LANTRONIX INC
Form 10-Q/A
June 25, 2002

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

FORM 10-Q/A
Amendment No. 1

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

For the quarterly period ended December 31, 2001

OR

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

For the transition period from _________ to ___________.

Commission file number: 1-16027

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

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

15353 Barranca Parkway Irvine, California 92618
(Address of principal executive offices and zip code)

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

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

As of January 31, 2002, 52,771,640 shares of the Registrant's common stock were outstanding.

EXPLANATORY NOTE

This Amendment No. 1 to Quarterly Report on Form 10-Q/A of Lantronix, Inc. (the "Company") amends Part I of the Company's Quarterly Report on Form 10-Q for

the quarter ended December 31, 2001, as filed by the Company on February 14, 2002 (the "Original 10-Q"), to reflect the changes described below.

The Company changed its accounting method for recognizing revenue on sales to distributors effective as of the beginning of fiscal 2001, July 1, 2000. Under the new accounting method, recognition of revenue and related gross profit on sales to distributors is deferred until the distributor resells the product to an end customer. Previously, the Company had recognized revenue from these transactions upon shipment of product to the distributor, net of estimates for possible returns and allowances. In addition, for the quarterly periods ended September 30, 2001 and December 31, 2001, the Company also made further corrections to its condensed consolidated financial statements (1) to defer the recognition of certain sales made to customers who were not distributors as revenue because they did not meet all of the criteria for revenue recognition at the time of shipment, and (2) to reclassify to other expense certain amounts originally charged in error to other comprehensive income. The effect of these matters is to reduce net revenues by $713,000 and $429,000 and increase loss before cumulative effect of accounting change by $746,000 or $0.02 per share and $286,000 or $0.01 per share in the quarters ended December 31, 2001 and 2000, respectively. The effect of these matters for the six month periods ended December 31, 2001 and 2000 are to reduce net revenues by $1,151,000 and $822,000 and increase loss before cumulative effect of accounting change by $869,000 or $0.02 per share and $492,000 or $0.02, respectively. Additionally, the cumulative effect of the accounting change recorded as of July 1, 2000 was a charge of $597,000 (net of income tax benefit of $176,000) or $0.02 per share. See Note 2 to the financial statements, "Accounting Change and Restatement of Financial Statements", for more detail. Conforming changes reflecting the foregoing are made in: Part I - Item 1 Financial Statements (and footnotes thereto); and - Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations.

In addition, the Company made changes to the Original 10-Q to clarify or correct information with respect to the following:

- Part I Item 1 "Financial Statements": separation in the condensed consolidated balance sheet of accounts as follow: "Goodwill" and "Purchased intangible assets, net"; and "Officer loans" and "Other assets";
- Part I Item 1 "Financial Statements", reclassification of amounts between "Selling, General and Administrative" and "Amortization of Purchased Intangibles"; and between "Interest Income (Expense), Net" and "Other Income (Expense), Net";
- Part I Item 1 "Financial Statements": additions to Note 3 "Recent Accounting Pronouncements" and Note 6 "Goodwill and Purchased Intangible Assets" to provide additional information concerning the Company's adoption of SFAS 142 "Goodwill and Other Intangible Assets";
- Part I Item 1 "Financial Statements": addition to Note 3 "Recent Accounting Pronouncements" for newly issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets";
- Part I Item 1 "Financial Statements": clarification in Note 8 "Stockholders' Equity" of the number of shares sold in the secondary offering;
- Part I Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations": clarification under the heading "Net Revenues" as to European sales;
- Part I Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations": clarification under the heading "Gross Profit" as to royalty payments to Gordian;
- Part I Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations": additional information under the heading "Impact of Adoption of New Accounting

Standards";
- Part II Item 2 "Changes in Securities and Use of Proceeds": clarification of the number of shares sold in our secondary offering; and
- Part II Item 2 "Changes in Securities and Use of Proceeds": clarification regarding the acquisition of U.S. Software.

Except as noted above, this Form 10-Q does not reflect events occurring after the filing of the Original 10-Q on February 14, 2002, nor does it modify or update the disclosures contained in such original report, except as necessary or appropriate to reflect the effects of the restatement.

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LANTRONIX, INC.

FORM 10-Q/A
FOR THE QUARTER ENDED DECEMBER 31, 2001

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

LANTRONIX, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 3 2001 (Unaudited (Restat
ASSETS	
Current assets:	
Cash and cash equivalents	$ 38,649
Short-term investments	9,872
Accounts receivable, net	7,418
Inventories	16,176
Deferred income taxes	5,297
Prepaid income taxes	622
Prepaid expenses and other current assets	7,015
Total current assets	85,049
Property and equipment, net	7,014
Long-term investments	6,981
Goodwill	57,303
Purchased intangible assets, net	21,296
Officer loans.	4,131
Other assets	1,724
Total assets	$183,498
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable	$ 5,376
Due to related party	711
Accrued payroll and related expenses	1,284
Other current liabilities	3,559
Total current liabilities	10,930
Deferred income taxes	10,995
Stockholders' equity:	
Common stock	5
Additional paid-in capital.	174,682
Employee notes receivable	(790)
Deferred compensation	(8,719)

Retained earnings (accumulated deficit)	(3,613)
Accumulated other comprehensive income (loss)	8
Total stockholders' equity	161,573
Total liabilities and stockholders' equity	$183,498

See accompanying notes.

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LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Three Months December 3	
	2001	(
Net revenues (A)	$ 15,726	$
Cost of revenues (B)	7,538	
Gross profit	8,188	
Operating expenses:		
Selling, general and administrative (C)	7,695	
Research and development (C)	1,956	
Stock-based compensation (B)(C)	781	
Amortization of purchased intangible assets	523	
Total operating expenses	10,955	
Loss from operations	(2,767)	
Interest income (expense), net	479	
Other income (expense), net	(176)	
Loss before income taxes and cumulative effect of accounting change	(2,464)	
Benefit for income taxes	(547)	
Loss before cumulative effect of accounting change	(1,917)	
Cumulative effect of accounting change, net of income taxes of $176 (Note 2)	--	
Net loss	$ (1,917)	$
Basic and diluted loss per share before cumulative effect of accounting change	$ (0.04)	$
Cumulative effect of accounting change per share	--	

Basic and diluted net loss per share	$ (0.04)	$
Weighted average shares (basic and diluted)	51,261	
(A) Includes net revenues from related parties	$ 579	$
(B) Cost of revenues includes the following:		
Amortization of purchased intangible assets	$ 560	$
Stock-based compensation	48	
	$ 608	$
(C) Stock-based compensation is excluded from the following:		
Selling, general and administrative expenses	$ 676	$
Research and development expenses	105	
	$ 781	$

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Mon Dece
	2001 (Restate
Cash flows from operating activities:	
Net loss	$ (4,195)
Adjustments to reconcile net loss to net cash used in operating activities:	
Cumulative effect of accounting change, net of income taxes of $176	-
Depreciation	1,225
Amortization of purchased intangible assets	1,707
Stock-based compensation	2,028
Provision for doubtful accounts	464
Deferred income taxes	(565)
Revaluation of investment	500
Equity losses from unconsolidated business	476
Loss on disposal of asset	-
Changes in operating assets and liabilities, net of effect from acquisitions:	
Accounts receivable	2,540
Inventories	(2,310)
Prepaid expenses and other current assets	(2,176)
Other assets	(1,004)

Accounts payable	(2,781)
Other current liabilities	(72)
Net cash used in operating activities	(4,163)
Cash flows from investing activities:	
Purchase of property and equipment, net	(2,625)
Purchase of minority investments, net	(4,318)
Acquisition of businesses, net of cash acquired	(3,393)
Purchase of held-to-maturity investments	(12,184)
Proceeds from sale of held-to-maturity investments	1,975
Net cash used in investing activities	(20,545)
Cash flows from financing activities:	
Net proceeds from underwritten offerings of common stock	47,085
Net proceeds from other issuances of common stock	869
Net cash provided by financing activities	47,954
Effect of foreign exchange rates on cash	36
Increase in cash and cash equivalents	23,282
Cash and cash equivalents at beginning of period	15,367
Cash and cash equivalents at end of period	$ 38,649

See accompanying notes.

LANTRONIX, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2001

1. Basis of Presentation

The condensed consolidated financial statements included herein are unaudited. They contain all normal recurring accruals and adjustments which, in the opinion of management, are necessary to present fairly the consolidated financial position of Lantronix, Inc. and its subsidiaries (collectively, the "Company") at December 31, 2001, and the consolidated results of its operations and its cash flows for the three and six months ended December 31, 2001 and 2000. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three and six months ended December 31, 2001 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

These financial statements do not include certain footnotes and financial presentations normally required under generally accepted accounting principles. Therefore, they should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended June 30, 2001, included in the Company's Annual Report on Form 10-K/A filed with the Securities and Exchange Commission ("SEC") in June 2002.

In May 2002, the Company undertook a special investigation of its accounting and determined that certain sales to distributors and others made in fiscal 2001 and 2002 did not qualify for recognition as revenue upon shipment. As a result, the Company has restated its condensed consolidated financial statements contained herein as well as all other interim and annual financial statements for periods within fiscal 2001 and the first six months of fiscal 2002 (July 1, 2000 through December 31, 2001) as further described in Note 2. In addition to this form 10-Q/A, the Company has filed a Form 10-K/A for the fiscal year ended June 30, 2001, and a Form 10-Q/A for the quarterly period ended September 30, 2001 to reflect the restatement.

Also effective July 1, 2001, the Company elected to early adopt Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). As a result, the Company will no longer amortize goodwill and certain intangible assets deemed to have indefinite lives (Note 3).

2. Accounting Change and Restatement of Financial Statements

In originally preparing the condensed consolidated financial statements at December 31, 2001, the Company changed its accounting method for recognizing revenue on sales to distributors effective as of July 1, 2001, the beginning of fiscal 2002. Under the new accounting method, the recognition of revenue and related gross profit on sales to distributors is deferred until the distributor resells the product to an end customer. Formerly, the Company recognized revenue from these transactions upon shipment of product to the distributor, net of estimates for possible returns and allowances.

