LANTRONIX INC
Form 10-Q
May 10, 2011

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

FORM 10-Q

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from ___________ to ___________.

Commission file number: 1-16027

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

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

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

92618
(Zip Code)

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

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

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

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

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

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

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

As of May 3, 2011, there were 10,486,769 shares of the Registrant's common stock outstanding.

LANTRONIX, INC.

FORM 10-Q
FOR THE FISCAL QUARTER ENDED
March 31, 2011

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	March 31, 2011	June 30, 2010
Assets		
Current assets:		
Cash and cash equivalents	$8,480	$10,075
Accounts receivable, net	2,490	1,342
Contract manufacturers' receivable	1,222	1,015
Inventories, net	9,392	6,873
Prepaid expenses and other current assets	548	515
Deferred tax assets	542	542
Total current assets	22,674	20,362
Property and equipment, net	1,908	2,392
Goodwill	9,488	9,488
Purchased intangible assets, net	89	155
Other assets	167	135
Total assets	$34,326	$32,532
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$8,289	$6,545
Accrued payroll and related expenses	1,381	1,568
Warranty reserve	211	183
Short-term debt	667	667
Other current liabilities	3,682	3,776
Total current liabilities	14,230	12,739
Non-current liabilities:		
Long-term liabilities	428	646
Long-term capital lease obligations	73	153
Long-term debt	1,000	111
Deferred tax liabilities	542	542
Total non-current liabilities	2,043	1,452
Total liabilities	16,273	14,191
Commitments and contingencies		
Stockholders' equity:		
Common stock	1	1
Additional paid-in capital	192,515	191,147
Accumulated deficit	(174,862)	(173,206)

Accumulated other comprehensive income	399	399
Total stockholders' equity	18,053	18,341
Total liabilities and stockholders' equity	$34,326	$32,532

See accompanying notes.

1

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

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010	Nine Months Ended March 31, 2011	Nine Months Ended March 31, 2010
Net revenue (1)	$ 12,382	$ 12,124	$ 37,293	$ 34,556
Cost of revenue	6,023	5,772	18,429	16,438
Gross profit	6,359	6,352	18,864	18,118
Operating expenses:				
Selling, general and administrative	4,942	4,804	15,083	14,279
Research and development	1,752	1,643	5,272	4,638
Amortization of purchased intangible assets	18	18	54	54
Total operating expenses	6,712	6,465	20,409	18,971
Loss from operations	(353)	(113)	(1,545)	(853)
Interest expense, net	(29)	(29)	(87)	(118)
Other income (expense), net	(7)	17	17	(8)
Loss before income taxes	(389)	(125)	(1,615)	(979)
Provision for income taxes	10	11	41	31
Net loss	$ (399)	$ (136)	$ (1,656)	$ (1,010)
Net loss per share (basic and diluted)	$ (0.04)	$ (0.01)	$ (0.16)	$ (0.10)
Weighted-average shares (basic and diluted)	10,463	10,318	10,414	10,262
Net revenue from related parties	$ 194	$ 214	$ 647	$ 481

(1) Includes net revenue from related parties

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended March 31, 2011	2010
Operating activities		
Net loss	$(1,656)	$(1,010)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Share-based compensation	1,353	1,527
Depreciation	773	658
Provision (recovery) for inventories	181	(132)
Amortization of purchased intangible assets	67	88
Provision for doubtful accounts	15	12
Changes in operating assets and liabilities:		
Accounts receivable	(1,163)	(736)
Contract manufacturers' receivable	(207)	(347)
Inventories	(2,699)	162
Prepaid expenses and other current assets	(89)	(53)
Other assets	(31)	(12)
Accounts payable	1,740	1,603
Accrued payroll and related expenses	(202)	(287)
Warranty reserve	28	-
Restructuring reserve	-	(76)
Other liabilities	(62)	(15)
Cash received related to tenant incentives	32	280
Net cash (used in) provided by operating activities	(1,920)	1,662
Investing activities		
Purchases of property and equipment, net	(292)	(644)
Net cash used in investing activities	(292)	(644)
Financing activities		
Proceeds from term loan	2,000	-
Payment of term loan	(1,110)	(499)
Minimum tax withholding paid on behalf of employees for restricted shares	(131)	(263)
Payment of capital lease obligations	(271)	(209)
Net proceeds from issuances of common stock	76	155
Net cash provided by (used in) financing activities	564	(816)
Effect of foreign exchange rate changes on cash	53	(26)
(Decrease) Increase in cash and cash equivalents	(1,595)	176
Cash and cash equivalents at beginning of period	10,075	9,137
Cash and cash equivalents at end of period	$8,480	$9,313

See accompanying notes.

3

LANTRONIX, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Lantronix, Inc. (the "Company" or "Lantronix") have been prepared by the Company in accordance with generally accepted accounting principles ("GAAP") for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2010, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on September 13, 2010. The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of the Company at March 31, 2011, and the consolidated results of its operations and cash flows for the three and nine months ended March 31, 2011 and 2010. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three and nine months ended March 31, 2011 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

2. Computation of Net Loss per Share

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

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands, except per share data)			
Numerator:				
Net loss	$ (399)	$ (136)	$ (1,656)	$ (1,010)
Denominator:				
Weighted-average shares outstanding	10,639	10,611	10,590	10,555
Less: Unvested common shares outstanding	(176)	(293)	(176)	(293)
Weighted-average shares (basic and diluted)	10,463	10,318	10,414	10,262
Net loss per share (basic and diluted)	$ (0.04)	$ (0.01)	$ (0.16)	$ (0.10)

