGE
(1)	Report of Independent Registered Public Accounting Firm on Financial Statement Schedule.	S-1
(2)	Schedule II-Consolidated Valuation and Qualifying Accounts.	S-2

All other financial statement schedules have been omitted because they are not applicable, not required, or the information is included in the consolidated financial statements or notes thereto.

3. Exhibits

The exhibits listed on the accompanying index to exhibits immediately follow the financial statements are filed as part of, or hereby incorporated by reference into, this Form 10-K.

(b) Reports on Form 8-K.

We filed the following current reports on Form 8-K during the quarter ended June 30, 2004:

Form 8-K filed on April 2, 2004, Lantronix, reporting the Company's sale of its Premise software unit assets to an undisclosed buyer for $1.0 million in cash.

Form 8-K filed on May 7, 2004 reporting the results of the Company's third fiscal quarter ended March 31, 2004, with selected consolidated balance sheet data and selected unaudited consolidated statement of operations data.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders Lantronix, Inc.

We have audited the accompanying consolidated balance sheets of Lantronix, Inc. as of June 30, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 2004. 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 audits.

We conducted our audits 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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lantronix, Inc. at June 30, 2004 and 2003, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 2004, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 5, effective July 1, 2001, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."

/s/ ERNST & YOUNG LLP

Orange County, California
September 10, 2004

LANTRONIX, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

	JUNE 30,	
	2004	2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,128	$ 7,
Marketable securities	3,050	6,
Accounts receivable (net of allowance for doubtful accounts of $177 and $572 at June 30, 2004 and 2003, respectively)	3,242	3,
Inventories	6,677	6,
Contract manufacturers receivable (net of allowance of $38 and $62 at June 30, 2004 and 2003, respectively)	999	1,
Prepaid expenses and other current assets	1,450	3,
Assets of discontinued operations	-	3,
Total current assets	24,546	33,
Property and equipment, net	865	2,
Goodwill	9,488	9,
Purchased intangible assets, net	2,056	4,
Long-term investments	-	5,
Officer loans (net of allowance of $4,470 at June 30, 2004 and 2003, respectively)	110	
Other assets	185	
Total assets	$ 37,250	$ 54,

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	$ 4,049	$ 4,
Accrued payroll and related expenses	1,599	1,
Due to Gordian	-	1,
Accrued litigation settlement	-	1,
Warranty reserve	1,770	1,
Restructuring reserve	752	3,
Other current liabilities	2,922	2,
Liabilities of discontinued operations	-	
Convertible note payable	867	
Bank line of credit	500	
Total current liabilities	12,459	15,
Deferred income taxes	-	
Convertible note payable	-	
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.0001 par value; 5,000,000 shares authorized; none issued and outstanding	-	
Common stock, $0.0001 par value; 200,000,000 shares authorized; 58,154,747 and 55,425,774 shares issued and outstanding at June 30, 2004 and 2003, respectively	6	
Additional paid-in capital	180,712	178,
Deferred compensation	(103)	(
Accumulated deficit	(156,078)	(140,
Accumulated other comprehensive gain	254	
Total stockholders' equity	24,791	37,
Total liabilities and stockholders' equity	$ 37,250	$ 54,

See accompanying notes.

LANTRONIX, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	YEARS ENDED JUNE 30,		
	2004	2003	2002
Net revenues (A)	$ 48,885	$ 49,389	$ 57,5
Cost of revenues (B)	25,026	36,264	40,2
Gross profit	23,859	13,125	17,3
Operating expenses:			
Selling, general and administrative (C)	23,293	28,660	40,5
Research and development (C)	7,813	9,430	8,6