In May 2002, the Company undertook a special investigation of its accounting, which revealed that beginning in the third and fourth quarters of fiscal 2001 certain shipments made to distributors and recorded as revenues in fiscal 2001 and 2002 did not qualify for revenue recognition upon shipment due to terms present in agreements with the distributors that were not considered in the Company's original accounting decisions. As a result, the Company's new method of accounting for distributor sales, which is based on recognizing revenue and related gross profit on sales to distributors only as the distributor resells the product to end customers, has been adopted effective as of July 1, 2000, the beginning of fiscal 2001, or one year earlier. This manner of correcting the errors in sales recognition made in previously issued financial statements for fiscal 2001 is deemed to be preferable in the circumstances because (1) it eliminates from revenue any effect of shipping excessive levels of inventory to the distributors; (2) all revenue from distributor sales in fiscal 2001 and 2002 will be recognized on a common basis; and (3) there is assurance that any additional agreements with distributors that may have existed with respect to specific orders but are presently unknown will not have an impact on amounts reported as revenue after the restatement. The restatement for the year ended June 30, 2001, results in a reduction in revenue of approximately $6.2 million and an increase in the loss before cumulative effect of accounting change of $2.9 million or $0.07 per share. The cumulative effect of the accounting change for the six months ended December 31, 2000 recorded as of July 1, 2000 was a charge of $597,000 (net of income tax benefit of $176,000) or $0.02 per share.

Management believes that the new accounting method better reflects the substance of the transactions considering the Company's recent entry into the semiconductor marketplace and the changing business environment; is consistent with other

companies in the Company's industry thereby providing greater comparability in the presentation of financial results among the Company and its peers, and better focuses the Company on end customer sales.

In the special investigation conducted in May 2002, the Company also discovered (i) that the terms and circumstances of certain sales made in the first six months of fiscal 2002 to customers who were not distributors also preclude revenue from being recognized upon shipment, as originally reported (ii) that certain amounts initially reported as other comprehensive income (loss) should be accounted for as elements of net loss. Accordingly, in the accompanying restated condensed consolidated financial statements, the Company has made corrections to defer the recognition of such sales as revenue until all revenue recognition criteria have been met and to reclassify to other expense the amounts improperly charged to other comprehensive income (loss). These corrections result in a reduction in revenue of approximately $1.2 million and an increase in the loss before cumulative effect of accounting change of $869,000 or $0.02 per share in the six months ended December 31, 2001.

The effects of these corrections on net revenues; loss before cumulative effect of accounting change, net of income tax benefit; cumulative effect of accounting change; net loss; and related per share amounts for the interim periods of fiscal 2001 and 2002 are shown in the tables below (in thousands, except per share amounts):

	Three Months December
	2001
As reported:	
Net revenues	$ 16,439
Loss before cumulative effect of accounting change	$ (1,171)
Cumulative effect of accounting change, net of income tax benefit of $1,049	--
Net loss	$ (1,171)
Loss per share before cumulative effect of accounting change	$ (0.02)
Cumulative effect of accounting change per share	--
Basic and diluted net loss per share	$ (0.02)
As restated:	
Net revenues	$ 16,439
Corrections	(713)
Net revenues, as restated	$ 15,726
Loss before cumulative effect of accounting change	$ (1,171)
Corrections, net of tax	(746)
Loss before cumulative effect of accounting change, as restated	(1,917)
Cumulative effect of accounting change, net of income tax benefit of $176, as	

restated	--
Net loss, as restated	$ (1,917)
Loss per share before cumulative effect of accounting change, as restated	$ (0.04)
Cumulative effect of accounting change per share, as restated	--
Basic and diluted net loss per share, as restated	$ (0.04)

3. Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations" ("SFAS No. 141"), effective for acquisitions consummated after June 30, 2001, and SFAS No. 142, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and certain intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives.

The Company has elected to early adopt the rules set forth in SFAS No. 142 on accounting for goodwill and other intangibles effective as of July 1, 2001. For the six months ended December 31, 2001, early adoption resulted in non-amortization of goodwill of $3.5 million or $0.07 per share based on the weighted average shares outstanding for the six months ended December 31, 2001.

The transition provisions of SFAS No. 142 require that the Company complete its assessment of whether impairment may exist as of the date of adoption by December 31, 2001 and complete its determination of the amount of any impairment as of the date of adoption by June 30, 2002. Any impairment that is required to be recognized when adopting SFAS 142 will be reflected as the cumulative effect of a change in accounting principle as of July 1, 2001. The Company has completed its initial assessment and concluded that goodwill arising from the acquisition of United States Software Corporation (USSC), having a carrying amount of approximately $5.4 million as of July 1, 2001, may be impaired. The Company expects to complete its

determination of the amount of the impairment charge, if any, to be reflected as a cumulative effect of a change in accounting principle during the fourth fiscal quarter ending June 30, 2002.

The Company intends to perform the first of the required annual impairment tests of goodwill under the guidelines of SFAS No. 142 effective as of April 1, 2002. The Company has not yet determined the effect, if any, that this test will have on its consolidated statement of operations or financial position. An impairment charge, if any, identified as a result of completing the Company's annual impairment test will be reflected as an operating expense in the fourth quarter of fiscal 2002.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS No. 121") and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and

Extraordinary, Unusual and Infrequently Occurring Events and Transactions." This statement retains certain requirements of SFAS No. 121 relating to the recognition and measurement of impairment of long-lived assets to be held and used. Additionally, this statement results in one accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sales and also addresses certain implementation issues related to SFAS No. 121, including the removal of goodwill from its scope due to the issuance of SFAS No. 142. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company has not yet determined the effect, if any, on the carrying value of its long-lived assets resulting from the adoption of SFAS No. 144.

4. Business Combinations

On October 18, 2001, the Company completed the acquisition of Synergetic Micro Systems, Inc. ("Synergetic"). This acquisition has been accounted for under the purchase method of accounting. The condensed consolidated financial statements include the results of operations of the acquisition of Synergetic after its acquisition date. The acquisition of Synergetics provides the Company with high-performance embedded network communications to complement its external device products. A summary of the transaction is outlined below:

Company Acquired	Date Acquired	Business	Shares Issued	Shares Reserved For Options Assumed
Synergetic....................	Oct. 2001	Embedded network communications solutions provider	2,234,715	615,705

The share issuance was exempt from registration pursuant to section 3(a)(10) of the Securities Act of 1933, as amended. Portions of the cash consideration and shares issued will be held in escrow pursuant to the terms of the acquisition agreement.

Allocation of Purchase Consideration

The Company is in the process of obtaining an independent appraisal of the fair value of the tangible and intangible assets acquired in order to allocate the purchase price in accordance with SFAS No. 141. The Company does not expect that the final allocation of purchase price will produce materially different results from those reflected herein. The preliminary purchase price was allocated as follows based upon management's best estimate of the tangible and intangible assets (in thousands):

Company Acquired	Net Tangible Assets Acquired	Goodwill	Purchased Intangibles	Deferre Compensat
Synergetic	$178	$13,608	$11,100	$203

The consideration for the purchase transaction was calculated as

follows: a) common shares issued were valued based upon the Company's stock price for a short period just before and after the companies reached agreement and the proposed transaction was announced and b) employee stock options were valued in accordance with FIN 44, "Accounting for Certain Transactions involving Stock Compensation - an interpretation of APB Opinion No. 25." Net tangible assets acquired in connection with the purchase transaction include the acquisition costs incurred by the Company. Additionally, the net tangible assets reflect an outstanding note payable and credit facility aggregating $626,000, which was paid in full by the Company in connection with the terms of the merger agreement.

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Pro Forma Data

The pro forma statements of operations data of the Company set forth below gives effect to the acquisition of Synergetic as if it had occurred at the beginning of fiscal 2001. The following unaudited pro forma statements of operations data includes the amortization of purchased intangible assets and stock-based compensation. This pro forma data is presented for informational purposes only and does not purport to be indicative of the results of future operations of the Company or the results that would have actually occurred had the acquisition taken place at the beginning of fiscal 2001 (in thousands, except per share data):

	Three M Dece
	2001
Net revenues	$17,474
Loss before cumulative effect of accounting change	$(2,851)
Cumulative effect of accounting change, net of income taxes of $176	--
Net loss	$(2,851)
Loss per share before cumulative effect of accounting change	$ (0.06)
Cumulative effect of accounting change per share	-
Basic and diluted net loss per share	$ (0.06)

5. Net Loss per Share

Basic net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is calculated by adjusting outstanding shares assuming any dilutive effects of options. However, for periods in which the Company incurred a net loss, these shares are excluded because their effect would be to reduce recorded net loss per share. The following table sets forth the computation of net loss

per share (in thousands, except per share amounts):

	Three M Dece
	2001
Numerator:	
Loss before cumulative effect of accounting change	$(1,917)
Cumulative effect of accounting change, net of income taxes of $176	--
Net loss	$(1,917)
Denominator:	
Weighted-average shares outstanding	51,842
Less: Non-vested common shares outstanding	(581)
Denominator for basic and diluted loss per share	51,261
Loss per share before cumulative effect of accounting change	$ (0.04)
Cumulative effect of accounting change per share	--
Basic and diluted net loss per share	$ (0.04)

6. Inventories

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

Raw materials ....
Finished goods ....
Inventory at distributors ....
Reserve for excess and obsolete inventory ....

7. Goodwill and Purchased Intangible Assets

Goodwill

The changes in the carrying amount of goodwill for the six months ended December 31, 2001, are as follows (in thousands):

Balance as of July 1, 2001 ....

Goodwill acquired during the period (based, in part, on preliminary allocations) ....

Reclassification of assembled workforce in connection with adoption of SFAS No. 142 at July 1, 20

Less: accumulated amortization ....

Balance as of December 31, 2001 ....

