LANTRONIX INC
Form 10-Q/A
November 12, 2003

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

FORM 10-Q

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

For the quarterly period ended September 30, 2003

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 October 31, 2003, 57,430,096 shares of the Registrant's common stock were outstanding.

LANTRONIX, INC.

FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2003

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	SEPTEMBER 30,	JUNE 30,

	2003	2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,867	$ 7,328
Marketable securities	4,600	6,750
Accounts receivable, net	3,721	3,858
Inventories	6,112	6,011
Deferred income taxes	7,909	7,909
Contract manufacturers receivable, net	1,065	1,744
Prepaid expenses and other current assets	2,501	3,861
Total current assets	34,775	37,461
Property and equipment, net	2,090	2,541
Goodwill	11,726	11,726
Purchased intangible assets, net	4,653	5,394
Long-term investments	5,249	5,458
Officer loans.	104	104
Other assets	176	172
Total assets	$ 58,773	$ 62,856
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,741	$ 4,801
Accrued payroll and related expenses	1,633	1,367
Due to Gordian	-	1,000
Accrued litigation settlement	-	1,533
Warranty reserve	1,301	1,193
Restructuring reserve	3,168	3,235
Other current liabilities	3,008	2,634
Convertible note payable	867	-
Total current liabilities	13,718	15,763
Deferred income taxes	8,509	8,509
Convertible note payable	-	867
Stockholders' equity:		
Common stock	6	6
Additional paid-in capital.	180,246	178,628
Deferred compensation	(446)	(695)
Accumulated deficit	(143,473)	(140,424)
Accumulated other comprehensive loss	213	202
Total stockholders' equity	36,546	37,717
Total liabilities and stockholders' equity	$ 58,773	$ 62,856

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	THREE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Net revenues (A)	$12,230	$ 12,681
Cost of revenues (B)	6,112	8,196
Gross profit	6,118	4,485
Operating expenses:		
Selling, general and administrative (C)	6,705	7,871
Research and development (C)	1,984	2,430
Stock-based compensation (B) (C)	155	445
Amortization of purchased intangible assets	144	228
Restructuring charges	-	4,929
Total operating expenses	8,988	15,903
Loss from operations	(2,870)	(11,418)
Interest income (expense), net	24	192
Other income (expense), net	(170)	(90)
Loss before income taxes	(3,016)	(11,316)
Provision for income taxes	33	86
Net loss	$(3,049)	$(11,402)
Basic and diluted net loss per share	$ (0.05)	$ (0.21)
Weighted average shares (basic and diluted)	55,484	53,935
(A) Includes net revenues from related parties.	$ 311	$ 467
(B) Cost of revenues includes the following:		
Amortization of purchased intangible assets	$ 597	$ 1,028
Stock-based compensation	16	19
	$ 613	$ 1,047

(C) Stock-based compensation is excluded from the following:

Selling, general and administrative expenses	$ 113	$ 363
Research and development expenses	42	82
	$ 155	$ 445

See accompanying notes.

LANTRONIX, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	THREE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Cash flows from operating activities:		
Net loss	$(3,049)	$(11,402)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	504	616
Amortization of purchased intangible assets	741	1,256
Stock-based compensation.	171	464
Provision for inventory reserves	(914)	654
Provision for doubtful accounts	142	231
Loss on sale of fixed assets	31	-
Equity losses from unconsolidated businesses	209	329
Restructuring charges	-	4,474
Changes in operating assets and liabilities, net of effect from acquisition:		
Accounts receivable	(5)	623
Inventories	813	(1,062)
Contract manufacturers receivable	679	942
Prepaid expenses and other current assets	1,360	476
Other assets	(4)	(82)
Accounts payable.	(1,060)	(111)
Due to related party	-	(246)
Due to Gordian	(1,000)	(2,000)
Accrued Lightwave settlement	-	(2,004)
Warranty reserve	108	277
Restructuring reserve	(67)	-
Other current liabilities	640	(257)
Net cash used in operating activities	(701)	(6,822)
Cash flows from investing activities:		
Purchase of property and equipment, net	(84)	(216)
Purchases of marketable securities	-	(9,250)
Acquisition of business, net of cash acquired	-	(2,114)
Proceeds from sale of marketable securities	2,150	3,000
Net cash provided by (used in) investing activities	2,066	(8,580)

Cash flows from financing activities:		
Net proceeds from other issuances of common stock	163	9
Net cash provided by financing activities	163	9
Effect of foreign exchange rates on cash.	11	23
Increase (decrease) in cash and cash equivalents	1,539	(15,370)
Cash and cash equivalents at beginning of period.	7,328	26,491
Cash and cash equivalents at end of period.	$ 8,867	$ 11,121

See accompanying notes.