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Common stock equivalents	948	1,143	966	1,184

4

3. Inventories

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

	March 31, 2011	June 30, 2010
	(In thousands)	
Finished goods	$ 6,242	$ 4,258
Raw materials	2,030	1,390
Inventory at distributors *	1,587	1,924
Large scale integration chips **	856	516
Inventories, gross	10,715	8,088
Reserve for excess and obsolete inventory	(1,323)	(1,215)
Inventories, net	$ 9,392	$ 6,873

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

4. Warranty

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

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

	Nine Months Ended March 31, 2011	Year Ended June 30, 2010
	(In thousands)	
Beginning balance	$ 183	$ 224
Charged to cost of revenues	181	84
Usage	(153)	(125)
Ending balance	$ 211	$ 183

5. Bank Line of Credit and Debt

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

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

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

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

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

	March 31, 2011	June 30, 2010
	(In thousands)	
Term Loan	$ 1,667	$ 778
Amount Available under the Revolving Line	$ 1,318	$ 1,031
Outstanding letters of credit	$ 764	$ 343

6. Stockholders' Equity

Share-Based Plans

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

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

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

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Cost of revenues	$ 10	$ 11	$ 45	$ 30
Selling, general and administrative	202	257	992	1,108
Research and development	80	116	316	389
Total share-based compensation	$ 292	$ 384	$ 1,353	$ 1,527

6

The following table presents a summary of remaining unrecognized share-based compensation by the vesting condition for the Company's share-based plans as of March 31, 2011:

Vesting Condition		Remaining Unrecognized Compensation Cost	Remaining Years To Vest
		(In thousands)	
Stock Option Awards:			
Service-based	$	1,651	
Market- and service-based		5	
Stock option awards	$	1,656	2.2
Restricted Stock Awards:			
Service-based	$	377	
Restricted stock awards	$	377	1.4

Stock Option Awards

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

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

	Number of Shares
Balance of options outstanding at June 30, 2010	1,890,339
Options granted	425,679
Options forfeited	(136,842)
Options expired	(122,883)
Options exercised	(27,180)
Balance of options outstanding at March 31, 2011	2,029,113

The following table presents stock option grant date information:

	Three Months Ended March 31,				Nine Months Ended March 31,			
		2011		2010		2011		2010
Weighted-average grant date fair value per share	$	2.26	$	2.30	$	2.20	$	1.89
Weighted-average grant date exercise price per share	$	3.58	$	3.24	$	3.45	$	2.67

Nonvested Share Awards

The following table presents a summary of nonvested share activity:

	Number of Shares Unvested	Weighted Average Grant - Date Fair Value per Share
Balance of nonvested shares at June 30, 2010	291,646	$ 3.16
Granted	-	-
Forfeited	(18,755)	3.00
Vested	(96,874)	3.21
Balance of nonvested shares at March 31, 2011	176,017	$ 3.15

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Fair value of shares vested	$ 27	$ 18	$ 371	$ 443

Warrants to Purchase Common Stock

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

7. Income Taxes

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

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Effective tax rate	3%	9%	3%	3%

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

8

8. Comprehensive Income (Loss)

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Net loss	$ (399)	$ (136)	$ (1,656)	$ (1,010)
Other comprehensive income (loss):				
Change in translation adjustments, net of taxes of $0	-	(49)	-	(27)
Total comprehensive loss	$ (399)	$ (185)	$ (1,656)	$ (1,037)

9. Litigation

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

10. Internal Investigation

As disclosed in the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 14, 2011, Bernhard Bruscha, a director of Lantronix, delivered a letter to the Company's Audit Committee setting forth certain allegations for which he requested an independent investigation. In response to Mr. Bruscha's allegations, the Company has retained the law firm of Paul, Hastings, Janofsky & Walker ("Paul Hastings") to conduct an independent investigation of each of the allegations (the "Investigation"). The Company currently expects that Paul Hastings will conclude the Investigation in the quarter ended June 30, 2011. The Company will publicly report the results of the Investigation shortly after its completion. At this time, Mr. Bruscha's allegations are only assertions, and the Investigation has made no determination as of this date, preliminary or otherwise, regarding their validity. Presently, the Company does not anticipate that the resolution of these allegations would result in a material effect on the Company's previously issued financial statements. The Company is incurring and will continue to incur significant expenses relating to the Investigation. For the quarter ended March 31, 2011, the Company incurred approximately $460,000 of expenses relating to the Investigation. The Company currently anticipates that total expenses relating to the Investigation will be approximately $1.1 million to $1.5 million for the fiscal year ending June 30, 2011.

For more details regarding the allegations subject to the Investigation, we request you review the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 14, 2011.

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

Cautionary Statement

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

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

Overview

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

Our innovative networking solutions include fully-integrated hardware and software devices, as well as software tools, to develop related customer applications. Because we deal with network connectivity, we provide solutions to broad market segments, including industrial, security, energy, information technology (“IT”), data centers, transportation, government, healthcare, and many others. We also recently identified medical device connectivity as a particularly promising direction for investment and growth.

Products and Solutions

Device Enablement Solutions

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

Our device servers allow a wide range of equipment to be quickly network-enabled without the need for intermediary gateways, workstations or personal computers (“PC”). Our device servers and web servers eliminate the high cost of ownership and added support issues associated with networking, which frequently would otherwise require using PCs or workstations to perform connectivity and remote management functions. Our solutions contain high-performance processors capable of not only controlling the attached device, but in many cases are also capable of accumulating data and status information. The accumulated data can then be formatted by the device server and presented to users via web pages, e-mail, and other network, transport and application level protocols. Our device servers have a built-in HTTP server, making them easy to manage using any standard Web browser. These device servers include the latest security protocols, such as AES, IPsec, SSL, and SSH, which support the stringent security requirements of the medical, banking, and physical security markets.