Purchased Intangible Assets

The composition of purchased intangible assets is as follows (in thousands):

	December 31, 2001			
	Useful Lives	Gross	Accumulated Amortization	Net
Existing technology	5 years	$ 12,245	$(1,119)	$ 11,126
Customer agreements	5	3,800	(154)	3,646
Customer lists	5	3,500	(394)	3,106
Patent/core technology	5	1,600	(232)	1,368
Tradename/trademark	5	1,258	(185)	1,073
Assembled workforce	5	--	--	--
Distribution network	5	755	(151)	604
Non-compete agreements	3	400	(27)	373
Total		$ 23,558	$(2,262)	$ 21,296

As required by SFAS No. 142, assembled workforce was reclassified as goodwill effective July 1, 2001.

The amortization expense for purchased intangible assets for the six months ended December 31, 2001 was $1.7 million, of which $898,000 was amortized to cost of revenues and $809,000 was amortized to operating expenses. The estimated amortization expense for the remainder of fiscal 2002 and the next five years are as follows:

Cost of Revenues

Fiscal year ending June 30:	
2002	$ 1,225
2003	2,449
2004	2,449
2005	2,449
2006	2,228
2007	326
Total	$ 11,126

8. Long-term Investments

In September and October 2001, the Company paid an aggregate of $3.0 million to Xanboo Inc. ("Xanboo") for convertible promissory notes, which are convertible to Xanboo preferred stock. The notes have a ten year maturity and provide for automatic conversion into the next round of equity securities of Xanboo that raises at least $5.0 million. The notes accrue interest at 8% per annum (Note 12).

Throughout fiscal 2002, the Company loaned $1.2 million to Premise Systems Inc ("Premise"). The notes commencing in September 2001 bear interest at the rate of 9.0% per annum (Note 12).

The Company periodically reviews its investments for which fair value is less than cost to determine if the decline in value is other than temporary. If the decline in value is judged to be other than temporary, the cost basis of the security is written down to fair value. During the six months ended December 31, 2001, the Company recorded a $500,000 revaluation of a non-marketable equity investment resulting from an other-than-temporary decline in its value. This amount is included within the condensed consolidated statement of operations as other expense.

9. Stockholders' Equity

In July 2001, the Company completed a public offering of 8,534,000 shares of its common stock, including an underwriters' over-allotment option to purchase an additional 534,000 shares, at an offering price of $8.00 per share. The Company sold 6,000,000 shares and selling stockholders sold 2,000,000 shares of the primary offering. Additionally, the Company sold 400,500 shares and selling stockholders sold 133,500 shares of the over-allotment option. The Company received net proceeds of approximately $47.1 million in connection with this offering.

10. Comprehensive Loss

SFAS No. 130, "Reporting Comprehensive Income (Loss)," establishes standards for reporting and displaying comprehensive income (loss) and its components in the condensed consolidated financial statements. The components of comprehensive loss are as follows (in thousands):

	Three Months ended December 31,	Six

	2001	2000	20
		(Restated)	
Net loss	$(1,917)	$ (161)	$(4
Other comprehensive loss:			
Change in net unrealized loss on investment	--	--	
Change in accumulated translation adjustments	(2)	13	
Total comprehensive loss	$(1,919)	$ (148)	$(4

11. Litigation

From time to time, the Company has received letters claiming that their products infringe upon patents or other intellectual property of third-parties. On July 3, 2001, Digi International, Inc., filed a complaint in the United States District Court for the district of Minnesota claiming patent infringement and alleging that Lantronix directly and/or indirectly infringes upon Digi's U.S. Patent No. 6,047,319 by making, using, selling and or offering for sale certain of Lantronix's Multiport device servers, including the ETS line of products, coupled with a device driver called the Comm Port Redirector Software. Digi alleges that the Company has willfully and intentionally infringed Digi's patent, and its complaint seeks injunctive relief as well as unspecified damages, treble damages, attorney's fees, interest and costs. On August 17, 2001, the Company filed its answer to the complaint, asserting affirmative defenses, and counterclaiming for a declaratory judgment that the patent in issue is invalid. The Court has scheduled a pre-trial conference for February 19, 2002, in which discovery parameters and a trial date will likely be set. Based on the facts known to date, the Company believes that the claims are without merit and intends to vigorously defend the suit.

From time to time, the Company is subject to legal proceedings and claims in the ordinary course of business. The Company currently is 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.

12. Subsequent Events

On January 11, 2002, the Company completed the acquisition of Premise, a developer of client-side software applications. Prior to the acquisition, the Company held shares of Premise representing 19.99% ownership interest and in addition held convertible promissory notes of $1.2 million with interest accrued thereon at the rate of 9.0%. The convertible promissory notes were converted into equity securities of Premise at the closing of the transaction. The Company agreed to issue an aggregate of 1,063,371 shares of its common stock in exchange for all remaining outstanding shares of Premise common stock and reserved 875,000 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Premise. Pursuant to the Acquisition Agreement, 106,337 of such shares will be held in escrow to secure certain indemnification obligations, and 531,686 of such shares will be held in escrow pending achievement of certain performance obligations. The

Company intends to issues those shares on or around February 18, 2002. In connection with the acquisition, the Company expects to record a one-time charge for purchased in-process research and development expenses related to the

acquisition in its fourth fiscal quarter ending June 30, 2002.

In January 2002, Xanboo (Note 8) completed a $13.0 million equity round. As a result, the Company's $3.0 million investment in Xanboo convertible promissory notes was converted into shares of Xanboo preferred stock. In addition, the Company purchased $4.0 million of Xanboo preferred stock in January 2002. After these transactions, the Company holds an 18.73% ownership interest in Xanboo.

In January 2002, the Company entered into a two-year line of credit with a bank in an amount not to exceed $20.0 million. Borrowings under the line of credit bear interest at the prime rate or the LIBOR rate plus 2.0%. The Company is required to pay a $100,000 facility fee of which $50,000 was paid upon the closing and $50,000 is to be paid in January 2003. The Company is also required to pay a quarterly unused line fee of .125% of the unused line of credit balance. The line of credit contains customary affirmative and negative covenants. To date the Company has not borrowed against this line of credit.

Effective January 2, 2002, the Company entered into revised employment agreements with the Company's Chief Executive and Chief Financial Officers. The agreement with the Chief Executive Officer provides that employment is at-will and sets forth a revised annual base salary of $325,000, a signing bonus of $206,250, and incentive compensation of up to 100% of his annual base salary. Pursuant to this agreement, the Chief Executive Officer was granted 300,000 options that will vest over the next four years. The agreement with the Chief Financial Officer provides that employment is at-will and sets forth a revised annual base salary of $262,500, a signing bonus of $144,722, and incentive compensation of up to 100% of his annual base salary. Pursuant to this agreement, the Chief Financial Officer was granted 250,000 options that will vest over the next four years. Upon termination or resignation due to a change in control, the Chief Executive Officer and Chief Financial Officer will continue to receive their annual base salary with benefits and bonuses for a period of two years following termination or resignation.

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

You should read the following discussion and analysis in conjunction with the Unaudited Condensed Consolidated Financial Statements and related Notes thereto contained elsewhere in this Report. The information in this Quarterly Report on Form 10-Q/A is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in other reports filed with the SEC, including our restated Annual Report on Form 10-K/A for the fiscal year ended June 30, 2001, Form 10-Q/A for the fiscal quarter ended September 30, 2001, and our subsequent reports on Form 8-K, that discuss our business in greater detail.

We have restated our consolidated financial statements for the fiscal quarters covered hereby and for our fiscal year ended June 30, 2001 and each fiscal quarter therein in a Form 10-K/A filed in June 2002. To the extent the following discussion and analysis refers to data from our consolidated financial statements for such periods, such references are to the data as restated.

The sections entitled "Risk Factors" set forth below, and similar discussions in our other SEC filings, discuss some of the important factors that may affect our business, results of operations and financial condition. You

should carefully consider those factors, in addition to the other information in this Report and in our other filings with the SEC, before deciding to invest in our company or to maintain or increase your investment.

This report contains forward-looking statements which include, but are not limited to, statements concerning projected net revenues, expenses, gross profit and income (loss), the need for additional capital, market acceptance of our products, our ability to consummate acquisitions and integrate their operations successfully, our ability to achieve further product integration, the status of evolving technologies and their growth potential and our production capacity. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's 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. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Accounting Change and Restatement of Financial Statments

In originally preparing the condensed consolidated financial statements at December 31, 2001, we changed our accounting method for recognizing revenue on sales to distributors effective as of July 1, 2001, the beginning of fiscal 2002. Under the new accounting method, the recognition of revenue and related gross profit on sales to distributors is deferred until the distributor resells the product to an end customer. Formerly, we recognized revenue from these transactions upon shipment of product to the distributor, net of estimates for possible returns and allowances.

In May 2002, we undertook a special investigation of our accounting, which revealed that beginning in the third and fourth quarters of fiscal 2001 certain shipments made to distributors and recorded as revenues in fiscal 2001 and 2002 did not qualify for revenue recognition upon shipment due to terms present in agreements with the distributors that were not considered in our original accounting decisions. As a result, our new method of accounting for distributor sales, which is based on recognizing revenue and related gross profit on sales to distributors only as the distributor resells the product to end customers, has been adopted effective as of July 1, 2000, the beginning of fiscal 2001, or one year earlier. This manner of correcting the errors in sales recognition made in previously issued financial statements for fiscal 2001 is deemed to be preferable in the circumstances because (1) it eliminates from revenue any effect of shipping excessive levels of inventory to the distributors; (2) all revenue from distributor sales in fiscal 2001 and 2002 will be recognized on a common basis; and (3) there is assurance that any additional agreements with distributors that may have existed with respect to specific orders but are presently unknown will not have an impact on amounts reported as revenue after the restatement. The restatement for the year ended June 30, 2001, results in a reduction in revenue of approximately $6.2 million and an increase in the loss before cumulative effect of accounting change of $2.9 million or $0.07 per share. The cumulative effect of the accounting change recorded for the six months ended December 31, 2000 as of July 1, 2000 was a charge of $597,000 (net of income tax benefit of $176,000) or $0.02 per share.