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LANTRONIX, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2003

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 September 30, 2003, and the consolidated results of its operations and its cash flows for the three months ended September 30, 2003 and 2002. All intercompany accounts and transactions have been eliminated. It should be understood that accounting measurements at interim dates inherently involve greater reliance on estimates than at year-end. The results of operations for the three months ended September 30, 2003 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, 2003, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC") on September 29, 2003.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, Consolidation of Variable Interest Entities ("FIN 46"). FIN 46 requires the primary beneficiary of a variable interest entity ("VIE") to consolidate the entity and also requires majority and significant variable interest investors to provide certain disclosures. A VIE is an entity in which the equity investors do not have a controlling interest, equity investors participate in losses or residual interests of the entity on a basis that differs from its ownership interest, or the equity investment at risk is insufficient to finance the entity's activities without receiving additional subordinated financial support from the other parties. For arrangements entered

into with VIEs created prior to January 31, 2003, the provisions of FIN 46 are required to be adopted at the beginning of the first interim or annual period beginning after December 15, 2003. The Company is currently reviewing its investments and other arrangements to determine whether any of its investee companies are VIEs. The Company does not expect to identify any significant VIEs that would be consolidated, but may be required to make additional disclosures.

3. 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 MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Numerator: Net loss	$(3,049)	$(11,402)
Denominator:		
Weighted-average shares outstanding	55,816	54,267
Less: non-vested common shares outstanding	(332)	(332)
Denominator for basic and diluted loss per share	55,484	53,935
Basic and diluted net loss per share	$ (0.05)	$ (0.21)

4. MARKETABLE SECURITIES

The Company defines marketable securities as income yielding securities, which can be readily converted to cash. Marketable securities consist of obligations of U.S. Government agencies, state, municipal and county governments' notes and bonds.

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5. INVENTORIES

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

	SEPTEMBER 30, 2003	JUNE 30, 2003
Raw materials	$ 4,711	$ 5,109
Finished goods.	6,211	7,940
Inventory at distributors	874	959
	11,796	14,008
Reserve for excess and obsolete inventory	(5,684)	(7,997)
	$ 6,112	$ 6,011

6. PURCHASED INTANGIBLE ASSETS

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

		SEPTEMBER 30, 2003			JUNE 30, 2	
	USEFUL LIVES	GROSS	ACCUMULATED AMORTIZATION	NET	GROSS	ACCUMULATE AMORTIZATI
Existing technology. .	1-5 years	$ 8,060	$ (3,691)	$4,369	$ 8,060	$ (3,0
Patent/core technology	5	405	(311)	94	405	(2
Tradename/trademark. .	5	32	(19)	13	32	(
Non-compete agreements	2-3	940	(763)	177	940	(6
Total		$ 9,437	$ (4,784)	$4,653	$ 9,437	$ (4,0

The amortization expense for purchased intangible assets for the three months ended September 30, 2003 was $741,000, of which $597,000 was amortized to cost of revenues and $144,000 was amortized to operating expenses. The amortization expense for purchased intangible assets for the three months ended September 30, 2002 was $1.3 million, of which $1.0 million was amortized to cost of revenues and $228,000 was amortized to operating expenses. The estimated amortization expense for the remainder of fiscal 2004 and the next three years are as follows:

Fiscal year ending June 30:	COST OF REVENUES	OPERATING EXPENSES	TOTAL
2004 (Remainder of fiscal year)	$ 1,734	$ 217	$1,951
2005.	1,690	65	1,755
2006.	816	2	818
2007.	129	-	129
Total	$ 4,369	$ 284	$4,653

7. LONG-TERM INVESTMENTS

Long-term investments consist of a 15.3% ownership interest in Xanboo at September 30, 2003 and June 30, 2003. The Company is accounting for this long-term investment under the equity method based upon the Company's ability through representation on Xanboo's board of directors to exercise significant influence over its operations. The Company's interest in the losses of Xanboo aggregating $209,000 and $329,000 for the three months ended September 30, 2003 and 2002, respectively, have been recognized as other expense in the condensed consolidated statements of operations.

