

LANTRONIX INC  
Form 10-Q  
November 14, 2011

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

OR

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

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

Commission file number: 1-16027

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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)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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  No

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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 x 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   Smaller reporting company x  
(do not check if a smaller reporting company)

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 October 28, 2011, there were 10,581,235 shares of the Registrant's common stock outstanding.

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LANTRONIX, INC.  
FORM 10-Q  
FOR THE FISCAL QUARTER ENDED  
September 30, 2011

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

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

	September 30, 2011	June 30, 2011
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$4,035	\$5,836
Accounts receivable, net	2,056	2,908
Contract manufacturers' receivable	322	636
Inventories, net	9,285	9,160
Prepaid expenses and other current assets	470	605
Deferred tax assets	569	569
<b>Total current assets</b>	<b>16,737</b>	<b>19,714</b>
Property and equipment, net	1,826	1,761
Goodwill	9,488	9,488
Purchased intangible assets, net	36	54
Other assets	110	175
<b>Total assets</b>	<b>\$28,197</b>	<b>\$31,192</b>
<b>Liabilities and stockholders' equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$6,869	\$8,358
Accrued payroll and related expenses	2,328	2,000
Warranty reserve	259	268
Short-term debt	667	667
Other current liabilities	3,012	3,199
<b>Total current liabilities</b>	<b>13,135</b>	<b>14,492</b>
<b>Non-current liabilities:</b>		
Long-term liabilities	365	550
Long-term capital lease obligations	73	45
Long-term debt	667	833
Deferred tax liabilities	569	569
<b>Total non-current liabilities</b>	<b>1,674</b>	<b>1,997</b>
<b>Total liabilities</b>	<b>14,809</b>	<b>16,489</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Common stock	1	1
Additional paid-in capital	192,909	192,780
Accumulated deficit	(179,921 )	(178,477 )
Accumulated other comprehensive income	399	399

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Total stockholders' equity	13,388	14,703
Total liabilities and stockholders' equity	\$28,197	\$31,192

See accompanying notes.

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

	Three Months Ended September 30,	
	2011	2010
Net revenue (1)	\$11,184	\$12,192
Cost of revenue	5,882	5,965
Gross profit	5,302	6,227
Operating expenses:		
Selling, general and administrative	4,964	5,053
Research and development	1,695	1,823
Amortization of purchased intangible assets	18	18
Total operating expenses	6,677	6,894
Loss from operations	(1,375 )	(667 )
Interest expense, net	(27 )	(22 )
Other income (expense), net	(29 )	29
Loss before income taxes	(1,431 )	(660 )
Provision for income taxes	13	18
Net loss	\$(1,444 )	\$(678 )
Net loss per share (basic and diluted)	\$(0.14 )	\$(0.07 )
Weighted-average shares (basic and diluted)	10,560	10,348
Net revenue from related parties	\$237	\$241

(1) Includes net revenue from related parties

See accompanying notes.

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

	Three Months Ended September 30,	
	2011	2010
Operating activities		
Net loss	\$(1,444	) \$(678
Adjustments to reconcile net loss to net cash used in operating activities:		
Share-based compensation	160	583
Depreciation	234	257
Provision for inventories	1	4
Amortization of purchased intangible assets	18	23
Provision for doubtful accounts	16	1
Provision for officer loans	17	-
Loss on sale/write off of property and equipment	1	-
Changes in operating assets and liabilities:		
Accounts receivable	836	(424
Contract manufacturers' receivable	314	(128
Inventories	(126	) (640
Prepaid expenses and other current assets	127	125
Other assets	49	(37
Accounts payable	(1,487	) 467
Accrued payroll and related expenses	300	68
Warranty reserve	(9	) (31
Other liabilities	(370	) (242
Cash received related to tenant incentives	-	32
Net cash used in operating activities	(1,363	) (620
Investing activities		
Purchases of property and equipment, net	(209	) (83
Net cash used in investing activities	(209	) (83
Financing activities		
Proceeds from term loan	-	2,000
Payment of term loan	(167	) (778
Minimum tax withholding paid on behalf of employees for restricted shares	-	(131
Payment of capital lease obligations	(52	) (54
Net cash provided by (used in) financing activities	(219	) 1,037
Effect of foreign exchange rate changes on cash	(10	) 49
Increase (decrease) in cash and cash equivalents	(1,801	) 383
Cash and cash equivalents at beginning of period	5,836	10,075
Cash and cash equivalents at end of period	\$4,035	\$10,458

See accompanying notes.