We believe that the new accounting method better reflects the substance of the transactions considering our recent entry into the semiconductor

marketplace and the changing business environment; is consistent with other companies in our industry

thereby providing greater comparability in the presentation of financial results among us and our peers, and better focuses us on end customer sales.

In the special investigation conducted in May 2002, we also discovered (i) that the terms and circumstances of certain sales made in the first six months of fiscal 2002 to customers who were not distributors also preclude revenue from being recognized upon shipment, as originally reported and (ii) that certain amounts initially reported as other comprehensive income (loss) should be accounted for as elements of net loss. Accordingly, in the accompanying restated condensed consolidated financial statements, we have made corrections to defer the recognition of such sales as revenue until all revenue recognition criteria have been met and to reclassify to other expense the amounts improperly charged to other comprehensive income (loss). These corrections result in a reduction in revenue of approximately $1.2 million and an increase in the loss before cumulative effect of accounting change of $869,000 or $0.02 per share in the six months ended December 31, 2001.

The effects of these error corrections on net revenues; loss before cumulative effect of accounting change, net of income tax benefit; cumulative effect of accounting change; net loss; and related per share amounts for the interim periods of fiscal 2001 and 2002 are shown in the tables below (in thousands, except per share amounts):

	Three Months Ende	
	December 31,	
	2001	200
As originally reported:		
Net revenues	$ 16,439	$ 12,
Loss before cumulative effect of accounting change	$ (1,171)	$
Cumulative effect of accounting change, net of income tax benefit of $1,049	--	
Net loss	$ (1,171)	$
Loss per share before cumulative effect of accounting change	$ (0.02)	$ (0
Cumulative effect of accounting change per share	--	
Basic and diluted net loss per share	$ (0.02)	$ (0
As restated:		
Net revenues	$ 16,439	$ 12,
Error corrections	(713)	(
Net revenues, as restated	$ 15,726	$ 12,
Loss before cumulative effect of accounting change	$ (1,171)	$

Error corrections, net of tax	(746)	(
Loss before cumulative effect of accounting change, as restated	(1,917)	(
Cumulative effect of accounting change, net of income tax benefit of $176, as restated	--	
Net loss, as restated	$ (1,917)	$ (
Loss per share before cumulative effect of accounting change and error corrections, as resta	$ (0.04)	$ (0
Cumulative effect of accounting change per share, as restated	--	
Basic and diluted net loss per share, as restated	$ (0.04)	$ (0

Under the leadership of new management, we are actively working to strengthen our policies, procedures, personnel, controls and internal communications in response to the circumstances that led to the restatement.

Overview

Lantronix designs network-enabling and system management solutions consisting of hardware and software that permit almost any electronic device to be accessed, managed, controlled over the Internet, intranets or other networks. Since our inception in 1989, we have developed an array of network-enabling products including external Device Servers, embedded Device Servers, Multiport Device Servers, Print Servers and other products. Beginning in fiscal year 1999, we began to experience an increase in sales of our Device Servers reflecting our focus on this higher margin product line. At the same time, we began to experience a decline in sales of Print Server and other products as we shifted resources to our Device Server business, which we believe represents a greater opportunity for long-term growth. We believe sales in our Device Server business will continue to represent an increasing percentage of our net revenues in the future. Our strategy for continuing to increase sales of our Device Server product line involves a two-fold approach. First, we have and intend to continue to substantially increase our research and development expenditures to enhance our Device Server product line and develop new products. Second, we intend to grow our Device Server business through strategic acquisitions, investments and partnerships, which we believe will support our product lines and allow us to secure additional intellectual property, increase our customer base and provide access to new markets.

Our products are sold to original equipment manufacturers (OEMs), value added resellers (VARs), systems integrators and distributors, as well as directly to end-users. One of our distributors, Ingram Micro, accounted for 13.8% of our net revenues for the six months ended December 31, 2001, compared to 13.2% for the six months ended December 31, 2000. Another distributor, Tech Data, accounted for 7.4% of our net revenues for the six months ended December 31, 2001, compared to 10.9% for the six months ended December 31, 2000. transtec AG, an international OEM and related party due to common ownership by our Chairman and major stockholder, accounted for 3.5% of our net revenues for the six months ended December 31, 2001, compared to 8.5% for the six months ended December 31, 2000. There was no outstanding accounts receivable balance due from transtec AG at December 31, 2001.

In July 2001, we completed a public offering of 8,534,000 shares of our common stock, including an underwriter's over-allotment option to purchase an additional 534,000 shares, at an offering price of $8.00 per share. We sold

6,000,000 shares and selling stockholders sold 2,000,000 shares of the primary offering. Additionally, we sold 400,500 shares and selling stockholders sold 133,500 shares of the over-allotment option. We received net proceeds of approximately $47.1 million in connection with this offering.

On October 18, 2001, we completed the acquisition of Synergetic, a provider of high performance embedded network communication solutions that compliment our external device products. In connection with the acquisition, we paid cash consideration of $2.7 million and issued an aggregate of 2,234,715 shares of our common stock in exchange for all outstanding shares of Synergetic common stock and reserved 615,705 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Synergetic. Portions of the cash consideration and shares issued will be held in escrow pursuant to the terms of the acquisition agreement.

On January 11, 2002, we completed the acquisition of Premise, a developer of client-side software applications that compliment our device networking products by providing superior management and control capabilities for devices that have been network and internet enabled. Prior to the acquisition, we held shares of Premise representing 19.9% ownership and, in addition, held convertible promissory notes of $1.2 million with interest accrued there-on at a rate of 9.0%. The convertible promissory notes were converted into equity securities of Premise at the closing of the transaction. We issued an aggregate of 1,063,371 shares of our common stock in exchange for all remaining outstanding shares of Premise common stock and reserved 875,000 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Premise. Pursuant to the acquisition agreement, 106,337 shares will be held in escrow to secure certain indemnification obligations, and 531,686 of such shares will be held in escrow pending achievement of certain performance obligations. The transaction was exempt from registration pursuant to section 4(2) of the Securities Act of 1933, as amended. In connection with the acquisition, we expect to record a one-time charge for purchased in-process research and development expenses related to the acquisition in our fourth fiscal quarter ending June 30, 2002.

In September and October 2001, we paid an aggregate of $3.0 million to Xanboo for convertible promissory notes, which converted in January 2002, in accordance with their terms, into Xanboo preferred stock. In addition, we purchased $4 million of Xanboo preferred stock in January 2002. As of January 2002, we hold an 18.7% ownership interest in Xanboo and, accordingly, we will account for our investment in Xanboo using the equity method of accounting based upon our ability through representation on Xanboo's board of directors to exercise significant influence over its operations.

Stock-based compensation primarily relates to deferred compensation recorded in connection with the grant of stock options to employees where the option exercise price is less than the estimated fair value of the underlying shares of common stock as determined for financial reporting purposes, as well as the fair market value (determined using the Black-Scholes option pricing model) of the vested portion of non-employee stock options determined. Deferred compensation also includes the value of employee stock options assumed in connection with acquisitions of businesses calculated in accordance with current accounting guidelines. Deferred compensation is presented as a reduction to stockholders' equity and is amortized over the vesting period of the related stock options, which is generally four years. At December 31, 2001, a deferred compensation balance of $8.7 million remains and will be amortized as follows: $1.6 million in the remainder of fiscal 2002, $3.0 million in fiscal 2003, $2.6 million in fiscal 2004, $1.4 million in fiscal 2005 and $174,000 in fiscal 2006. The amount of stock-based compensation in future periods will increase if we grant stock options where the exercise price is less than the quoted market price of the underlying shares or if we assume employee stock options in connection with additional acquisitions of businesses. The amount of stock-based

compensation actually recognized in future periods could decrease if options for which deferred compensation has been recorded are forfeited.

On February 6, 2002, we announced and began implementing a plan to restructure our operations in response to the current economic climate and to integrate and consolidate recent acquisitions. In connection with this plan, we expect to record in the third fiscal quarter ending March 31, 2002 a one-time restructuring charge of approximately $2.8 million.

Results of Operations

The following table sets forth certain statement of operations data expressed as a percentage of total net revenues:

	Three Months En December 31,	
	2001	20
Net revenues	100.0%	100
Cost of revenues	47.9	46
Gross profit	52.1	53
Operating expenses:		
Selling, general and administrative	48.9	47
Research and development	12.4	8
Stock based-compensation	5.0	5
Amortization of purchased intangible assets	3.3	3
Total operating expenses	69.7	64
Loss from operations	(17.6)	(10
Interest income (expense), net	3.0	5
Other income (expense), net	(1.1)	0
Loss before income taxes and cumulative effect of accounting change	(15.7)	(4
Benefit for income taxes	(3.5)	(1
Loss before cumulative effect of accounting change	(12.2)	(2
Cumulative effect of accounting change, net of income taxes of $176	(-)	1
Net loss	(12.2)%	(1