Stock-based compensation (B) (C)	347	1,453	2,8
Amortization of purchased intangible assets	148	602	9
Impairment of goodwill and purchased intangible assets	-	2,353	50,4
Restructuring (recovery) charges	(2,093)	5,600	3,4
Litigation settlement costs	-	1,533	1,9
Total operating expenses	29,508	49,631	108,8
Loss from operations	(5,649)	(36,506)	(91,5
Interest income (expense), net	50	248	1,5
Other income (expense), net	(5,333)	(926)	(7
Loss before income taxes and cumulative effect of an accounting change	(10,932)	(37,184)	(90,7
Provision (benefit) for income taxes	(325)	250	(6,6
Loss from continuing operations before cumulative effect of an accounting change	(10,607)	(37,434)	(84,1
Loss from discontinued operations	(5,047)	(10,115)	(3,4
Loss before cumulative effect of an accounting change	(15,654)	(47,549)	(87,5
Cumulative effect of adoption of new accounting standard, SFAS No. 142	-	-	(5,9
Net loss	$(15,654)	$(47,549)	$(93,4
Basic and diluted loss per share from continuing operations before cumulative effect of an accounting change	$ (0.19)	$ (0.69)	$ (1.
Loss from discontinued operations	(0.09)	(0.19)	(0.
Loss before cumulative effect of an accounting change	(0.28)	(0.88)	(1.
Cumulative effect of adoption of new accounting standard, SFAS No. 142	-	-	(0.
Basic and diluted net loss per share	$ (0.28)	$ (0.88)	$ (1.
Weighted average shares (basic and diluted)	56,862	54,329	51,4
(A) Includes revenues from related parties	$ 1,416	$ 1,845	$ 2,6
(B) Cost of revenues includes the following:			
Amortization of purchased intangible assets	$ 2,071	$ 3,619	$ 2,2
Impairment of purchased intangible assets	-	3,082	6,4
Stock-based compensation	48	89	1
	$ 2,119	$ 6,790	$ 8,7
(C) Stock-based compensation is excluded from the following:			
Selling, general and administrative expenses	$ 306	$ 1,074	$ 2,0
Research and development expenses	41	379	7
	$ 347	$ 1,453	$ 2,8

See accompanying notes.

LANTRONIX, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(IN THOUSANDS, EXCEPT SHARE DATA)

	COMMON STOCK		ADDI- TIONAL PAID-IN CAPITAL	NOTES RECEI- VABLE FROM OFFICERS	DEFERRED COMPEN- SATION	RETAI EARNI (ACCU ULAT DEFIC
	SHARES	AMOUNT				
Balance at June 30, 2001	43,301,803	$ 4	$109,871	$ (790)	$ (10,020)	$
Issuance of common stock in secondary public offering	6,400,500	1	47,085	-	-	
Stock options exercised	1,073,452	-	1,619	-	-	
Employee stock purchase plan	178,687	-	437	-	-	
Deferred compensation, net	-	-	(1,899)	-	1,899	
Stock-based compensation	-	-	-	-	3,575	
Repayment of notes receivable	-	-	-	513	-	
Provision for notes receivable from officers	-	-	-	249	-	
Purchase transactions	3,298,086	-	22,941	-	-	
Repurchase of common stock	-	-	(507)	-	-	
Components of comprehensive loss:						
Translation adjustment	-	-	-	-	-	
Change in net unrealized loss on investment	-	-	-	-	-	
Net loss	-	-	-	-	-	(93,
Comprehensive loss						
Balance at June 30, 2002	54,252,528	5	179,547	(28)	(4,546)	(92,
Stock options exercised	152,004	-	37	-	-	
Repurchase of common stock	(448,335)	-	-	-	-	
Employee stock purchase plan	406,205	-	280	-	-	
Deferred compensation, net	-	-	(2,310)	-	2,548	
Stock-based compensation	-	-	-	-	1,303	
Repayment of notes receivable	-	-	-	28	-	
Premise settlement	1,063,372	1	1,074	-	-	
Components of comprehensive loss:						
Translation adjustment	-	-	-	-	-	
Net loss	-	-	-	-	-	(47,
Comprehensive loss						
Balance at June 30, 2003	55,425,774	6	$178,628	(-)	(695)	(140,
Stock options exercised	496,335	-	359	-	-	
Employee stock purchase plan	505,935	-	369	-	-	
Deferred compensation, net	-	-	(197)	-	197	
Stock-based compensation	-	-	-	-	395	
Dunstan settlement	1,726,703	-	1,553	-	-	
Components of comprehensive loss:						
Translation adjustment	-	-	-	-	-	
Net loss	-	-	-	-	-	(15,

Comprehensive loss						
Balance at June 30, 2004	58,154,747	$ 6	$180,712	$ (-)	$ (103)	$(156,
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