LANTRONIX, INC.

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 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, 2011, included in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on September 15, 2011. The unaudited condensed consolidated financial statements contain all normal recurring accruals and adjustments that in the opinion of management, are necessary to present fairly the consolidated financial position of the Company at September 30, 2011, and the consolidated results of its operations and cash flows for the three months ended September 30, 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 months ended September 30, 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 September 30,	
	2011	2010
	(In thousands except per share data)	
Numerator:		
Net loss	\$(1,444	) \$(678
Denominator:		
Weighted-average shares outstanding	10,612	10,548
Less: Unvested common shares outstanding	(52	) (200
Weighted-average shares (basic and diluted)	10,560	10,348
Net loss per share (basic and diluted)	\$(0.14	) \$(0.07

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  
September 30,

	2011 (In thousands)	2010
Common stock equivalents	1,762	1,195

## 3. Inventories

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

	September 30, 2011	June 30, 2011
	(In thousands)	
Finished goods	\$6,533	\$6,475
Raw materials	1,931	1,912
Inventory at distributors	1,211	1,436
Large scale integration chips *	869	714
Inventories, gross	10,544	10,537
Reserve for excess and obsolete inventory	(1,259 )	(1,377 )
Inventories, net	\$9,285	\$9,160

\* 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 and 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:

	Three Months Ended September 30, 2011	Year Ended June 30, 2011
	(In thousands)	
Beginning balance	\$268	\$183
Charged to cost of revenues	58	288
Usage	(67 )	(203 )
Ending balance	\$259	\$268

## 5. Bank Line of Credit and Debt

In September 2010, we entered into an Amendment to the Loan and Security Agreement (the "Amended 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 Amended 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 September 30, 2011.

The Borrowing Base (as defined in the Amended Loan Agreement) under the Revolving Line is based upon eligible accounts receivable as defined per the Amended 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.

On August 18, 2011, we entered into another amendment (“Amendment”) to the Amended Loan Agreement. The Amendment provided for (1) a limited waiver to the minimum tangible net worth financial covenant, (2) a modification of the minimum tangible net worth financial covenant, and (3) a modification to the interest rate such that the interest will accrue at a per annum rate equal to 2.50 percentage points above the prime rate, payable monthly. If the Company achieves two consecutive fiscal quarters of earnings before interest, taxes, depreciation and amortization (“EBITDA”) greater than \$1.00 (commencing with this fiscal quarter ending September 30, 2011), and only for so long as the Company maintains EBITDA greater than \$1.00 at the end of each subsequent fiscal quarter, the interest shall accrue at a per annum rate equal to 1.50 percentage points above the Prime Rate, payable monthly.

Upon entering into the Amended Loan Agreement, we paid a fully earned, non-refundable commitment fee of \$20,000. On September 28, 2011, we paid an additional \$15,000, which was required on the first anniversary of the effective date as per the Amended Loan Agreement. In connection with the Amendment, we paid an additional \$5,000 in fees in the fiscal quarter ending September 30, 2011.

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:

	September 30, 2011	June 30, 2011
	(In thousands)	
Term Loan	\$1,334	\$1,500
Amount Available under the Revolving Line	\$1,747	\$2,302
Outstanding letters of credit	\$84	\$84

## 6. Stockholders' Equity

### Share-Based Plans

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

	Three Months Ended September 30,	
	2011	2010
	(In thousands)	
Cost of revenues	\$13	\$25
Selling, general and administrative	81	408
Research and development	66	150
Total share-based compensation	\$160	\$583

### Stock Option Awards

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, 2011	1,817,988
Options granted	667,053
Options forfeited	(104,976 )
Options expired	(28,900 )
Options exercised	-
Balance of options outstanding at September 30, 2011	2,351,165



The following table presents stock option grant date information:

	Three Months Ended September 30,	
	2011	2010
Weighted-average grant date fair value per share	\$1.14	\$2.84
Weighted-average grant date exercise price per share	\$1.83	\$4.24

## 7. Income Taxes

At July 1, 2011, the Company's fiscal 2007 through fiscal 2011 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 2002 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 September 30,	
	2011	2010
Effective tax rate	1%	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. 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.