Net Revenues

Net revenues increased $3.7 million, or 30.7%, to $15.7 million for the three months ended December 31, 2001 from $12.0 million for the three months ended December 31, 2000. Net revenues increased $7.9 million, or 33.3%, to $31.6 million for the six months ended December 31, 2001 from $23.7 million for the six months ended December 31, 2000. The increase was primarily attributable to

an increase in net revenues of our Multiport Device Server and Device Server products, partially offset by a decline in our Print Server and other products. Multiport Device Server net revenues increased $2.8 million, or 101.4%, to $5.6 million, or 35.9% of net revenues, for the three months ended December 31, 2001 from $2.8 million, or 23.3% of net revenues, for the three months ended December 31, 2000. Multiport Device Server net revenues increased $7.9 million, or 138.5%, to $13.6 million, or 43.2% of net revenues, for the six months ended December 31, 2001 from $5.7 million, or 24.1% of net revenues, for the six months ended December 31, 2000. The increase in our Multiport Device Server net revenues is primarily attributable to the acquisition of Lightwave Communications, Inc. ("Lightwave"). Device Server net revenues increased $1.4 million, or 17.4%, to $9.7 million, or 61.7% of net revenues, for the three months ended December 31, 2001 from $8.3 million, or 68.6% of net revenues, for the three months ended December 31, 2000. Device Server net revenues increased $888,000, or 5.5%, to $16.9 million, or 53.6% of net revenues, for the six months ended December 31, 2001 from $16.0 million, or 67.7% of net revenues, for the six months ended December 31, 2000. Device Server net revenues for the three months ended December 31, 2001 and 2000 includes $548,000 and $238,000, respectively, of software revenue generated from United States Software Corporation ("USSC"). Device Server net revenues for the six months ended December 31, 2001 and 2000 includes $909,000 and $238,000, respectively, of software revenue generated from USSC. In addition, Device Server net revenue for the three and six months ended December 31, 2001 includes $259,000 of Destiny LX-1 chip revenue. No Destiny LX-1 chip revenue was recorded for the three and six months ended December 31, 2000. The increase in our Device Server net revenue is primarily due to an increase in our Embedded Device Servers offset by a decrease in our External Device Servers. This change between Embedded and External is consistent with our expectations as our customers shift to an Embedded solution. Print Server and other net revenues decreased $591,000, or 60.7%, to $383,000, or 2.4% of net revenues, for the three months ended December 31, 2001 from $973,000, or 8.1% of net revenues, for the three months ended December 31, 2000. Print Server and other net revenues decreased $923,000, or 47.6%, to $1.0 million, or 3.2% of net revenues, for the six months ended December 31, 2001 from $1.9 million, or 8.2% of net revenues, for the six months ended December 31, 2000. The decreases in our Print Server and other products net revenues are due to a more rapid transition to our Multiport Device Server and Device Server products.

Net revenues generated from sales in the Americas increased $4.9 million, or 62.8%, to $12.8 million, or 81.4% of net revenues, for the three months ended December 31, 2001 from $7.9 million, or 65.3% of net revenues, for the three months ended December 31, 2000. Net revenues generated from sales in the Americas increased $10.3 million, or 63.0%, to $26.6 million, or 84.4% of net revenues, for the six months ended December 31, 2001 from $16.3 million, or 69.0% of net revenues, for the six months ended December 31, 2000. Our net revenues derived from customers located in Europe decreased $1.0 million, or 28.5%, to $2.5 million, or 16.0% of net revenues, for the three months ended December 31, 2001 from $3.5 million, or 29.2% of net revenues, for the three months ended December 31, 2000. Our net revenues derived from customers located in Europe decreased

$2.0 million, or 33.3%, to $4.1 million, or 12.9% of net revenues, for the six months ended December 31, 2001 from $6.1 million, or 25.8% of net revenues, for the six months ended December 31, 2000. Our net revenues derived from customers located in Europe as a percentage of total net revenues decreased due to the acquisition of Lightwave which primarily sells in the Americas. Our net revenues derived from customers located in other geographic areas decreased slightly to $415,000, or 2.6% of net revenues, for the three months ended December 31, 2001

from $659,000, or 5.5% of net revenues, for the three months ended December 31, 2000. Our net revenues derived from customers located in other geographic areas decreased to $841,000, or 2.7% of net revenues, for the six months ended December 31, 2001 from $1.2 million, or 5.2% of net revenues, for the six months ended December 31, 2000.

Gross Profit

Gross profit represents net revenues less cost of revenues. Cost of revenues consists primarily of the cost of raw material components, subcontract labor assembly from outside manufacturers and associated overhead costs. Additionally, cost of revenues for the three and six months ended December 31, 2001 consisted of $560,000 and $898,000, respectively, of non-cash amortization of purchased intangible assets. No similar charges were recorded for the three and six months ended December 31, 2000. We pay Gordian, Inc., an outside research and development firm, a royalty based on the sale of certain of our products. As a result, a royalty charge is included in cost of revenues and is calculated based on the related products sold. Gross profit increased by $1.7 million, or 26.5%, to $8.2 million, or 52.1% of net revenues, for the three months ended December 31, 2001 from $6.5 million, or 53.8% of net revenues, for the three months ended December 31, 2000. Gross profit increased by $3.6 million, or 28.0%, to $16.5 million, or 52.2% of net revenues, for the six months ended December 31, 2001 from $12.9 million, or 54.4% of net revenues, for the six months ended December 31, 2000. For the three months ended December 31, 2001 and 2000, Gordian royalties were $431,000 and $488,000, respectively. For the six months ended December 31, 2001 and 2000, Gordian royalties were $847,000 and $1.0 million, respectively. The increase in gross profit was mainly attributable to the significant increase in the Multiport Device Server product. The decrease in gross profit as a percentage of net revenues for the six months ended December 31, 2001 is primarily attributable to non-cash amortization of acquisition-related charges, volume-pricing agreements and competitive pricing strategies.

Selling, General and Administrative

Selling, general and administrative expenses consist primarily of personnel-related expenses including salaries and commissions, facility expenses, information technology, trade show expenses, advertising, and professional fees. Selling, general and administrative expenses increased $2.0 million, or 36.0%, to $7.7 million, or 48.9% of net revenues, for the three months ended December 31, 2001 from $5.7 million, or 47.0% of net revenues, for the three months ended December 31, 2000. Selling, general and administrative expenses increased $4.3 million, or 39.2%, to $15.3 million, or 48.4% of net revenues, for the six months ended December 31, 2001 from $11.0 million, or 46.3% of net revenues, for the six months ended December 31, 2000. This increase is due primarily to increased depreciation of fixed assets, increased personnel-related costs and facilities costs from the acquisitions of USSC, Lightwave and Synergetic as well as hiring of sales personnel, and increased legal and other professional fees. We expect selling, general and administrative expenses in absolute dollars will decrease in the foreseeable future as a result of our planned restructuring announced February 6, 2002 and decrease as a percentage of net revenues. Selling, general and administrative expenses will include the signing bonuses for the Chief Executive and Chief Financial Officer totaling $351,000 in the third fiscal quarter of 2002.

Research and Development

Research and development expenses consist primarily of salaries and the related costs of employees, as well as expenditures to third-party vendors for research and development activities. Research and development expenses increased $935,000, or 91.6%, to $2.0 million, or 12.4% of net revenues, for the three months ended December 31, 2001 from $1.0 million, or 8.5% of net revenues,

for the three months ended December 31, 2000. Research and development expenses increased $2.0 million, or 95.3%, to $4.0 million, or 12.8% of net revenues, for the six months ended December 31, 2001 from $2.1 million, or 8.8% of net revenues, for the six months ended December 31, 2000. This increase resulted primarily from increased personnel-related costs due to the acquisition of USSC, Lightwave and Synergetic, as well as hiring of senior management and expenses related to new product development.

Stock-based Compensation

Stock-based compensation generally represents the amortization of deferred compensation. We recorded approximately $885,000 of deferred compensation for the six months ended December 31, 2001. Deferred compensation represents the difference between the fair value of the underlying common stock for accounting purposes and the exercise price of the stock options at the date of grant. Deferred compensation is presented as a reduction of stockholders' equity and is amortized ratably over the respective vesting periods of the applicable options, which is generally four years. Stock-based compensation increased

$120,000, or 18.2%, to $780,000, or 5.0% of net revenues, for the three months ended December 31, 2001 from $660,000, or 5.5% of net revenues, for the three months ended December 31, 2000. Stock-based compensation increased $641,000, or 48.9%, to $2.0 million, or 6.2% of net revenues, for the six months ended December 31, 2001 from $1.3 million, or 5.5% of net revenues, for the six months ended December 31, 2000. The increase in stock-based compensation primarily reflects stock options assumed in three purchase transactions that were accounted for in accordance with the Financial Accounting Standards Board ("FASB") Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation--An Interpretation of APB Opinion No. 25". We expect to incur additional stock-based compensation in future periods as a result of the continued amortization of deferred compensation related to these and other stock option grants. Included in cost revenues is stock-based compensation of $49,000 and $14,000 for the three months ended December 31, 2001 and 2000, respectively, and $75,000 and $25,000 for the six months ended December 31, 2001 and 2000, respectively.

Amortization of Purchased Intangible Assets

In connection with the two purchase transactions completed during fiscal 2001 and the one purchase transaction completed during the second fiscal quarter of 2002, we recorded approximately $14.2 million and $11.1 million of identified purchased intangible assets, respectively. Goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. Generally, we obtain independent appraisals of the fair value of tangible and intangible assets acquired in order to allocate the purchase price. We are in the process of obtaining an independent appraisal of the fair value of the tangible and intangible assets acquired related to the acquisition of Synergetic in order to allocate the purchase price in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" ("SFAS No. 141"). We do not expect that the final allocation of purchase price will produce materially different results from those reflected herein. Purchased intangible assets are amortized on a straight-line basis over the economic lives of the respective assets, generally three to five years. The amortization of purchased intangible assets increased $161,000, or 44.4%, to $524,000, or 3.3% of net revenues, for the three months ended December 31, 2001 from $363,000, or 3.0% of net revenues, for the three months ended December 31, 2000. The

amortization of purchased intangible assets increased $403,000, or 99.3%, to $809,000, or 2.6% of net revenues, for the six months ended December 31, 2001 from $406,000, or 1.7% of net revenues, for the six months ended December 31, 2000. In addition, approximately $560,000 and $898,000 of amortization of purchased intangible assets have been classified as cost of revenue for the three and six months ended December 31, 2001, respectively. No comparable amortization of purchased intangible assets was classified as cost of revenue for the three and six months ended December 31, 2000.

Interest Income (Expense), Net

Interest income (expense), net consists primarily of interest earned on cash, cash equivalents, short-term and long-term investments. Interest income (expense), net was $479,000 and $671,000 for the three months ended December 31, 2001 and 2000, respectively. Interest income (expense), net was $1.0 million and $1.2 million for the six months ended December 31, 2001 and 2000, respectively. The decrease is primarily due to lower average investment balances and interest rates for the three and six months ended December 31, 2001 compared to December 31, 2000, as a result of the acquisitions of USSC, Lightwave and Synergetic as well as loans to Premise Systems and Xanboo.