8. RESTRUCTURING CHARGES

On September 12, 2002 and March 14, 2003, the Company announced a restructuring plan to prioritize its initiatives around the growth areas of its business, focus on profit contribution, reduce expenses, and improve operating efficiency. These restructuring plans include a worldwide workforce reduction, consolidation of excess facilities and other charges. The Company recorded restructuring costs totaling $5.7 million, which were classified as operating expenses in the consolidated statement of operations for the year ended June 30,

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2003. These restructuring plans resulted in the reduction of approximately 58 regular employees worldwide. The Company recorded workforce reduction charges of approximately $1.3 million related to severance and fringe benefits for the terminated employees. The Company recorded charges of approximately $4.4 million related to the consolidation of excess facilities, relating primarily to lease terminations, non-cancelable lease costs, write-off of leasehold improvements and termination of a contractual obligation. The restructuring costs will be substantially paid in cash over the next five years. The remaining restructuring reserve is related to facility lease terminations and a contractual settlement.

A summary of the activity in the restructuring reserve account is as follows (in thousands):

		CHARGES AGAINST	
		RESERVE	
	RESTRUCTURING		RESTRUCTURING

	RESERVE AT JUNE 30, 2003	NON-CASH	CASH	RESERVE AT SEPTEMBER 30, 2003
Workforce reductions	$ 260	$ -	$ -	$ 260
Contractual obligations.	2,000	-	-	2,000
Consolidation of excess facilities	975	-	(67)	908
Total.	$ 3,235	$ -	$ (67)	$ 3,168

9. WARRANTY

Upon shipment to its customers, the Company provides for the estimated cost to repair or replace products to be returned under warranty. The Company's current warranty periods generally range from ninety days to two years from the date of shipment. The following table is a reconciliation of the changes to the product warranty liability for the periods presented:

	THREE MONTHS ENDED SEPTEMBER 30, 2003	YEAR ENDED JUNE 30, 2003
Balance beginning of period .	$ 1,193	$ 479
Charged to costs and expenses	414	878
Charged to other expenses . .	(306)	(153)
Deductions.	-	(11)
Balance end of period	$ 1,301	$ 1,193

10. PROVISION FOR INCOME TAXES AND EFFECTIVE TAX RATE

The Company utilizes the liability method of accounting for income taxes as set forth in Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes." The Company's effective tax rate was (1)% for both the three month periods ended September 30, 2003 and September 30, 2002. The federal statutory rate was 34% for both periods. The effective tax rate associated with the income tax expense for both the three month periods ended September 30, 2003 and 2002, was lower than the federal statutory rate primarily due to the increase in valuation allowance, as well as the amortization of stock-based compensation for which no current year tax benefit was provided. In October 2003, the Internal Revenue Service completed its audit of the Company's federal income tax returns for the years ended June 30, 1999, 2000 and 2001. As a result, the Company will be required to pay approximately $500,000 in tax and interest to the Internal Revenue Service and the California Franchise Tax Board, in fiscal 2004. The Company had accrued for this liability in prior fiscal periods.

11. BANK LINE OF CREDIT AND DEBT

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 either (i) the prime rate or (ii) the LIBOR rate plus 2.0%. The Company was required to pay a $100,000 facility fee of which $50,000 was paid upon the closing and $50,000 was to be paid. The Company was also

required to pay a quarterly unused line fee of .125% of the unused line of credit balance. Since establishing the line of credit, the Company has twice reduced the amount of the line, modified customary financial covenants, and adjusted the interest rate to be charged on borrowings to the prime rate plus ..50%, and eliminated the LIBOR option. Effective July 25, 2003, the Company further modified this line of credit, reducing the revolving line to $5.0 million, and adjusting the customary affirmative and negative covenants. The Company is also required to maintain certain financial ratios as defined in the agreement. The agreement has an annual revolving maturity date that renews on the effective date. The $50,000 facility fee was reduced to $12,500 and was paid. Prior to any advances being made under the line of credit, the bank is required to complete an initial field examination to determine its borrowing base. To date, the Company has not borrowed against this line of credit. The Company is currently in compliance with the revised financial covenants of the July 25, 2003 amended line of credit. Pursuant to the line of credit, the Company is restricted from paying any dividends. The Company has secured two deposits totaling approximately $365,000 under its line of credit.