## 9. Subsequent Events

On November 10, 2011, the Company announced that it had commenced the implementation of a restructuring plan on November 7, 2011 consisting of a reduction in headcount. The restructuring is designed to reduce operating expenses and bring them more in line with revenue levels in order to improve future results of operations. The Company's revenue has declined over the past two quarters due in part to the effects of the economic recession.

The workforce reduction, which affected all functional groups, represented approximately 11% of the Company's total workforce. This measure is expected to reduce annualized cash expenses by approximately \$2.0 million. The Company expects to incur an estimated restructuring charge of approximately \$300,000 for employee severance and related costs. Substantially all of this amount will consist of severance payments in the second quarter of fiscal 2012, which ends December 31, 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, 2011 and subsequent reports on our Current Reports on Form 8-K.

This Report contains forward-looking statements, which include, but are not limited to, statements concerning projected net revenues, expenses, gross profit and net income (loss), the need for additional capital, market acceptance of our products, our ability to achieve further product integration, the status of evolving technologies and their growth potential and our production capacity. Among these forward-looking statements are statements regarding a potential decline in net revenue from non-core product lines, potential variances in quarterly operating expenses, the adequacy of existing resources to meet cash needs, some reduction in the average selling prices and gross margins of products, need to incorporate software from third-party vendors and open source software in our future products and the potential impact of an increase in interest rates or fluctuations in foreign exchange rates on our financial condition or results of operations. These forward-looking statements are based on our current expectations, estimates and projections about our industry, our beliefs and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are 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.

### 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. 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, provide competitive advantages with new features, and greatly reduce engineering and marketing risks.

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 (personal computers) 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. 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. Many original equipment manufacturers ("OEMs") actually host their application on the device server, further reducing their design cycles and product complexity. 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 which support the stringent security requirements of the healthcare, banking and physical security markets. We are making continual enhancements to our product line to make our products even easier to integrate into enterprise and cloud infrastructures.

## 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 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 and service calls can be reduced, 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

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended September 30, 2011:

As reported in a Form 8-K dated June 24, 2011, during the fourth fiscal quarter of 2011 we substantially completed the independent investigation of certain allegations asserted by a director of Lantronix, which commenced in June 2011. We incurred an additional \$108,000 of expenses in the first quarter of fiscal 2012 related to activities associated with concluding the investigation. At September 30, 2011, we had incurred \$2.2 million in total costs associated with the investigation.

Also reported in a Form 8-K dated June 24, 2011, the Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) resigned and entered into separation agreements with Lantronix. We incurred an additional \$153,000 of expenses in the first quarter of fiscal 2012 related to consulting services per the terms of the separation agreements.

On November 10, 2011, we announced that we had commenced the implementation of a restructuring plan on November 7, 2011 consisting of a reduction in headcount. The restructuring is designed to reduce operating expenses and bring them more in line with revenue levels in order to improve future results of operations. Our revenue has declined over the past two quarters due in part to the effects of the economic recession. The workforce reduction, which affected all functional groups, represented approximately 11% of our total workforce. This measure is expected to reduce annualized cash expenses by approximately \$2.0 million. We expect to incur an estimated restructuring charge of approximately \$300,000 for employee severance and related costs. Substantially all of this amount will consist of severance payments

in the second quarter of fiscal 2012, which ends December 31, 2011.

Net revenue was \$11.2 million for the fiscal quarter ended September 30, 2011, a decrease of \$1.0 million or 8.3%, compared to \$12.2 million for the fiscal quarter ended September 30, 2010. The decrease was primarily the result of a \$1.1 million, or 11.3%, decrease in sales of our device enablement product lines, primarily due to decreased unit sales, offset by a \$57,000, or 2.6%, increase in sales of our device management product lines and a \$55,000, or 36.4%, increase in our non-core product lines.

Gross profit margin was 47.4% for the fiscal quarter ended September 30, 2011, compared to 51.1% for the fiscal quarter ended September 30, 2010. The decrease in gross profit margin as a percent of net revenue was due to an increase in sales discounts and allowances and a reduction in royalty revenues, which generally have no associated cost of sales.