Other Income (Expense), Net

Other income (expense), net was $(176,000) and $79,000 for the three months ended December 31, 2001 and 2000, respectively. Other income (expense), net was $(804,000) and $5,000 for the six months ended December 31, 2001 and 2000, respectively. The increase in other expense for the six months ended December 31, 2001 is primarily attributable to the $500,000 revaluation of a strategic investment, less gains on foreign currency translation.

Provision for Income Taxes - Effective Tax Rate

We utilize the liability method of accounting for income taxes as set forth in SFAS No. 109, "Accounting for Income Taxes." Our effective tax rate was 22% for the six months ended December 31, 2001, and 21% for the six months ended December 31, 2000. The federal statutory rate was 34% for both periods. Our effective tax rate associated with the income tax benefit for the six months ended December 31, 2001, was lower than the federal statutory rate primarily due to foreign losses and amortization of stock-based compensation for which no current year tax benefit was provided. Our effective tax rate associated with the income tax benefit for the six months ended December 31, 2001, was lower than the statutory rate primarily due to the nondeductible goodwill amortization, amortization of stock-based compensation for which no benefit was provided, and the effects of an unfavorable foreign tax rate variance.

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Impact of Adoption of New Accounting Standards

In June 2001, the FASB issued SFAS No. 141 "Business Combinations" ("SFAS No. 141"), effective for acquisitions consummated after June 30, 2001, and SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and certain intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives.

We have elected to early adopt the rules set forth in SFAS No. 142 on accounting for goodwill and other intangibles effective as of July 1, 2001. For the six months ended December 31, 2001, early adoption resulted in

non-amortization of goodwill of $3.5 million or $0.07 per share based on the weighted average shares outstanding for the six months ended December 31, 2001.

The transition provisions of SFAS No. 142 require that we complete our assessment of whether impairment may exist as of the date of adoption by December 31, 2001 and complete our determination of the amount of any impairment as of the date of adoption by June 30, 2002. Any impairment that is required to be recognized when adopting SFAS No. 142 will be reflected as the cumulative effect of a change in accounting principle as of July 1, 2001. We have completed our initial assessment and concluded that goodwill arising from the acquisition of USSC having a carrying amount of approximately $5.4 million as of July 1, 2001 may be impaired. We expect to complete our determination of the amount of the impairment charge, if any, to be reflected as a cumulative effect of a change in accounting principle during the fourth fiscal quarter ending June 30, 2002.

We intend to perform the first of the required annual impairment tests of goodwill under the guidelines of SFAS No. 142 effective as of April 1, 2002. We have not yet determined the effect, if any, that this test will have on our consolidated statement of operations or financial position. An impairment charge, if any, identified as a result of completing our annual impairment test will be reflected as an operating expense in the fourth quarter of fiscal 2002.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" ("SFAS No. 121") and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." This statement retains certain requirements of SFAS No. 121 relating to the recognition and measurement of impairment of long-lived assets to be held and used. Additionally, this statement results in one accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sales and also addresses certain implementation issues related to SFAS No. 121, including the removal of goodwill from its scope due to the issuance of SFAS No. 142. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. We have not yet determined the effect, if any, on the carrying value of our long-lived assets resulting from the adoption of SFAS No. 144.

Liquidity and Capital Resources

Since inception, we have financed our operations through the issuance of common stock and through net cash generated from operations. We consider all highly liquid investments purchased with original maturities of 90 days or less to be cash equivalents. Cash and cash equivalents consisting of money-market funds and commercial paper totaled $38.6 million at December 31, 2001. Short-term investments consist of investments maturing in twelve months or less and totaled $9.9 million at December 31, 2001. Long-term investments totaled $7.0 million at December 31, 2001 and consist of investments in debt securities of two privately held companies, Premise Systems and Xanboo, and other investments maturing in more than twelve months. Subsequent to December 31, 2001, we completed the acquisition of Premise Systems. Our convertible promissory notes of Xanboo were converted into Xanboo Preferred Stock as a result of Xanboo completing a $13.0 million equity round. In addition, we purchased $4.0 million of preferred stock of Xanboo in January 2002. We currently hold an 18.73% ownership interest in Xanboo.

Our operating activities used cash of $4.2 million for the six months ended December 31, 2001 compared to $4.4 million for the six months ended December 31, 2000. We incurred a net loss of $4.2 million, which includes

amortization and depreciation of $2.9 million, amortization of stock-based compensation of $2.0 million, and the revaluation of a strategic investment of $500,000, all of which are non-cash. This was reduced by increased inventories of $2.3 million, increased prepaid expenses and other current assets of $2.2 million, an increase in other assets of $1.0 million, and decreased accounts payable of $2.8 million, offset by a decrease in accounts receivable of $2.5 million. The increase in inventory was primarily due to a one-time purchase of embedded chips in preparation for our entry into the semiconductor industry, as well as slower than expected sales of our Multiport Device Server product line. The increase in prepaid expenses and other current assets was primarily due to increased receivables from our contract manufacturers and convertible notes from Premise. The increase in other assets was primarily due to the purchase of intellectual property for the development of embedded chips. The decrease in accounts payable

was primarily due to a reduction of Synergetic liabilities subsequent to the acquisition. The decrease in accounts receivable was primarily due to improved cash collections from customers.

Our investing activities used $20.5 million of cash for the six months ended December 31, 2001. We used $3.4 million, net of cash acquired, to acquire Synergetic in October 2001. We used $10.2 million to invest in held-to-maturity investments in debt securities, net of $2.0 million in proceeds from the sales of securities. We used $3.0 million to purchase convertible promissory notes with ten year maturities that automatically convert into the next round of equity securities of Xanboo.

We also used $2.6 million to purchase property and equipment, primarily computer hardware and software pertaining to Oracle software enhancements to support of our international operations and a software package to support our sales force.

Cash provided by financing activities was $48.0 million for the six months ended December 31, 2001, primarily related to the net proceeds from our secondary public offering completed in July 2001. Cash provided by financing activities was $53.9 million for the six months ended December 31, 2000, primarily related to the net proceeds from our initial public offering in August 2000.

In January 2002, we entered into a two-year line of credit with a bank in an amount not to exceed $20.0 million. Borrowings under the line of credit bear interest at the prime rate or the LIBOR rate plus 2.0%. We are required to pay a $100,000 facility fee of which $50,000 was paid and $50,000 is to be paid in January 2003. We are also required to pay a quarterly unused line fee of .125% of the unused line of credit balance. The line of credit contains customary affirmative and negative covenants. To date we have not borrowed against this line of credit.

We believe that our existing cash, cash equivalents and short-term investments and any available borrowings under our line of credit facility 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 revenues and research and development and infrastructure investments as well as our intentions to make strategic acquisitions or investments in other companies, which will affect our ability to generate additional cash. If cash generated from operations and financing activities is insufficient to satisfy our working capital requirements, we may need to borrow funds through bank loans, sales of securities or other means.

There can be no assurance that we will be able to raise any such capital on terms acceptable to us, if at all. If we are unable to secure additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competition or continue to operate our business.

Risk Factors

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

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

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

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

- changes in the mix of net revenues attributable to higher-margin and lower-margin products;
- customers' decisions to defer or accelerate orders;
- variations in the size or timing of orders for our products;
- short-term fluctuations in the cost or availability of our critical components, such as flash memory;

- changes in demand for our products generally;
- loss or gain of significant customers;
- announcements or introductions of new products by our competitors;
- defects and other product quality problems; and
- changes in demand for devices that incorporate our connectivity products.

IF WE MAKE UNPROFITABLE ACQUISITIONS OR ARE UNABLE TO SUCCESSFULLY INTEGRATE ANY FUTURE ACQUISITIONS, OUR BUSINESS COULD SUFFER.

We have in the past and intend to continue in the future to acquire businesses, client lists, products or technologies that we believe complement or expand our existing business. In October 1998, we acquired ProNet GmbH, a German supplier of industrial application Device Server technology. In December 2000, we acquired USSC, a company that provides software solutions for use in embedded technology applications. In June 2001, we acquired Lightwave, a company that provides console management solutions. In October 2001, we acquired Synergetic, a provider of embedded network communication solutions. In January 2002, we acquired Premise Systems, a developer of client-side software applications. Acquisitions of this type involve a number of risks, including:

- difficulties in assimilating the operations and employees of acquired companies;
- diversion of our management's attention from ongoing business concerns;
- our potential inability to maximize our financial and strategic position through the successful incorporation of acquired technology and rights into our products and services;
- additional expense associated with amortization of acquired assets;
- maintenance of uniform standards, controls, procedures and policies; and
- impairment of existing relationships with employees, suppliers and customers as a result of the integration of new management employees.

Any acquisition or investment could result in the incurrence of debt and the loss of key employees. Moreover, we often assume specified liabilities of the companies we acquire. Some of these liabilities, such as environmental and tort liabilities, are difficult or impossible to quantify. If we do not receive adequate indemnification for these liabilities our business may be harmed. In addition, acquisitions are likely to result in a dilutive issuance of equity securities. For example, we issued common stock and assumed options to acquire our common stock in connection with our acquisitions of USSC, Lightwave, Synergetic and Premise Systems. We cannot assure you that any acquisitions or acquired businesses, client lists, products or technologies associated therewith will generate sufficient net revenues to offset the associated costs of the acquisitions or will not result in other adverse effects. Moreover, from time to time we may enter into negotiations for the acquisition of businesses, client lists, products or technologies, but be unable or unwilling to consummate the acquisition under consideration. This could cause significant diversion of managerial attention and out of pocket expenses to us. We could also be exposed to litigation as a result of an unconsummated acquisition, including claims that we failed to negotiate in good faith, misappropriated confidential information or other claims.