The Company issued a two-year note in the principal amount of $867,000 as a result of its acquisition of Stallion, accruing interest at a rate of 2.5% per annum. Interest expense related to the note totaled approximately $5,400 and $3,600 for the three months ended September 30, 2003 and 2002, respectively. The note is convertible into the Company's common stock at any time, at the election of the holders, at a $5.00 conversion price. The note is due in August 2004.

12. 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 SEPTEMBER 30,	
	2003	2002
Net loss	$(3,049)	$(11,402)
Other comprehensive loss:		
Change in accumulated translation adjustments	11	23
Total comprehensive loss	$(3,038)	$(11,379)

13. STOCK-BASED COMPENSATION

The Company has in effect several stock-based plans under which non-qualified and incentive stock options have been granted to employees, non-employee board members and other non-employees. The Company also has an employee stock purchase plan for all eligible employees. The Company accounts for stock-based awards to employees in accordance with Accounting Principles Board ("APB") No. 25, "Accounting for Stock Issues to Employees" ("APB 25"), and related interpretations, and has adopted the disclosure-only alternative of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123") and SFAS No. 148, "Accounting for Stock-Based Compensation Transition and Disclosure." Options granted to non-employees, as defined, have been accounted for at fair market value in accordance with SFAS No. 123.

In accordance with the disclosure requirements of SFAS No. 123, set forth below are the assumptions used and pro forma statement of operations data of the Company giving effect to valuing stock-based awards to employees using the Black-Scholes option pricing model instead of the guidelines provided by APB No. 25. Among other factors, the Black-Scholes model considers the expected life of the option and the expected volatility of the Company's stock price in arriving at an option valuation.

The results of applying the requirements of the disclosure-only alternative of SFAS No. 123 to the Company's stock-based awards to employees would approximate the following:

	THREE MONTHS ENDED SEPTEMBER 30,	
	2003	2002
Net loss - as reported	$(3,049)	$(11,402)
Add: Stock-based compensation expense included in net loss - as reported	171	464
Deduct: Stock-based compensation expense determined under fair value method	(953)	(1,902)
Net loss - pro forma	$(3,831)	$(12,480)
Net loss per share (basic and diluted) - as reported	$ (0.05)	$ (0.21)
Net loss per share (basic and diluted) - pro forma	$ (0.07)	$ (0.24)

14. LITIGATION SETTLEMENT

On August 23, 2002, a complaint entitled Dunstan v. Lantronix, Inc., et al., was filed in the Circuit Court of the State of Oregon, County of Multnomah, against the Company and certain of its current and former officers and directors by the cofounders of United States Software Corporation ("USSC"). The complaint

and subsequently filed arbitration demand alleged Oregon state law claims for securities violations, fraud, and negligence, as well as other claims related to the Company's acquisition of USSC. Plaintiffs sought more than $14.0 million in damages, interest, attorneys' fees, costs, expenses, and an unspecified amount of punitive damages. The parties participated in a mediation on June 30, 2003, and subsequently reached an agreement to settle the dispute. Pursuant to the parties' settlement agreement, the Company released to the plaintiffs approximately $400,000 in cash and 49,038 shares of the Company's common stock that had been held in an escrow since December 2000 as part of the acquisition of USSC. On September 15, 2003, the Company also issued to the plaintiffs 1,726,703 additional shares of its common stock worth approximately $1.5 million, which was recorded in the Company's results of operations as litigation settlement costs for the year ended June 30, 2003. In exchange, the plaintiffs released all claims against all defendants.