Net loss was \$1.4 million, or \$0.14 per basic and diluted share, for the fiscal quarter ended September 30, 2011, compared to \$678,000, or \$0.07 per basic and diluted share, for the fiscal quarter ended September 30, 2010, which was primarily the result of the decrease in net revenue and gross profit margin from the year ago quarter.

Cash and cash equivalents were \$4.0 million as of September 30, 2011, a decrease of \$1.8 million, compared to \$5.8 million as of June 30, 2011. The use of cash was driven by the net loss and payment of expenses related to the special investigation.

Net accounts receivable were \$2.1 million as of September 30, 2011, a decrease of \$852,000, compared to \$2.9 million as of June 30, 2011. Days sales outstanding (“DSO”) in receivables were 20 days for the fiscal quarter ended September 30, 2011 compared to 16 days for the fiscal quarter ended June 30, 2011. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped by us to distributors).

Net inventories were \$9.3 million as of September 30, 2011, compared to \$9.2 million as of June 30, 2011. Inventory turns were 2.6 turns for the fiscal quarter ended September 30, 2011 compared to 3.1 turns for the fiscal quarter ended June 30, 2011. The decrease in turns is primarily due to a decline in net revenue.

#### 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, 2011. Except as described below, there have been no significant changes in our critical accounting policies and estimates during the fiscal quarter ended September 30, 2011 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2011.

Goodwill impairment testing requires us to compare the fair value of our one reporting unit to its carrying amount, including goodwill, and record an impairment charge if the carrying amount of a reporting unit exceeds its estimated fair value. We perform goodwill impairment tests on an annual basis, and more frequently if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. We operate in one segment that is comprised of a single reporting unit. We evaluate goodwill for potential impairment by comparing the carrying value of total stockholder’s equity to the Company’s market capitalization.

During the current quarter, we noted a significant reduction in our stock price due in part to what we believe was a reaction to the change in our executive management team and our financial performance. The decline in stock price significantly affected our market capitalization. As of September 30, 2011, the fair value of the reporting unit was estimated to be \$19.5 million based upon the Company’s market capitalization compared to the reporting unit’s carrying amount, including goodwill, of \$13.4 million. As of September 30, 2011, we have \$9.5 million of goodwill reflected in our consolidated balance sheet. If actual results are not consistent with our assumptions and judgments used in estimating fair value, we may be exposed to goodwill impairment losses.

#### Recent Accounting Pronouncements

In May 2011, the FASB issued additional guidance on fair value measurements that clarifies the application of existing guidance and disclosure requirements, changes certain fair value measurement principles and requires additional disclosures about fair value measurements. The updated guidance is effective on a prospective basis for financial statements issued for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. We don’t expect the adoption of this guidance to have a material impact on our financial statements.

In September 2011, the FASB issued new accounting guidance intended to simplify goodwill impairment testing. Entities will be allowed to perform a qualitative assessment on goodwill impairment to determine whether a quantitative assessment is necessary. This guidance is effective for goodwill impairment tests performed in interim and annual periods for fiscal years beginning after December 15, 2011. Early adoption is permitted. We don't expect the adoption of this guidance to have a material impact on our financial statements.

## Comparison of the Fiscal Quarters Ended September 30, 2011 and 2010

## Net Revenue by Product Line

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

	Three Months Ended September 30,		Three Months Ended September 30,		Change \$	)	%
	2011	% of Net Revenue	2010	% of Net Revenue			
(In thousands, except percentages)							
Device enablement	\$8,763	78.4%	\$9,883	81.1%	\$(1,120	)	(11.3%)
Device management	2,215	19.8%	2,158	17.7%	57		2.6%
Device networking	10,978	98.2%	12,041	98.8%	(1,063	)	(8.8%)
Non-core	206	1.8%	151	1.2%	55		36.4%
Net revenue	\$11,184	100.0%	\$12,192	100.0%	\$(1,008	)	(8.3%)