In addition, from time to time we intend to invest in businesses that we believe present attractive investment opportunities, or provide other synergetic benefits. In September and October 2001, we paid an aggregate of $3.0 million to Xanboo for convertible promissory notes, which have converted, in accordance with their terms, into Xanboo preferred stock. In addition, we purchased an additional $4.0 million of preferred stock of Xanboo. We currently hold an 18.73% ownership interest in Xanboo. These investments are speculative in nature, and there is a significant chance we will lose part or all of our investments.

STOCK-BASED COMPENSATION WILL NEGATIVELY AFFECT OUR OPERATING RESULTS.

We have recorded deferred compensation in connection with the grant of stock options to employees where the option exercise price is less than the estimated fair value of the underlying shares of common stock as determined for financial reporting purposes. We have recorded deferred compensation net of forfeitures within stockholders' equity of $885,000 at December 31, 2001 and a total of $14.2 million of deferred compensation through fiscal 2001, which is being amortized over the vesting period of the related stock options, which is generally four years. A balance of $8.7 million remains at December 30, 2001 and will be amortized as follows: $1.6 million in the remainder of fiscal 2002, $3.0 million in fiscal 2003, $2.6 million in fiscal 2004, $1.4 million in fiscal 2005, and $174,000 in fiscal 2006.

The amount of stock-based compensation in future periods will increase if we grant stock options where the exercise price is less than the quoted market price of the underlying shares. The amount of stock-based compensation amortization in future periods could decrease if options for which accrued, but unvested deferred compensation has been recorded are forfeited.

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

We primarily outsource all of our manufacturing to three third-party manufacturers, APW, Inc., Irvine Electronics and Express Manufacturing. We recently entered into a relationship with Uniprecision in China, and we intend to transition a significant portion of our workload to this manufacturer during approximately the next three months. Our reliance on these third-party manufacturers exposes us to a number of significant risks, including:

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

Our agreements with these manufacturers provide for services on a purchase-order basis. If our manufacturers were to become unable or unwilling to continue to manufacture our products in required volumes, at acceptable quality, quantity, yields and costs, or in a timely manner, our business would be seriously harmed. We may also experience unforeseen problems as we attempt to transition a significant portion of our manufacturing requirements to Uniprecision. We do not have a significant operating history with either of these entities and if these entities are unable to provide us with satisfactory service, or we are unable to successfully complete the transition, our operations could be interrupted. 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. In addition, a natural disaster could disrupt our manufacturers' facilities and could inhibit our manufacturers' ability to provide us with manufacturing capacity on a timely basis, or at all. If this were to occur, we likely would be unable to fill customers' existing orders or accept new orders for our products. The resulting decline in net revenues would harm our business. In addition, we

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

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

Substantial litigation regarding intellectual property rights exists in our industry. There is a risk that third-parties, including current and potential competitors, current developers of our intellectual property, our manufacturing partners, or parties with which we have contemplated a business combination will claim that our products, or our customers' products, infringe on their intellectual property rights or that we have misappropriated their intellectual property. In addition, software, business processes and other property rights in our industry might be increasingly subject to third-party infringement claims as the number of competitors grows and the functionality of products in different industry segments overlaps. Other parties might currently have, or might eventually be issued, patents that infringe on the proprietary rights we use. Any of these third parties might make a claim of infringement against us.

From time to time we have received letters claiming that our products infringe upon patents or other intellectual property of third-parties. On July 3, 2001, Digi International, Inc. filed a complaint in the United States District Court for the district of Minnesota claiming patent infringement and alleging that Lantronix directly and/or indirectly infringes upon Digi's U.S. Patent No. 6,047,319 by making, using, selling, and/or offering for sale certain of Lantronix's Multiport device servers, including the ETS line of products, coupled with a device driver called the Comm Port Redirector Software. Digi alleges that Lantronix has willfully and intentionally infringed Digi's patent, and its complaint seeks injunctive relief as well as unspecified damages, treble damages, attorneys fees, interest and costs. On August 17, 2001, Lantronix filed its answer to the complaint, asserting affirmative defenses, and counterclaiming for a declaratory judgment that the patent in issue is invalid. The Court has scheduled a pre-trial conference for February 19, 2002, in which discovery parameters and a trial date will likely be set. Based on the facts known to date, Lantronix believes that the claims are without merit and intends to vigorously defend this suit.

Although we believe that the claims or any litigation arising there from will have no material impact on us or our business, the litigation is in the preliminary stage, and we cannot predict its outcome with certainty. The litigation process is inherently uncertain and we may not prevail. Moreover, patent litigation is particularly complex and can extend for a protracted time, which can substantially increase the cost of such litigation. In the event the Digi litigation is not resolved at a preliminary stage, the cost of defending the claim will be substantial. In addition, the Digi litigation will likely divert the efforts and attention of some of our key management and technical personnel. Should the outcome of the litigation be adverse to us, we would be required to pay monetary damages to Digi and we could be enjoined from selling those of our products found to infringe Digi's patent unless and until we are able to negotiate a license from Digi which may not be available on acceptable terms or at all. If we are required to pay significant monetary damages, are

enjoined from selling any of our products or are required to make substantial royalty payments pursuant to any such license agreement, our business would be harmed. This litigation, or other similar litigation brought by us or others, could result in the expenditure of significant financial resources and the diversion of management's time and efforts.

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

IF WE ARE UNABLE TO CONTINUE USING INTELLECTUAL PROPERTY DEVELOPED BY GORDIAN, INC. WE COULD LOSE THE RIGHTS TO VALUABLE INTELLECTUAL PROPERTY AND OUR BUSINESS WOULD BE HARMED.

Gordian, Inc. developed intellectual property used in our Micro Serial Server, or MSS, Print Servers and ETS and LRS lines of Multiport Device Server products. These products represent a substantial portion of our net revenues. We pay royalties based on the gross margin of certain of our products incorporating Gordian Developed Technology. For the six months ended December 31, 2001 and 2000, we paid Gordian approximately $847,000 and $1.0 million in royalties, respectively. Under the terms of an agreement dated February 29, 1989, between Gordian and US, Gordian owns the rights to the intellectual property developed by it. Our agreement with Gordian may be terminated by either Gordian or ourselves with 30-days written notice. We have offered to purchase the Gordian developed intellectual property that we will need to continue selling our MSS products. Gordian and Lantronix have agreed to use the services of a neutral third party to establish a reasonable price for intellectual property. Gordian has expressed its intent to terminate its relationship with us in the event we are unable to agree upon a price for this intellectual property. In the event we are unable to continue using the Gordian Developed Technology we might be prevented from marketing some or all of our MSS line of products in the future. This would result in the loss of customers and net revenues, which would harm our business.

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

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

TERRORIST ATTACKS OR THREATS OR ATTACKS, AND BUSINESS INTERRUPTIONS CAUSED BY SUCH ATTACKS, NATURAL DISASTERS AND ELECTRICAL BLACKOUTS IN THE STATE

OF CALIFORNIA COULD ADVERSELY AFFECT OUR BUSINESS.

Interruptions in business, a decline in demand in our products, or a general economic decline resulting from actual or threatened terrorist attacks or military action could harm our business. Adverse effects could include, but are not limited to, physical damage to our facilities, and disruptions caused by trade restrictions imposed by the United States or foreign governments. In addition, a general economic downturn in any of our target markets or general disruption of the financial markets caused by such attacks could substantially harm our business. Moreover, our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster

recovery plan. Our facilities in the State of California may be subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations of our affected facilities.

WE INTEND TO CONTINUE TO DEVOTE SIGNIFICANT RESOURCES TO OUR RESEARCH AND DEVELOPMENT, WHICH, IF NOT SUCCESSFUL, COULD CAUSE A DECLINE IN OUR REVENUES AND COULD HARM OUR BUSINESS.

We intend to continue to devote significant resources to research and development in the coming years to enhance and develop additional products. For the six months ended December 31, 2001, research and development expenses comprised 12.8% of our net revenues. If we are unable to develop new products as a result of this effort, or if the products we develop are not successful, our business could be harmed. Even if we do develop new products that are accepted by our target markets, we do not know whether the net revenue from these products will be sufficient to justify our investment in research and development.

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

Our top five customers accounted for 31.8% and our top ten customers accounted for 38.9% of our net revenues for the six months ended December 31, 2001. Ingram Micro and Tech Data, domestic distributors, accounted for 13.8% and 7.4% of our net revenues for the six months ended December 31, 2001, respectively. The number and timing of sales to our customers have been difficult for us to predict. For the six months ended December 31, 2001, large individual sales have occurred in the last weeks or even days of a quarter, which has resulted in a substantial portion of the net revenues for that quarter being realized in the last month of the quarter. The loss or deferral of one or more significant sales in a quarter could harm our operating results. We have in the past, and might in the future, lose one or more major customers. If we fail to continue to sell to our major customers in the quantities we anticipate, or if any of these customers terminate our relationship, our reputation, the perception of our products and technology in the marketplace and the growth of our business could be harmed. The demand for our products from our OEM, VAR and systems integrator customers depends primarily on their ability to successfully sell their products that incorporate our Device Server Technology. Our sales are usually completed on a purchase order basis and we have no long-term purchase commitments from our customers.

Our future success also depends on our ability to attract new customers, which often involves an extended process. The sale of our products often involves a significant technical evaluation, and we often face delays because of

our customers' internal procedures used to evaluate and deploy new technologies. For these and other reasons, the sales cycle associated with our products is typically lengthy, often lasting six to nine months and sometimes longer. Therefore, if we were to lose a major customer, we might not be able to replace the customer on a timely basis or at all. This would cause our net revenues to decrease and could cause the price of our stock to decline.

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

In the past, we have experienced some reduction in the average selling prices and gross margins of products and we expect that this will continue for our products as they mature. In the future, we expect competition to increase, and we anticipate this could result in additional pressure on our pricing. In addition, our average selling prices for our products might decline as a result of other reasons, including promotional programs and customers who negotiate price reductions in exchange for longer-term purchase commitments. In addition, we might not be able to increase the price of our products in the event that the price of components or our overhead costs increase. If this were to occur, our gross margins would decline.