15. LITIGATION

Government Investigation

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

Class Action Lawsuits

On May 15, 2002, Stephen Bachman filed a class action complaint entitled Bachman v. Lantronix, Inc., et al., No. 02-3899, in the U.S. District Court for the Central District of California against the Company and certain of its current and former officers and directors alleging violations of the Securities Exchange Act of 1934 and seeking unspecified damages. Subsequently, six similar actions were filed in the same court. Each of the complaints purports to be a class action lawsuit brought on behalf of persons who purchased or otherwise acquired the Company's common stock during the period of April 25, 2001 through May 30, 2002, inclusive. The complaints allege that the defendants caused the Company to improperly recognize revenue and make false and misleading statements about its business. Plaintiffs further allege that the defendants materially overstated the Company's reported financial results, thereby inflating its stock price during its securities offering in July 2001, as well as facilitating the use of its common stock as consideration in acquisitions. The complaints have subsequently been consolidated into a single action and the court has appointed a lead plaintiff. The lead plaintiff filed a consolidated amended complaint on January 17, 2003. The amended complaint now purports to be a class action brought on behalf of persons who purchased or otherwise acquired the Company's common stock during the period of August 4, 2000 through May 30, 2002, inclusive. The amended complaint continues to assert that the Company and the individual officer and director defendants violated the 1934 Act, and also includes alleged claims that the Company and its officers and directors violated the Securities Act of 1933 arising from the Company's Initial Public Offering in August 2000. The Company has filed a motion to dismiss the additional allegations on March 3, 2003. The Court has taken the motion under submission.

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The Company has not yet answered the complaint, discovery has not commenced, and no trial date has been established.

Derivative Lawsuit

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

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

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

On September 6, 2002, Steven Cotton, the Company's former CFO and COO, filed a complaint entitled Cotton v. Lantronix, Inc., et al., No. 02CC14308, in the Superior Court of the State of California, County of Orange. The complaint alleges claims for breach of contract, breach of the covenant of good faith and fair dealing, wrongful termination, misrepresentation, and defamation. The complaint seeks unspecified damages, declaratory relief, attorneys' fees and costs. Discovery has not commenced and no trial date has been established.

The Company filed a motion to dismiss on October 16, 2002, on the grounds that Mr. Cotton's complaints are subject to the binding arbitration provisions in Mr. Cotton's employment agreement. On January 13, 2003, the Court ruled that five of the six counts in Mr. Cotton's complaint are subject to binding arbitration. The court is staying the sixth count, for declaratory relief, until the underlying facts are resolved in arbitration. No arbitration date has been set.

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

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

Suit filed by Lantronix Against Logical Solutions, Inc. ("Logical")

On March 25, 2003, the Company filed in Connecticut state court (Judicial District of New Haven) a complaint entitled Lantronix, Inc. and Lightwave Communications, Inc. v. Logical Solutions, Inc., et. al. This is an action for unfair and deceptive trade practices, unfair competition, unjust enrichment, conversion, misappropriation of trade secrets and tortuous interference with contractual rights and business expectancies. The Company seeks preliminary and permanent injunctive relief and damages. The individual defendants are all

former employees of Lightwave Communications, a company that the Company acquired in June 2001. The Court held a non-jury trial October 10-17, 2003; closing arguments are set for November 14, 2003.

Other

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

The pending lawsuits involve complex questions of fact and law and likely will continue to require the expenditure of significant funds and the diversion of other resources to defend. Management is unable to determine the outcome of its outstanding legal proceedings, claims and litigation involving the Company, its subsidiaries, directors and officers and cannot determine the extent to which these results may have a material adverse effect on the Company's business, results of operations and financial condition taken as a whole. The results of litigation are inherently uncertain, and adverse outcomes are possible. The Company is unable to estimate the range of possible loss from outstanding litigation, and no amounts have been provided for such matters in the condensed consolidated financial statements.

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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 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 Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the fiscal year ended June 30, 2003 and our subsequent reports on Form 8-K that discuss our business in greater detail.

The section 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, our beliefs, and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any

underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

OVERVIEW

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

We have a history of providing devices that enable information technology ("IT") equipment to network using standard protocols for connectivity, including fiber optic, Ethernet and wireless. Our first device was a terminal server that allowed "dumb" terminals to connect to a network. Building on the success of our terminal servers, we introduced a complete line of print servers in 1991 that enabled users to inexpensively share printers over a network. Over the years, we have continually refined our core technology and have developed additional innovative networking solutions that expand upon the business of providing our customers network connectivity. With the expansion of networking and the Internet, our technology focus is increasingly broader, so that our device solutions provide a product manufacturer with the ability to network their products within the industrial, sevice and consumer markets.