The decrease in net revenue for the three months ended September 30, 2011, compared to the three months ended September 30, 2010 was the result of a decrease in net revenue from our device enablement product lines, which was negatively impacted by general economic conditions in the U.S. The decrease in net revenue from our device enablement product lines was partially offset by an increase in net revenue from our device management and non-core product lines. The decrease in net revenue from our device enablement product line was primarily due to a decrease in unit sales of some of our embedded device enablement products, in particular our XPort and, to a lesser extent, our Micro, which is a legacy embedded serial-to-ethernet solution. In addition, we had a \$275,000 embedded royalty sale in the 2010 fiscal quarter that did not recur in the 2011 fiscal quarter. The decreases to the embedded device enablement products were partially offset by an increase in unit sales of our new products, XPort Pro and PremierWave. To a lesser extent, the decrease in net revenue from our device enablement product line was impacted by a decrease in unit sales of our external device enablement products, in particular our UDS and MSS product families, partially offset by an increase in unit sales of our EDS and Xpress product families. The increase in net revenue from our device management product line was due to an increase in unit sales of our SLS Spider product family, partially offset by a decrease in unit sales of our SCS product family.

## Net Revenue by Geographic Region

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

	Three Months Ended September 30,		Three Months Ended September 30,		Change \$	)	%
	2011	% of Net Revenue	2010	% of Net Revenue			
(In thousands, except percentages)							
Americas	\$5,677	50.8%	\$6,571	53.9%	\$(894	)	(13.6%)
EMEA	3,515	31.4%	3,531	29.0%	(16	)	(0.5%)
Asia Pacific	1,992	17.8%	2,090	17.1%	(98	)	(4.7%)
Net revenue	\$11,184	100.0%	\$12,192	100.0%	\$(1,008	)	(8.3%)

The decrease in net revenue for the three months ended September 30, 2011 compared to the three months ended September 30, 2010 reflects decreased unit sales in the Americas, Asia Pacific, and Europe, Middle East and Africa

(the “EMEA”). The decrease in net revenue from the Americas region was primarily due to a decrease in unit sales of our device enablement product lines and, to a lesser extent, our device management product lines. The decrease in net revenue in the Asia Pacific region was due to a decrease in unit sales of our device enablement product lines. The decrease in net revenue from EMEA region was due to a decrease in unit sales in our device management product lines and device enablement product lines, partially offset by an increase in unit sales of our non-core product lines.

#### 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 September 30,		2010	% of Net Revenue	\$	Change %
	2011	% of Net Revenue				
	(In thousands, except percentages)					
Gross profit	\$5,302	47.4%	\$6,227	51.1%	\$(925)	(14.9%)

The decrease in gross profit as a percent of net revenue (referred to as “gross margin”) for the three months ended September 30, 2011, compared to the three months ended September 30, 2010 was primarily due to an increase in sales discounts and allowances and a reduction in royalty revenues, which generally have no associated cost of sales.

#### 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 September 30,		2010	% of Net Revenue	Change \$	%
	2011	% of Net Revenue				
	(In thousands, except percentages)					
Personnel-related expenses	\$ 2,846		\$ 2,557		\$ 289	11.3%
Professional fees and outside services	1,007		806		201	24.9%
Advertising and marketing	209		450		(241)	(53.6%)
Facilities	296		257		39	15.2%
Share-based compensation	81		408		(327)	(80.1%)
Depreciation	128		165		(37)	(22.4%)
Bad debt expense	16		1		15	1500.0%
Other	381		409		(28)	(6.8%)
Selling, general and administrative	\$ 4,964	44.4%	\$ 5,053	41.4%	\$ (89)	(1.8%)

In order of significance, the decrease in selling, general and administrative expenses for the three months ended September 30, 2011, compared to the three months ended September 30, 2010 was primarily due to: (i) a decrease in share-based compensation due to the Company’s fiscal 2011 bonus plan being paid out partially in stock during the 2010 fiscal quarter and a lower average stock price for options granted during the 2011 fiscal quarter, (ii) a decrease in advertising and marketing expenses as a result of cost saving measures, partially offset by (iii) an increase in personnel-related expenses as a result of an increase in salaries due to an increase in head-count and annual merit increases and (iv) an increase in professional fees and outside services as a result of the consulting fees for former executives per their separation agreements and costs related to the investigation of allegations.