NET REVENUES FROM OUR LEGACY PRODUCTS, WHICH INCLUDE OUR PRINT SERVERS, SWITCHES, HUBS AND OTHER PRODUCTS, HAVE DECREASED SIGNIFICANTLY AND WE EXPECT THAT NET REVENUES FROM THESE LINES OF PRODUCTS WILL CONTINUE TO DECLINE IN THE FUTURE AS WE FOCUS OUR EFFORTS ON THE DEVELOPMENT OF OTHER PRODUCT LINES.

Since 1993, net revenues from our legacy products have accounted for a significant portion of our net revenues but have declined significantly recently. For example, revenues from our legacy products were approximately $1.0 million or 3.2% of our net revenues, compared to $1.9 million or 8.2% of our total net revenues for the six months ended December 31, 2001 and 2000, respectively. We anticipate that net revenues from our legacy products will continue to decline in the future as we plan to continue to focus on the development of our current Device Server and Multiport Device Server product lines. We do not know if this transition in product development will be successful. We do not know whether our new product lines will be accepted by our current and future target markets to the extent we anticipate. If the expected decline in net revenues attributable to our legacy products is not offset by increases in net revenues from our Device Server and Multiport Device Server lines of product, our

business could be harmed.

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

The market for our products is intensely competitive, subject to rapid change and is significantly affected by new product introductions and pricing strategies of our competitors. We face competition primarily from companies that network-enable devices, 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 offer an open architecture, our customers could develop products based on our technology that compete with our offerings. We might not have sufficient engineering staff or other required resources to modify our products to match our competitors. Similarly, competitive pressure could force us to reduce the price of our

products. In each case, we could lose new and existing customers to our competition. If this were to occur, our net revenues could decline and our business could be harmed.

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

Our contract manufacturers and we are responsible for procuring raw materials for our products. Our products incorporate components or technologies that are only available from single or limited sources of supply. In particular, some of our integrated circuits are available from a single source. From time to time in the past, integrated circuits we use in our products have been phased out of production. When this happens, we attempt to purchase sufficient inventory to meet our needs until a substitute component can be incorporated into our products. Nonetheless, we might be unable to purchase sufficient components to meet our demands, or we might incorrectly forecast our demands, and purchase too many or too few components. In addition, our products use components that have in the past been subject to market shortages and substantial price fluctuations. From time to time, we have been unable to meet our orders because we were unable to purchase necessary components for our products. We rely on a number of different component suppliers. Because we do not have long-term supply arrangements with any vendor to obtain necessary components or technology for our products, if we are unable to purchase components from these suppliers, product shipments could be prevented or delayed, which could result in a loss of sales. If we are unable to meet existing orders or to enter into new orders because of a shortage in components, we will likely lose net revenues and risk losing customers and harming our reputation in the marketplace.

OUR INTELLECTUAL PROPERTY PROTECTION MIGHT BE LIMITED.

We do not rely on patents to protect our proprietary rights. We do rely 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 of that precede the registration of our marks;
- 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;
- current federal laws that prohibit software copying provide only limited protection from software pirates; and
- the companies we acquire may not have taken similar precautions to protect their proprietary rights.

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

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

We currently offer warranties ranging from 90 days to five years on each of our products. Our products could contain undetected errors or defects. If there

is a product failure, we might have to replace all affected products without being able to book revenue for replacement units, or we may have to refund the purchase price for the units. Because of our recent introduction

of our line of Device Servers, we do not have a long history with which to assess the risks of unexpected product failures or defects for this product line. Regardless of the amount of testing we undertake, some errors might be discovered only after a product has been installed and used by customers. Any errors discovered after commercial release could result in loss of net revenues and claims against us. Significant product warranty claims against us could harm our business, reputation and financial results and cause the price of our stock to decline operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster recovery plan. Our facilities in the State of California may be subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations of our affected facilities.

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

Net revenues from international sales represented 15.6% and 31.0% of net revenues for the six months ended December 31, 2001 and 2000, respectively. Net revenues from Europe represented 12.9% and 25.8% of our net revenues for the six months ended December 30, 2001 and 2000, respectively.

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

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

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

OUR EXECUTIVE OFFICERS AND TECHNICAL PERSONNEL ARE CRITICAL TO OUR

BUSINESS, AND WITHOUT THEM WE MIGHT NOT BE ABLE TO EXECUTE OUR BUSINESS STRATEGY.

Our financial performance depends substantially on the performance of our executive officers and key employees. We are dependent in particular on Frederick G. Thiel, who serves as our President and Chief Executive Officer, and Steven V. Cotton, who serves as our Chief Operating Officer and Chief Financial Officer. We are also dependent upon our technical personnel, due to the specialized technical nature of our business. If we lose the services of Mr. Thiel, Mr. Cotton or any of our key personnel and are not able to find replacements in a timely manner, our business could be disrupted, other key personnel might decide to leave, and we might incur increased operating expenses associated with finding and compensating replacements.

WE MIGHT BE UNABLE TO HIRE AND RETAIN THE SKILLED PERSONNEL NECESSARY TO DEVELOP OUR OPERATIONS, SALES, TECHNICAL AND SUPPORT CAPABILITIES IN ORDER TO CONTINUE TO GROW, WHICH COULD HARM OUR BUSINESS.

Our business cannot continue to grow if we do not hire and retain qualified technical personnel. Competition for these individuals is intense, and we might not be able to attract, assimilate or retain highly qualified technical personnel in the future. In addition, we need to continue to hire and retain operations, sales and support personnel. Our failure to attract and retain highly trained personnel in these areas might limit the rate at which we can develop, which would harm our business.

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

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

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Interest Rate Risk. Our exposure to interest rate risk is limited to the exposure related to our cash, cash equivalents, short-term investments, and our credit facilities, which are tied to market interest rates. As of December 31, 2001, we had cash, cash equivalents and short-term investments of $48.5 million, which consisted of both domestic and foreign cash, cash equivalents and short-term investments. We believe our cash equivalents and short term investments would decline in value by only insignificant amounts if interest rates increase, and therefore, such change in value would not have a material effect on our financial condition or results of operations.

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

Investment Risk. At December 31, 2001, our investments in two privately held companies totaled $5.9 million, both of which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. We could lose our entire initial investment in these companies. Approximately $2.9 million of our investment risk is in Premise Systems which we acquired in January 2002.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time we have received letters claiming that our products infringe upon patents or other intellectual property of third-parties. On July 3, 2001, Digi International, Inc., filed a complaint in the United States District Court for the district of Minnesota claiming patent infringement and alleging that Lantronix directly and/or indirectly infringes upon Digi's U.S. Patent No. 6,047,319 by making, using, selling and or offering for sale certain of Lantronix's Multiport device servers, including the ETS line of products, coupled with a device driver called the Comm Port Redirector Software. Digi alleges that Lantronix has willfully and intentionally infringed Digi's patent, and its complaint seeks injunctive relief as well as unspecified damages, treble damages, attorneys fees, interest and costs. On August 17, 2001, Lantronix filed its answer to the complaint, asserting affirmative defenses, and counterclaiming for a declaratory judgment that the patent in issue is invalid. The Court has scheduled a pre-trial Conference for February 19, 2002, in which discovery parameters and a trial date will likely be set. Based on the facts known to date, Lantronix believes that the claims are without merit and intends to vigorously defend this suit.

Item 2. Changes in Securities and Use of Proceeds

On October 18, 2001, we completed the acquisition of Synergetic, a provider of embedded network communication solutions. In connection with the acquisition, we paid cash consideration of $2.7 million and issued an aggregate of 2,234,715 shares of our common stock in exchange for all outstanding shares of Synergetic common stock and reserved 615,705 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Synergetic. The transaction was exempt from registration pursuant to section 4(2) of the Securities Act of 1933, as amended. Portions of the cash consideration and shares issued will be held in escrow pursuant to the terms of the acquisition agreement as well as various employee share repurchase agreements.

On January 11, 2002, we completed the acquisition of Premise, a developer of client-side software applications. Prior to the acquisition we held shares of Premise representing 19.99% ownership and in addition held notes receivable of $1.2 million. We agreed to issue an aggregate of 1,063,371 shares of our common stock in exchange for all remaining outstanding shares of Premise common stock and reserved 875,000 additional shares of common stock for issuance upon exercise of outstanding employee stock options and other rights of Premise. Pursuant to the acquisition agreement, 106,337 of such shares will be held in escrow to secure certain indemnification obligations, and 531,686 of such shares will be held in escrow pending achievement of certain performance obligations.

We intend to issue these shares on or around February 18, 2002. The transaction was exempt from registration pursuant to section 4(2) of the Securities Act of 1933, as amended. In connection with the acquisition, we expect to record a one-time charge for purchased in-process research and development expenses related to the acquisition in our third fiscal quarter ending March 31, 2002.

Item 3. Defaults upon Senior Securities

None.

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit Number	Description of Document
2.1*	Agreement and Plan of Reorganization by and among Lantronix, Inc., S Company Acquisition Corporation, and Synergetic Micro Systems, Inc.
*	Incorporated by reference to exhibit 5.1 previously filed with Lantronix's Report on Form 8-K, originally filed September 20, 2001.
10.1	Employment Agreement between Lantronix, Inc. and Fred Thiel
10.2	Employment Agreement between Lantronix, Inc. and Steve Cotton
10.3	Loan and Security Agreement between Silicon Valley Bank and Lantronix, Inc., United States Software Corporation, Lightwave Communications, Inc. and Synergetic Micro Systems, Inc.

(b) Reports on Form 8-K

Date	Item Reported On
September 20, 2001	Lantronix announced it had entered into an agreement to acquire Synergetic Micro Systems, Inc.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1934, as amended, Lantronix has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Irvine, State of California, on the 24 day of June, 2002.

LANTRONIX, INC.

By: /s/ James Kerrigan

James Kerrigan

Interim Chief Financial Officer