We provide three broad categories of products: "device networking solutions," that enable almost any electronic product to be connected to a network; "IT management solutions," that enable multiple pieces of hardware, usually IT-related network hardware such as servers, routers, switches, and similar pieces of equipment to be managed over a network; and software that is either embedded in the hardware devices that are mentioned above, or stand-alone application software.

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

We sell our devices through a global network of distributors, system integrators, value added resellers (VARs), manufacturers' representatives and original equipment manufacturers (OEM's). In addition, we sell directly to selected accounts. One customer, Ingram Micro, accounted for approximately 13.4% and 10.5% of our net revenues for the three months ended September 30, 2003 and

2002, respectively. Another customer, Tech Data, accounted for approximately 10.3% and 9.7% of our net revenues for the three months ended September 30, 2003 and 2002, respectively. Accounts receivable attributable to these domestic customers accounted for approximately 12.2% and 16.0% of total accounts receivable at September 30, 2003 and June 30, 2003, respectively.

One international customer, transtec AG, which is a related party due to common ownership by our largest stockholder and former Chairman of our Board of Directors, Bernhard Bruscha, accounted for approximately 2.5% and 3.7% of our net revenues for the three months ended September 30, 2003 and 2002, respectively. Accounts receivable attributable to this international customer totaled $84,000 at September 30, 2003. No amounts were receivable on June 30, 2003.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

Revenue Recognition

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

affected by product failure rates, use of materials or service delivery costs that differ from our estimates. As a result, additional warranty reserves could be required, which could reduce gross margins.

Allowance for Doubtful Accounts

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

Inventory Valuation

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

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

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

Valuation of Deferred Income Taxes

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

Goodwill and Purchased Intangible Assets

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development ("IPR&D"). Goodwill and intangible assets deemed to have indefinite lives are no longer amortized but are subject to annual

impairment tests. The amounts and useful lives assigned to intangible assets impact future amortization and the amount assigned to IPR&D is expensed immediately. If the assumptions and estimates used to allocate the purchase price are not correct, purchase price adjustments or future asset impairment charges could be required.

Impairment of Long-Lived Assets

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

Strategic Investments

We have made strategic investments in privately held companies for the promotion of business and strategic investments. Strategic investments with less than a 20% voting interest are generally carried at cost. We will use the equity method to account for strategic investments in which we have a voting interest of 20% to 50% or in which we otherwise have the ability to exercise significant influence. Under the equity method, the investment is originally recorded at cost and adjusted to recognize our share of net earnings or losses of the investee, limited to the extent of our investment in, advances to and adjusted to recognize our share of net earnings or losses of the investee. From time to time we are required to estimate the amount of our losses of the investee. Our estimates are based on historical experience. The value of non-publicly traded securities is difficult to determine. We periodically review these investments for other-than-temporary declines in fair value based on the specific identification method and write down investments to their fair value when an other-than-temporary decline has occurred. We generally believe an other-than-temporary decline has occurred when the fair value of the investment is below the carrying value for two consecutive quarters, absent evidence to the contrary. Fair values for investments in privately held companies are estimated based upon the values of recent rounds of financing. Although we believe our estimates reasonably reflect the fair value of the non-publicly traded securities held by us, had there been an active market for the equity securities, the carrying values might have been materially different than the amounts reported. Future adverse changes in market conditions or poor operating results of companies in which we have such investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's current carrying value and which could require a future impairment charge.

Restructuring Charges.

Over the last several quarters we have undertaken, and we may continue to undertake, significant restructuring initiatives, which have required us to develop formalized plans for exiting certain business activities. We have had to

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

Settlement Costs

From time to time, we are involved in legal actions arising in the ordinary course of business. We cannot assure you that these actions or other third party assertions against us will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows. As facts concerning contingencies become known, we reassess our position and make appropriate adjustments to the financial statements. We are aggressively defending these litigation matters and believe no material adverse outcome will result. However, there are many uncertainties associated with any litigation. If our assessments prove to be wrong, our results of operations and financial condition could be materially and adversely affected. In addition, if further information becomes available that causes us to determine a loss in any of our pending litigation is probable and we can reasonably estimate a range of loss associated with such litigation, then we would record at least the minimum estimated liability. However, the actual liability in any such litigation may be materially different from our estimates, which could result in the need to record additional costs.