#### 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 September 30,					
	2011	% of Net Revenue	2010	% of Net Revenue	Change \$	%
	(In thousands, except percentages)					
Personnel-related expenses	\$ 1,178		\$ 1,123		\$ 55	4.9%
Facilities	211		267		(56 )	(21.0%)
Professional fees and outside services	174		191		(17 )	(8.9%)
Share-based compensation	66		150		(84 )	(56.0%)
Depreciation	9		12		(3 )	(25.0%)
Other	57		80		(23 )	(28.8%)
Research and development	\$ 1,695	15.2%	\$ 1,823	15.0%	\$ (128 )	(7.0%)

In order of significance, the decrease in research and development expenses for the three months ended September 30, 2011, compared to the three months ended September 30, 2010 was primarily due to: (i) a decrease in share-based compensation due to the Company's bonus plan being paid out partially in stock during the 2010 fiscal quarter and a lower average stock price for options granted during the 2011 fiscal quarter and (ii) a decrease in facilities expenses, partially offset by (iii) an increase in personnel-related expenses as a result of annual merit increases.

#### Other Income (Expense), Net

The following table presents other income (expense), net:

	Three Months Ended September 30,					
	2011	% of Net Revenues	2010	% of Net Revenues	Change \$	%
Other income (expense), net	\$ (29)	0.3%	\$ 29	0.2%	\$ (58)	(200.0%)

The change in other income (expense), net, is primarily due to foreign currency remeasurement and transaction adjustments related to our foreign subsidiaries whose functional currency is the U.S. dollar. Further, due to the decline in the Company's stock price during the quarter ended September 30, 2011, the Company reduced the carrying amount of a former director's non-recourse loan to the fair value of the collateralized shares as of September 30, 2011, which resulted in a \$17,000 charge to other expense.

#### Amortization of Purchased Intangibles

	Three Months Ended September 30,					
	2011	% of Net Revenues	2010	% of Net Revenues	Change \$	%
Amortization of purchased intangibles	\$ 18	0.2%	\$ 23	0.2%	\$ (5)	(21.7%)

The decrease in amortization of purchased intangibles from the prior year is related to a purchased intangible, which was fully amortized in June of 2011. The remaining balance of purchased intangibles of approximately \$36,000 will be fully amortized by March 2012.

#### Provision for Income Taxes

At July 1, 2011, our fiscal 2007 through fiscal 2011 tax years remained open to examination by the Federal, state, and foreign taxing authorities. We have net operating losses (“NOLs”) beginning in fiscal 2002 that would cause 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 September 30,	
	2011	2010
Effective tax rate	1%	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.

### Liquidity and Capital Resources

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

	September 30, 2011	June 30, 2011	Decrease
	(In thousands)		
Working capital	\$3,602	\$5,222	\$(1,620 )
Cash and cash equivalents	\$4,035	\$5,836	\$(1,801 )

Our working capital as of September 30, 2011 decreased as compared to June 30, 2011, primarily due to the net loss recorded during the period, a decrease in accounts payable due to the timing of shipments and inventory receipts, and cash payments for investigation-related expenses.

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, 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.

### Loan Agreement

In September 2010, we entered into an Amendment to the Loan and Security Agreement (the "Amended 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 Amended 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 September 30, 2011.

The Borrowing Base (as defined in the Amended Loan Agreement) under the Revolving Line is based upon eligible accounts receivable as defined per the Amended 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.

We did not meet the Minimum Tangible Net Worth (“Minimum TNW”) financial covenant for the months of May and June in fiscal 2011. On August 18, 2011, we entered into another amendment (“Amendment”) to the Amended Loan Agreement. The Amendment provided for (1) a limited waiver to the Minimum TNW financial covenant, (2) a modification of the Minimum TNW financial covenant, and (3) a modification to the interest rate such that the interest will accrue at a per annum rate equal to 2.50 percentage points above the prime rate, payable monthly. If the Company achieves two consecutive fiscal quarters of earnings before interest, taxes, depreciation and amortization (“EBITDA”) greater than \$1.00 (commencing with this fiscal quarter ending September 30, 2011), and only for so long as the Company maintains EBITDA greater than \$1.00 at the end of each subsequent fiscal quarter, the interest shall accrue at a per annum rate equal to 1.50 percentage points above the Prime Rate, payable monthly.

Minimum TNW, as defined in the Loan Agreement, is computed by taking total shareholders' equity less goodwill and intangible assets. If we continue to incur losses, we may have difficulty satisfying the Minimum TNW financial covenant in the future. The following table presents the calculation of our Minimum TNW compared to the financial covenant requirements per the Amendment:

	Actual		Financial Covenant Requirements as of		
	September 30, 2011	September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012
			(In Thousands)		
Minimum TNW	\$ 3,864	>\$3,000	>\$3,000	>\$3,500	>\$4,500

Upon entering into the Amended Loan Agreement, we paid a fully earned, non-refundable commitment fee of \$20,000. On September 28, 2011, we paid an additional \$15,000, which was required on the first anniversary of the effective date as per the Loan Agreement. In addition, in connection with the Amendment, we paid an additional \$5,000 in fees in the fiscal quarter ending September 30, 2011.