Device Management Solutions

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

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

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

Other Products

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

Financial Highlights and Other Information for the Fiscal Quarter Ended March 31, 2011

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended March 31, 2011:

- Net revenue was $12.4 million for the fiscal quarter ended March 31, 2011, an increase of $258,000 or 2%, compared to $12.1 million for the fiscal quarter ended March 31, 2010. The increase was primarily the result of a $267,000, or 11.2%, increase in sales of our device management product line. As part of an ongoing corporate initiative to optimize its sales distribution channel, the Company continued to renegotiate its agreements with certain direct customers. These new agreements remove stock rotation and price protection terms, which causes the Company to recognize revenue upon shipment as opposed to a sell-through basis. The Company has directed a majority of these customers to purchase through large Lantronix distributors located in their respective regions to create a more efficient sales channel. The result of these changes was the recognition of revenue during the third fiscal quarter that would have otherwise been deferred in the third fiscal quarter and recognized in the fourth fiscal quarter. The Company made similar changes to customer agreements in the second fiscal quarter which resulted in the recognition of revenue in that quarter that would have otherwise been recognized in the third fiscal quarter. As these customers are no longer required to provide sell-through reports and the majority of these customers are now buying from other Lantronix distributors (whose revenue is recognized on a sell-through basis by Lantronix) and not directly through Lantronix, the net impact to revenue in the current quarter is not practically determinable. It should be noted that the Company has not changed its revenue recognition policy as revenue is still recognized on a sell-through basis for those customers with stock rotation and price protection terms.

- Gross profit margin was 51.4% for the fiscal quarter ended March 31, 2011, compared to 52.4% for the fiscal quarter ended March 31, 2010. The decrease in gross profit margin was primarily due to increased reserves for excess and obsolete inventory related to end-of-life products and an increase in warranty reserves for a specific product.

- Loss from operations was $353,000 for the fiscal quarter ended March 31, 2011, compared to $113,000 for the fiscal quarter ended March 31, 2010. The loss from operations in the current fiscal quarter was negatively impacted by approximately $460,000 in legal expenses related to the Investigation. The Company currently anticipates that total expenses relating to the Investigation will be approximately $1.1 million to $1.5 million for the fiscal year ending June 30, 2011.

- Net loss was $399,000, or $0.04 per basic and diluted share, for the fiscal quarter ended March 31, 2011, compared to $136,000, or $0.01per basic and diluted share, for the fiscal quarter ended March 31, 2010. The GAAP net loss in the third fiscal quarter of 2011 was negatively impacted by approximately $460,000 of legal expenses related to the Investigation. The Company currently anticipates that total expenses relating to the Investigation will be approximately $1.1 million to $1.5 million for the fiscal year ending June 30, 2011.

- Cash and cash equivalents were $8.5 million as of March 31, 2011, a decrease of $1.6 million, compared to $10.1 million as of June 30, 2010. The decrease was due to purchases of inventory to support growth and on-time customer delivery, as well as payments for legal and consulting expenses related to the proxy contest and Investigation.

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Net accounts receivable were $2.5 million as of March 31, 2011, an increase of $1.2 million, compared to $1.3 million as of June 30, 2010. Days sales outstanding ("DSO") in receivables were 16 days for the fiscal quarter ended March 31, 2011 compared to 15 days for the fiscal quarter ended June 30, 2010. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues continue to be recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped to distributors).

- Net inventories were $9.4 million as of March 31, 2011, compared to $6.9 million as of June 30, 2010. Inventory turns were 2.5 turns for the fiscal quarter ended March 31, 2011 compared to 3.5 turns for the fiscal quarter ended June 30, 2010. The increase was attributable to a buildup of finished goods and strategic components to ensure timely delivery and enhance customer satisfaction.

Critical Accounting Policies and Estimates

The accounting policies that have the greatest impact on our financial condition and results of operations and that require the most judgment are those relating to revenue recognition, warranty reserves, allowance for doubtful accounts, inventory valuation, valuation of deferred income taxes, and goodwill. These policies are described in further detail in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010. There have been no significant changes in our critical accounting policies and estimates during the fiscal quarter ended March 31, 2011 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010.

Recent Accounting Pronouncements

During the three months ended March 31, 2011, there were no new accounting pronouncements that would have had a material effect on our unaudited consolidated financial statements.

Consolidated Results of Operations

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

	Three Months Ended March 31,				Nine Months Ended March 31,			
	2011		2010		2011		2010	
Net revenue	100.0	%	100.0	%	100.0	%	100.0	%
Cost of revenue	48.6	%	47.6	%	49.4	%	47.6	%
Gross profit	51.4	%	52.4	%	50.6	%	52.4	%
Operating expenses:								
Selling, general and administrative	39.9	%	39.6	%	40.4	%	41.3	%
Research and development	14.1	%	13.6	%	14.1	%	13.4	%
Amortization of purchased intangible assets	0.1	%	0.1	%	0.1	%	0.2	%
Total operating expenses	54.2	%	53.3	%	54.7	%	54.9	%
Loss from operations	(2.9	%)	(0.9	%)	(4.1	%)	(2.5	%)
Interest expense, net	(0.2	%)	(0.2	%)	(0.2	%)	(0.3	%)
Other income (expense), net	(0.1	%)	0.1	%	0.0	%	(0.0	%)
Loss before income taxes	(3.1	%)	(1.0	%)	(4.3	%)	(2.8	%)
Provision for income taxes	0.1	%	0.1	%	0.1	%	0.1	%
Net loss	(3.2	%)	(1.1	%)	(4.4	%)	(2.9	%)

Comparison of the Fiscal Quarters Ended March 31, 2011 and 2010

Net Revenue by Product Line

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

	Three Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Device enablement	$ 9,551	77.1%	$ 9,572	79.0 %	$ (21)	(0.2%)
Device management	2,652	21.4%	2,385	19.7 %	267	11.2%
Device networking	12,203	98.5%	11,957	98.7 %	246	2.1%
Non-core	179	1.5%	167	1.3 %	12	7.2%
Net revenue	$ 12,382	100.0%	$ 12,124	100.0 %	$ 258	2.1%

The increase in net revenue for the three months ended March 31, 2011, compared to the three months ended March 31, 2010 was the result of an increase in net revenue mainly from our device management product line. The increase in net revenue from our device management product line was due to an increase in unit sales of some of our management device enablement products, in particular our SLC, SLB and Spider product families.

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

	Nine Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Device enablement	$ 29,903	80.2 %	$ 27,567	79.8 %	$ 2,336	8.5%
Device management	6,886	18.5 %	6,287	18.2 %	599	9.5%
Device networking	36,789	98.7 %	33,854	98.0 %	2,935	8.7%
Non-core	504	1.3 %	702	2.0 %	(198)	(28.2%)
Net revenue	$ 37,293	100.0 %	$ 34,556	100.0 %	$ 2,737	7.9%

The increase in net revenue for the nine months ended March 31, 2011, compared to the nine months ended March 31, 2010 was the result of an increase in net revenue from our device enablement and device management product lines, partially offset by a decrease in net revenue from our non-core product lines. The increase in net revenue from our device enablement product line was due to an increase in unit sales of some of our embedded device enablement products, in particular our XPort, XPort Pro, MICRO, MatchPort and ASIC product families, partially offset by a decrease in unit sales of some of our external device enablement products, in particular our WiBox, UBox and MSS product families, offset by an increase in our EDS product family. The increase in net revenue from our device management product line was due to an increase in unit sales of our Spider and SCS product families, partially offset by a decrease in sales of our SLC product family.

Net Revenue by Geographic Region

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

	Three Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 6,698	54.1 %	$ 7,027	58.0 %	$ (329)	(4.7%)
EMEA	3,749	30.3 %	3,185	26.3 %	564	17.7%
Asia Pacific	1,935	15.6 %	1,912	15.7 %	23	1.2%
Net revenue	$ 12,382	100.0 %	$ 12,124	100.0 %	$ 258	2.1%

The increase in net revenue for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 reflects increased unit sales mainly from the Europe, Middle East and Africa (the "EMEA") region, offset by a decrease in revenue from the Americas. The increase in net revenue from the EMEA region was primarily due to an increase in unit sales in our device enablement product lines, in particular our XPort, MatchPort, MICRO and EDS product families. The decrease in net revenue in the Americas region was due to a decrease in unit sales in our device enablement product lines, in particular our XPort, UDS and MatchPort product families.

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

	Nine Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 19,375	52.0 %	$ 19,413	56.2 %	$ (38)	(0.2%)
EMEA	11,893	31.9 %	9,642	27.9 %	2,251	23.3%
Asia Pacific	6,025	16.1 %	5,501	15.9 %	524	9.5%
Net revenue	$ 37,293	100.0 %	$ 34,556	100.0 %	$ 2,737	7.9%

The increase in net revenue for the nine months ended March 31, 2011 compared to the nine months ended March 31, 2010 reflects increased unit sales primarily from the EMEA and Asia Pacific regions. The increase in net revenue from the EMEA region was mainly due to an increase in unit sales of our device enablement product lines, in particular our XPort, ASIC, MICRO, Xpress and EDS product families. The increase in net revenue in the Asia Pacific region was due to an increase in unit sales of our device management product lines, in particular our Spider and SLC product families, as well as our device enablement product lines, in particular our MICRO and MatchPort, WiPort and Xpress product families, partially offset by a decrease in sales of our XPort product family.

Gross Profit

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

The following table presents fiscal quarter gross profit:

	Three Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 6,359	51.4%	$ 6,352	52.4%	$ 7	0.1%

The decrease in gross profit as a percent of net revenue (referred to as “gross profit margin”) for the three months ended March 31, 2011 was primarily due to increased reserves for excess and obsolete inventory related to end-of-life products and an increase in warranty reserves for a specific product.

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

	Nine Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 18,864	50.6%	$ 18,118	52.4%	$ 746	4.1%

The decrease in gross profit margin for the nine months ending March 31, 2011 was partly due to a change in product mix primarily related to an increase in unit sales as a percentage of total sales of our embedded device enablement products, which have a lower margin than our other product lines. Gross profit margin was also negatively impacted by an increase in freight costs due to expediting charges relating to component and product shortages, transitional costs associated with the implementation of third-party logistics providers in Los Angeles and Hong Kong for inventory management and the increase in the volume of inventory receipts. In addition, gross profit margin was negatively impacted by increased reserves for excess and obsolete inventory related to end-of-life products and an increase in unfavorable purchase variances, offset by an increase in capitalized overhead due to the increase in inventory.