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:

	September 30, 2011	June 30, 2011
	(In thousands)	
Term Loan	\$1,334	\$1,500
Amount Available under the Revolving Line	\$1,747	\$2,302
Outstanding letters of credit	\$84	\$84

As of September 30, 2011 and June 30, 2011, approximately \$364,000 and \$339,000, 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 Months Ended September 30

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

	Three Months Ended September 30,	
	2011	2010
	(In thousands)	
Net cash provided by (used in):		
Net loss	\$(1,444 )	\$(678 )
Non-cash operating expenses, net	447	868
Changes in operating assets and liabilities:		
Accounts receivable	836	(424 )
Contract manufacturers' receivable	314	(128 )

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Inventories	(126	)	(640	)
Prepaid expenses and other current assets	127		125	
Other assets	49		(37	)
Accounts payable	(1,487	)	467	
Accrued payroll and related expenses	300		68	
Warranty reserve	(9	)	(31	)
Other liabilities	(370	)	(242	)
Cash received related to tenant incentives	-		32	
Net cash used in operating activities	(1,363	)	(620	)
Net cash used in investing activities	(209	)	(83	)
Net cash (used in) provided by financing activities	(219	)	1,037	
Effect of foreign exchange rate changes on cash	(10	)	49	
Increase (decrease) in cash and cash equivalents	\$(1,801	)	\$383	

Operating activities used cash during the three months ended September 30, 2011. This was the result of a net loss and cash used by operating assets and liabilities, partially 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 by operating activities included (i) a decrease in accounts payable and other liabilities as we paid for the special investigation costs and vendors for inventory that has built up over the last few quarters, partially offset by (ii) a decrease in accounts receivable due to a decrease in net revenue, (iii) a decrease in contract manufacturers' receivable as a result of a decrease in their purchase of raw materials, and (iv) an increase in accrued payroll and related expenses as a result of accrued severance for former executives.

Operating activities used cash during the three months ended September 30, 2010. This was the result of a net loss and cash used by operating assets and liabilities, partially 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 by operating activities included (i) an increase in inventories mainly due to the Company sourcing components directly to ensure supply and (ii) an increase in accounts receivable due to the timing of collections and linearity of sales, partially offset by an increase in accounts payable due to the timing of payments to vendors and an increase in inventory.

Investing activities used cash during the three months ended September 30, 2011 and 2010, due to the purchase of property and equipment primarily related to test equipment, software upgrades, and office equipment for our new sales offices in Hong Kong and Japan, respectively.

Financing activities used cash during the three months ended September 30, 2011 due to payments for the Term Loan and capital lease obligations.

Financing activities provided cash during the three months ended September 30, 2010 due to proceeds from the Term Loan, partially offset by (i) payments for the Term Loan, (ii) minimum tax withholding paid on behalf of employees related to the vesting of restricted shares and (iii) payments on capital lease obligations.

#### Off-Balance Sheet Arrangements

None.

#### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

#### 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 September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Not applicable.

### 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 net losses of \$1.4 million for the three months ended September 30, 2011 and \$3.6 million for the three months ended June 30, 2011. There can be no assurance that we will be profitable or generate positive cash flows in future periods. In the event we fail to achieve profitability in future periods, the value of our common stock may decline. In addition, if we are unable to generate positive cash flows, we would be required to seek additional funding, which may not be available on favorable terms, if at all.

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.

We currently have an Amended Loan Agreement, which provides for a Revolving Line and a Term Loan. The Amended Loan Agreement requires that we maintain a Tangible Net Worth ("TNW") covenant, which is described in further detail in the Liquidity and Capital Resources section of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. In May and June of 2011, we violated the TNW covenant and our bank provided a waiver and amended the covenant in August 2011. If we continue to generate net losses, it could result in us not meeting the amended TNW covenant. There can be no assurance that our bank will provide a limited waiver of future covenant violations or amend the TNW covenant again. If the Term Loan were to be called by the bank, we would have difficulty financing our operations.