Selling, General and Administrative

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

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

	Three Months Ended March 31,					
	2011	% of Net Revenue	2010	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 2,530		$ 2,561		$ (31)	(1.2%)
Professional fees and outside services	871		443		428	96.6%
Advertising and marketing	544		570		(26)	(4.6%)
Facilities	255		319		(64)	(20.1%)
Share-based compensation	202		257		(55)	(21.4%)
Depreciation	166		179		(13)	(7.3%)
Bad debt expense	14		-		14	100.0%
Other	360		475		(115)	(24.2%)
Selling, general and administrative	$ 4,942	39.9%	$ 4,804	39.6%	$ 138	2.9%

In order of significance, the increase in selling, general and administrative expenses for the three months ended March 31, 2011, compared to the three months ended March 31, 2010 was primarily due to: (i) an increase in professional fees and outside services mainly due to approximately $460,000 of legal expenses as a result of the Investigation; partially offset by (ii) a decrease in facility related expenses as a result of cost saving efforts, and (iii) a decrease in share based compensation and (iv) a decrease in franchise tax expense.

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

	Nine Months Ended March 31,					
	2011	% of Net Revenue	2010	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 7,705		$ 7,499		$ 206	2.7%
Professional fees and outside services	2,562		1,550		1,012	65.3%
Advertising and marketing	1,328		1,624		(296)	(18.2%)
Facilities	827		953		(126)	(13.2%)
	992		1,108		(116)	(10.5%)

Share-based compensation								
Depreciation		497			459			38	8.3%
Bad debt expense (recovery)		15			12			3	25.0%
Other		1,157			1,074			83	7.7%
Selling, general and administrative	$	15,083	40.4%	$	14,279	41.3%	$	804	5.6%

In order of significance, the increase in selling, general and administrative expenses for the nine months ended March 31, 2011, compared to the nine months ended March 31, 2010 was primarily due to: (i) an increase in professional fees and outside services mainly due to approximately $561,000 of legal and consulting expenses as a result of the proxy contest which was settled in November of 2010 and approximately $460,000 of legal expenses as a result of the Investigation, and (ii) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago, partially offset by (iii) a decrease in marketing expenses and facility related expenses due to cost saving efforts and (iv) a decrease in share based compensation.

Research and Development

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

The following table presents fiscal quarter research and development expenses:

	Three Months Ended March 31,					
	2011	% of Net Revenue	2010	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 1,151		$ 998		$ 153	15.3 %
Facilities	228		308		(80)	(26.0 %)
Professional fees and outside services	147		114		33	28.9 %
Share-based compensation	80		116		(36)	(31.0 %)
Depreciation	10		13		(3)	(23.1 %)
Other	136		94		42	44.7 %
Research and development	$ 1,752	14.1%	$ 1,643	13.6%	$ 109	6.6 %

In order of significance, the increase in research and development expenses for the three months ended March 31, 2011, compared to the three months ended March 31, 2010 was primarily due to: (i) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago; offset by (ii) a decrease in facility related expenses as a result of cost saving efforts. Research and development expenses could increase as we continue to invest in new development efforts.

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

	Nine Months Ended March 31,					
	2011	% of Net Revenue	2010	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 3,339		$ 2,917		$ 422	14.5%
Facilities	760		830		(70)	(8.4%)
Professional fees and outside services	505		257		248	96.5%
Share-based compensation	316		389		(73)	(18.8%)
Depreciation	33		45		(12)	(26.7%)
Other	319		200		119	59.5%
Research and development	$ 5,272	14.1%	$ 4,638	13.4%	$ 634	13.7%

In order of significance, the increase in research and development expenses for the nine months ended March 31, 2011, compared to the nine months ended March 31, 2010 was primarily due to: (i) an increase in personnel-related expenses due to the suspension of a Company-wide furlough program in the equivalent period one year ago and (ii) an increase in professional fees and outside services related to development projects for upcoming product releases; partially offset by (iii) a decrease in share based compensation and (iv) a decrease in facility related expenses as a result of cost saving efforts. Research and development expenses could increase as we continue to invest in new development efforts.

Provision for Income Taxes

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

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Effective tax rate	3%	9%	3%	3%

We utilize the liability method of accounting for income taxes. The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from our domestic losses being recorded with a fully reserved tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. As a result of our cumulative losses, we provided a full valuation allowance against our domestic net deferred tax assets for the fiscal quarters ended March 31, 2011 and 2010.

Liquidity and Capital Resources

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

	March 31, 2011	June 30, 2010	Increase (Decrease)
	(In thousands)		
Working capital	$ 8,444	$ 7,623	$ 821
Cash and cash equivalents	$ 8,480	$ 10,075	$ (1,595)

In order of significance, our working capital as of March 31, 2011 increased as compared to June 30, 2010, primarily due to: (i) an increase in inventory due to the timing of shipments and inventory receipts and (ii) an increase in accounts receivable as a result of the timing of shipments, cash collections and an increase in revenue. This was partially offset by (i) an increase in accounts payable related to the increase in inventory and (ii) a decrease in cash and cash equivalents as a result of purchases of inventory to support growth and on-time customer delivery, as well as payments for legal and consulting expenses related to the proxy contest and the Investigation and (iii) a decrease in accrued payroll and related expense due to the timing of payroll periods.

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

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

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

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

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

	March 31, 2011	June 30, 2010
	(In thousands)	
Term Loan	$ 1,667	$ 778
Amount Available under the Revolving Line	$ 1,318	$ 1,031
Outstanding letters of credit	$ 764	$ 343

As of March 31, 2011 and June 30, 2010, approximately $389,000 and $400,000, respectively, of our cash was held by our foreign subsidiaries in foreign bank accounts. Such cash may be unrestricted with regard to foreign liquidity needs; however, our ability to utilize a portion of this cash to satisfy liquidity needs outside of such foreign locations may be subject to approval by the foreign subsidiaries' board of directors.

Cash Flows for the Three and Nine Months Ended March 31

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

	Three Months Ended March 31,		Nine Months Ended March 31,	
	2011	2010	2011	2010
	(In thousands)			
Net cash provided by (used in):				
Net loss	$ (399)	$ (136)	$ (1,656)	$ (1,010)
Non-cash operating expenses, net	614	651	2,389	2,153
Changes in operating assets and liabilities:				
Accounts receivable	(534)	(813)	(1,163)	(736)
Contract manufacturers' receivable	266	24	(207)	(347)
Inventories	166	170	(2,699)	162
Prepaid expenses and other current assets	(176)	299	(89)	(53)
Other assets	-	(7)	(31)	(12)
Accounts payable	(1,470)	(325)	1,740	1,603
Accrued payroll and related expenses	84	191	(202)	(287)
Warranty reserve	2	-	28	-
Restructuring reserve	-	-	-	(76)
Other liabilities	(502)	(74)	(62)	(15)
Cash received related to tenant incentives	-	280	32	280
Net cash (used in) provided by operating activities	(1,949)	260	(1,920)	1,662
Net cash used in investing activities	(72)	(19)	(292)	(644)
Net cash (used in) provided by financing activities	(150)	(232)	564	(816)
Effect of foreign exchange rate changes on cash	6	(75)	53	(26)
(Decrease) Increase in cash and cash equivalents	$ (2,165)	$ (66)	$ (1,595)	$ 176

Cash Flows for the Three Months Ended March 31

Operating activities used $1.9 million in cash during the three months ended March 31, 2011. This was the result of a net loss and cash used by operating assets and liabilities, offset by non-cash operating expenses. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash used in operating activities included (i) a decrease in accounts payable due to the pay down of payables and (ii) an increase in accounts receivables due to the timing of collections and the increase in sales and (iii) a decrease in other liabilities due to the timing of payments; offset by (iv) a decrease in contract manufacturers' receivables due to the timing of collections and shipments and (v) a decrease in inventories due to the timing of shipments and inventory receipts.

Operating activities provided $260,000 in cash during the three months ended March 31, 2010. This was the result of non-cash operating expenses offset by cash used by operating assets and liabilities and a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided by operating activities included (i) a decrease in prepaid expenses and other current assets due to the payment of a large receivable from the Company's landlord for reimbursements related to improvements on the new corporate headquarters and (ii) cash received related to tenant incentives on the new corporate headquarters and (iii) an increase in accrued payroll and related expenses due to the timing of payroll periods and (iv) a decrease in inventories due to the timing of shipments and receipts; offset by (v) an increase in accounts receivable due to the timing of collections and linearity of sales and (vi) a decrease in accounts payable due to the timing of payments.

Investing activities used cash during the three months ended March 31, 2011 and 2010, due to the purchase of property and equipment.

Financing activities used cash during the three months ended March 31, 2011 and 2010, due to payments on capital lease obligations and the Term Loan, offset by proceeds from the sale of common shares through employee stock option exercises.

Cash Flows for the Nine Months Ended March 31

Operating activities used $1.9 million in cash during the nine months ended March 31, 2011. This was the result of a net loss and cash used by operating assets and liabilities, offset by non-cash operating expenses. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash used in operating activities included (i) an increase in inventories mainly due to sourcing components directly to ensure supply and (ii) an increase in accounts and contract manufacturers' receivables due to the timing of collections and the increase in sales; offset (iii) an increase in accounts payable due to the timing of payments and the increase in inventory.

Operating activities provided $1.7 million in cash during the nine months ended March 31, 2010. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses offset by a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided by operating activities included (i) an increase in accounts payable due to the timing of payments and (ii) cash received related to tenant incentives on the new corporate headquarters; offset by (iii) an increase in accounts receivable due to the timing of collections and linearity of sales and (iv) an increase in contract manufacturers' receivables due to the timing of collections and shipments and (v) a decrease in accrued payroll and related expenses due to the timing of payroll periods.

Investing activities used cash during the nine months ended March 31, 2011 and 2010, due to the purchase of property and equipment.

Financing activities provided cash during the nine months ended March 31, 2011 due to (i) proceeds from the amended term loan and (ii) proceeds from the sale of common shares through employee stock option exercises; offset by (iii) payments related to the Term Loan, (iv) payments on capital lease obligations and (v) minimum tax withholding paid on behalf of employees related to the vesting of restricted shares.

Financing activities used cash during the nine months ended March 31, 2010 due to (i) payments for the minimum tax withholdings on behalf of employees for vested restricted shares and (ii) payments on capital lease obligations and the term loan; offset by (iii) proceeds from the sale of common shares through employee stock option exercises.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

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

(b) Changes in internal controls over financial reporting

There have been no changes in our internal controls over financial reporting identified during the fiscal quarter that ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

We operate in a rapidly changing environment that involves numerous risks and uncertainties. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q and in the risks described in our Annual Report on Form 10-K. If any of these risks or uncertainties actually occurs with material adverse effects on Lantronix, our business, financial condition and results of operations could be seriously harmed. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

We have a history of losses.

We incurred a net loss of approximately $1.7 million for the nine months ended March 31, 2011 and had experienced a net loss of $1.5 million during our last full fiscal year. There can be no assurance that we will generate net profits in future periods. In addition, there can be no assurance that we will be cash flow positive in future periods. In particular, we anticipate that we will not be cash flow positive for at least our next two (2) quarters due in part to the costs associated with the Investigation. In the event we fail to achieve profitability in future periods, the value of our common stock my decline. In addition, if we were unable to maintain positive cash flows, we would be required to seek additional funding, which may not be available on favorable terms, if at all.