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 revenue, expenses and operating results from quarter-to-quarter. We therefore believe that quarter-to-quarter comparisons of our operating

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

changes in business and economic conditions, including the recent global economic recession;

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

customers' decisions to defer or accelerate orders;

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

changes in demand for our products;

fluctuations in exchange rates;

defects and other product quality problems;

loss or gain of significant customers;

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

announcements or introductions of new products by our competitors;

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

natural disasters in the U.S. and abroad;

changes in demand for devices that incorporate our products; and

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

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

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



If 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:

	Three Months Ended September 30,	
	2011	2010
Top five customers (1)(2)	51.3%	42.3%
Ingram Micro	16.5%	8.2%
Acal BFI Central Procurement UK Limited	11.6%	13.6%

(1) Includes Ingram Micro and Acal BFI Central Procurement UK Limited

(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.

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 September 30,		2010	% of Net Revenue	\$	Change %
	2011	% of Net Revenue				
	(In thousands, except percentages)					
Americas	\$5,677	50.8%	\$6,571	53.9%	\$(894)	(13.6%)
EMEA	3,515	31.4%	3,531	29.0%	(16)	(0.5%)
Asia Pacific	1,992	17.8%	2,090	17.1%	(98)	(4.7%)
Net revenue	\$11,184	100.0%	\$12,192	100.0%	\$(1,008)	(8.3%)

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

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

reduced protection for intellectual property rights in some countries;

differing labor regulations;

compliance with a wide variety of complex regulatory requirements;

fluctuations in currency exchange rates;

changes in a country's or region's political or economic conditions;

effects of terrorist attacks abroad;

greater difficulty in staffing and managing foreign operations; and

increased financial accounting and reporting burdens and complexities.

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

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

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

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

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

	September 30, 2011	June 30, 2011
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	(In thousands)	
Finished goods	\$6,533	\$6,475
Raw materials	1,931	1,912
Inventory at distributors	1,211	1,436
Large scale integration chips *	869	714
Inventories, gross	10,544	10,537
Reserve for excess and obsolete inventory	(1,259 )	(1,377 )
Inventories, net	\$9,285	\$9,160

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

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

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

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

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

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

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

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

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

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

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

Substantial litigation regarding intellectual property rights occurs frequently in our industry. For example, in May 2006, we settled a patent infringement lawsuit with Digi in which we signed an agreement with Digi to cross-license

each other's patents for six years. There is a risk that we will not be able to negotiate a new cross-license agreement when the current cross-license agreement expires in May 2012. The results of litigation are inherently uncertain, and adverse outcomes are possible. Adverse outcomes may have a material adverse effect on our business, financial condition or results of operations.

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

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

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

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

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

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

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

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

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

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

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

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

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

Consequently, we may be unable to prevent our proprietary technology from being exploited by others in the U.S. or abroad, which could require costly efforts to protect our technology. Policing the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impracticable. Litigation may be



necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which may harm our business, financial condition and results of operations.

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

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

Business interruptions could adversely affect our business.

Our operations and those of our suppliers are vulnerable to interruption by fire, earthquake, power loss, floods telecommunications failure, terrorist attacks and other events beyond our control. Our corporate headquarters and other critical business operations, are located near major earthquake faults and flood zones and, therefore, may be more susceptible to damage if an earthquake or flood 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.

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

During fiscal 2011, we transitioned almost all 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 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Reserved

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit

Number Description of Document

10.1	2012 Performance Award Agreement
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.*
101.INS	XBRL Instance Document **
101.SCH	XBRL Taxonomy Extension Schema Document **
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document **
101.LAB	XBRL Taxonomy Extension Label Linkbase Document **
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document**

\* Furnished, not filed.

\*\* Pursuant to applicable securities laws and regulations, we are deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as we have made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T, these interactive data files are deemed not filed and otherwise are not subject to liability.

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.

LANTRONIX, INC.  
(Registrant)

Date: November 11, 2011

By: /s/ Kurt Busch  
Kurt Busch  
President and Chief Executive Officer  
(Principal Executive Officer)

By: /s/ Jeremy Whitaker  
Jeremy Whitaker  
Chief Financial Officer and Secretary  
(Principal Financial Officer)

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