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

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

- changes in business and economic conditions, including the recent global economic recession;
- changes in the mix of net revenue attributable to higher-margin and lower-margin products;
- customers' decisions to defer or accelerate orders;
- variations in the size or timing of orders for our products;
- changes in demand for our products;
- fluctuations in exchange rates;
- defects and other product quality problems;

- loss or gain of significant customers;
- short-term fluctuations in the cost or availability of our critical components;
- announcements or introductions of new products by our competitors;
- effects of terrorist attacks in the U.S. and abroad;
- natural disasters in the U.S. and abroad;
- changes in demand for devices that incorporate our products; and

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

The independent Investigation is currently in process.

As disclosed in a Current Report on Form 8-K filed with the Securities and Exchange Commission on April 14, 2011, Bernhard Bruscha, a director of the Company, delivered a letter to the Company's Audit Committee setting forth certain allegations for which he requested an independent investigation. In response to Mr. Bruscha's allegations, the Company has retained the law firm of Paul, Hastings, Janofsky & Walker ("Paul Hastings") to conduct an independent investigation of each of the allegations (the "Investigation"). The Company currently expects that Paul Hastings will conclude the Investigation in our quarter ended June 30, 2011. The Company will report the results of the Investigation shortly after its completion. At this time, Mr. Bruscha's allegations are only assertions, and the Investigation has made no determination as of this date, preliminary or otherwise, regarding their validity. Presently, the Company does not anticipate that the resolution of these allegations would result in a material effect on the Company's previously issued financial statements. However, there can be no assurance in this regard until the Investigation is concluded and were to so determine, and there can be no assurance that the outcome of the Investigation will not have a material adverse impact on the Company's operations, including its employees and personnel.

The Company is incurring and will continue to incur significant expenses relating to the Investigation. For the quarter ended March 31, 2011, the Company incurred approximately $460,000 of expenses relating to the Investigation. The Company currently anticipates that total expenses relating to the Investigation will be approximately $1.1 million to $1.5 million for the fiscal year ended June 30, 2011. However, these expenses represent the Company's current estimate, and there can be no assurance the expenses relating to the Investigation will not exceed these current estimates once the Investigation is completed.

For more details regarding the allegations subject to the Investigation, we request you review the Current Report on Form 8-K filed with the Securities and Exchange Commission on April 14, 2011.

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

Substantial litigation, especially regarding intellectual property, proprietary rights and product liability, occurs frequently in our industry. Litigation can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of litigation are inherently uncertain and may result in adverse rulings or outcomes. We may enter into settlements or be subject to judgments, or other outcomes in litigation situations, that may, individually or in the aggregate, have a material adverse effect on our business, financial condition or operating results.

We routinely evaluate notices of alleged patent infringement and notices of patents from patent holders. Similar to other companies in our industry, we have received such notices from time to time and expect that we would continue to receive the same on an ongoing basis in the future. If claims or actions are asserted against us, we may be required to obtain a license or cross-license, modify our existing technology or design a new non-infringing technology. Such licenses or design modifications can be extremely costly, and in addition, may be disruptive to our business and operations. In addition, we may decide to settle a claim or action against us, which settlement could be significant expense. We may also be liable for any past infringement that has occurred. If there is an adverse ruling against us in an infringement lawsuit, among other judgments that could be imposed upon us, an injunction could be issued barring production or sale of any infringing product. We could also be liable for damages awarded against us equal to a reasonable royalty or lost profits or, if there is a finding of willful infringement, treble damages. Any such outcomes would increase our costs and harm our operating results.

Specifically, in May 2006, we settled a patent infringement lawsuit with Digi in which we signed an agreement with Digi to cross-license each other's patents for six (6) years. There is a risk that we will not be able to negotiate a new cross-license agreement when the current cross-license agreement expires in May 2012.

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

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

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

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

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

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

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

If a major distributor or customer cancels, reduces or delays purchases, our net revenues might decline and our business could be adversely affected.

The number and timing of sales to our distributors have been difficult for us to predict. While our distributors are customers in the sense that they buy our products from us, they are also part of our product distribution system. One or more of our distributors could be acquired by a competitor and stop buying product from us. The following table presents sales to our significant customers as a percentage of net revenue:

	Nine Months Ended March 31,	
	2011	2010
Top five customers (1)(2)	40.4%	39.4%
Ingram Micro	14.7%	10.7%
Tech Data	7.3%	9.0%

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

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

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

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

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

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

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

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

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

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

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

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

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

If we are unable to develop new products as a result of our research and development efforts, or if the products we develop are not successful, our business could be harmed. Even if we do develop new products that are accepted by our target markets, we do not know whether the net revenue from these products will be sufficient to justify our investment in the research and development of those products. On the other hand, if we do not invest sufficiently in research and development, we may be unable to maintain our competitive position. The continuing effects of the economic recession could require cost-containment measures, which could force us to reduce our investment in research and development and put us at a competitive disadvantage compared to our competitors.

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

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

Current or future litigation could adversely affect us.

We are subject to a wide range of claims and lawsuits in the course of our business. Any lawsuit may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources. The results of litigation are inherently uncertain, and adverse outcomes are possible.

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

We currently offer warranties ranging from one to two years on each of our products. Our products could contain undetected errors or defects. If there is a product failure, we might have to replace all affected products without being able to book revenue for replacement units, or we might have to refund the purchase price for the units. Regardless of the amount of testing we undertake, some errors might be discovered only after a product has been installed and used by customers. Any errors discovered after commercial release could result in loss of net revenue and claims against us. Significant product warranty claims against us could harm our business, reputation and financial results and cause the price of our stock to decline.

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

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

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

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

- reduced control over delivery schedules, quality assurance, manufacturing yields and production costs;
- lack of guaranteed production capacity or product supply; and
- reliance on these manufacturers to maintain competitive manufacturing technologies.

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

Due to the downturn in the economy, which has put some suppliers out of business, we have been experiencing higher component shortages. As we shift products among third-party manufacturers, we may incur substantial expenses, risk material delays or encounter other unexpected issues. In addition, a natural disaster could disrupt our manufacturers' facilities and could inhibit our manufacturers' ability to provide us with manufacturing capacity in a timely manner or at all. If this were to occur, we likely would be unable to fill customers' existing orders or accept new orders for our products. The resulting decline in net revenue would harm our business.

We also are responsible for forecasting the demand for our individual products. These forecasts are used by our contract manufacturers to procure raw materials and manufacture our finished goods. If we forecast demand too high, we may invest too much cash in inventory, and we may be forced to take a write-down of our inventory balance, which would reduce our earnings. If our forecast is too low for one or more products, we may be required to pay charges that would increase our cost of revenue or we may be unable to fulfill customer orders, thus reducing net revenue and therefore earnings.

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

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

	Three Months Ended March 31,				Change	
	2011	% of Net Revenue	2010	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 6,698	54.1 %	$ 7,027	58.0 %	$ (329)	(4.7%)
EMEA	3,749	30.3 %	3,185	26.3 %	564	17.7%
Asia Pacific	1,935	15.6 %	1,912	15.7 %	23	1.2%
Net revenue	$ 12,382	100.0 %	$ 12,124	100.0 %	$ 258	2.1%

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

• unexpected changes in regulatory requirements, taxes, trade laws and tariffs;

• reduced protection for intellectual property rights in some countries;

• differing labor regulations;

• compliance with a wide variety of complex regulatory requirements;

• fluctuations in currency exchange rates;

• changes in a country’s or region’s political or economic conditions;

• effects of terrorist attacks abroad;

• greater difficulty in staffing and managing foreign operations; and

• increased financial accounting and reporting burdens and complexities.

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

The recent earthquake and tsunami, and other collateral events, in Japan may adversely affect the demand for our products in the Japanese market and adversely affect our Japanese suppliers from providing components to enable us to build and supply Lantronix inventor. These risks may cause a decline in revenues and negatively affect our operating results.

The recent earthquake and tsunami in Japan, and other collateral events, including, among others, the catastrophic loss of lives, businesses, infrastructure, and delays in transportation, may have a negative impact on us by affecting our employees, customers, suppliers, or the overall economy in Japan. As a result, these events could cause a decline in our revenue in Japan and worldwide if we, or our customers, are unable to receive components from Japanese suppliers.

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

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

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

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

	March 31, 2011	June 30, 2010
	(In thousands)	
Finished goods	$ 6,242	$ 4,258
Raw materials	2,030	1,390
Inventory at distributors *	1,587	1,924
Large scale integration chips **	856	516
Inventories, gross	10,715	8,088
Reserve for excess and obsolete inventory	(1,323)	(1,215)
Inventories, net	$ 9,392	$ 6,873

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

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

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

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

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

Our financial performance depends substantially on the performance of our executive officers and of key engineers, marketing and sales employees. We are particularly dependent upon our technical personnel, due to the specialized technical nature of our business. If we were to lose the services of our executive officers or any of our key personnel and were not able to find replacements in a timely manner, our business could be disrupted, other key personnel might decide to leave, and we might incur increased operating expenses associated with finding and compensating replacements.

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

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

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

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

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

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

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

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

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

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

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

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

Also, the laws of some of the countries in which we market and manufacture our products offer little or no effective protection of our proprietary technology. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it. Consequently, we may be unable to prevent our proprietary technology from being exploited by others in the U.S. or abroad, which could require costly efforts to protect our technology. Policing the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impracticable. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which may harm our business, financial condition and results of operations.

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

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

Business interruptions could adversely affect our business.

Our operations and those of our suppliers are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, terrorist attacks and other events beyond our control. A substantial portion of our facilities, including our corporate headquarters and other critical business operations, are located near major earthquake faults and, therefore, may be more susceptible to damage if an earthquake occurs. We do not carry earthquake insurance for direct earthquake-related losses. If a business interruption occurs, our business could be materially and adversely affected.

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

Section 404 of the Sarbanes-Oxley Act of 2002 requires companies to evaluate periodically the effectiveness of their internal controls over financial reporting, and to include a management report assessing the effectiveness of their internal controls as of the end of each fiscal year. We are required to comply with the requirement of Section 404 of the Sarbanes-Oxley Act of 2002 to include in each of our annual reports an assessment by our management of the effectiveness of our internal controls over financial reporting.

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

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

Item 6. Exhibits

Exhibit Number	Description of Document
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	

Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

* Furnished, not filed.

SIGNATURES

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

Date: May 9, 2011	LANTRONIX, INC. (Registrant)
	By: /s/ Jerry D. Chase Jerry D. Chase President and Chief Executive Officer (Principal Executive Officer)
	By: /s/ Reagan Y. Sakai Reagan Y. Sakai Chief Financial Officer and Secretary (Principal Financial Officer)

30

Exhibit Index

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