CONSOLIDATED RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED

	SEPTEMBER 30, 2003	SEPTEMBER 30, 2002
Net revenues	100.0%	100.0%
Cost of revenues	50.0	64.6
Gross profit	50.0	35.4
Operating expenses:		
Selling, general and administrative. . . .	54.8	62.1
Research and development	16.2	19.2
Stock-based compensation	1.3	3.5
Amortization of purchased intangible assets	1.2	1.8
Restructuring charges.	-	38.9
Total operating expenses	73.5	125.4
Loss from operations	(23.5)	(90.0)
Interest income (expense), net	0.2	1.5
Other income (expense), net	(1.4)	(0.7)
Loss before income taxes	(24.7)	(89.2)
Provision for income taxes	0.3	0.7
Net loss	(24.9)%	(89.9)%

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NET REVENUES

Net revenues decreased $451,000, or 3.6%, to $12.2 million for the three months ended September 30, 2003 from $12.7 million for the three months ended September 30, 2002. The decrease for the three months ended September 30, 2003 was primarily attributable to a decrease in net revenues of our other products. IT management solutions net revenues were flat at $3.1 million, or 25.1% of net revenues, for the three months ended September 30, 2003 and $3.1 million, or 24.2% of net revenues, for the three months ended September 30, 2002. Device networking solutions net revenues were flat at $6.6 million, or 53.9% of net revenues, for the three months ended September 30, 2003 and $6.6 million, or 52.1% of net revenues, for the three months ended September 30, 2002. Other products net revenues decreased $432,000, or 14.4%, to $2.6 million, or 21.0% of net revenues, for the three months ended September 30, 2003 from $3.0 million, or 23.6% of net revenues, for the three months ended September 30, 2002. The decrease in other product net revenues is primarily due to a decrease in our legacy Print Server product line. We are no longer investing in the development of Print Server product lines and expect net revenues related to this product line to continue to decline in the future as we focus our investment in device networking and IT management products. Net revenues for the three months ended September 30, 2003 includes $52,000 of revenues from one of our industrial controller product lines that we exited during the quarter ended September 30, 2003. Net revenues for the three months ended September 30, 2002 included $530,000 of revenues from this exited industrial controller product line.

Net revenues generated from sales in the Americas decreased $308,000, or 3.1%, to $9.5 million, or 77.8% of net revenues, for the three months ended September 30, 2003 from $9.8 million, or 77.4% of net revenues, for the three

months ended September 30, 2002. Our net revenues derived from customers located in Europe decreased $204,000, or 8.6%, to $2.2 million, or 17.8% of net revenues, for the three months ended September 30, 2003 from $2.4 million, or 18.7% of net revenues, for the three months ended September 30, 2002. The decrease in net revenues in the Americas and Europe is primarily attributable to a decrease in industry technology spending. Our net revenues derived from customers located in other geographic areas increased slightly to $549,000, or 4.5% of net revenues, for the three months ended September 30, 2003 from $488,000, or 3.8% of net revenues, for the three months ended September 30, 2002.

We experienced a slight decline in our quarterly net revenues during fiscal 2003, although we began to show a year over year quarterly revenue improvement in the fourth quarter of fiscal 2003. In the first quarter of fiscal 2004, we showed a slight increase over the fourth quarter of fiscal 2003 and a slight decrease from the same period last year.

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, amortization of purchased intangible assets, establishing or relieving inventory reserves for excess and obsolete products or raw materials, overhead and warranty costs. Cost of revenues for the three months ended September 30, 2003 and 2002 consisted of $597,000 and $1.0 million of amortization of purchased intangible assets, respectively. At September 30, 2003 the unamortized balance of purchased intangible assets that will be amortized to cost of revenues was $4.4 million, of which $1.7 million will be amortized in the remainder of fiscal 2004, $1.7 million in fiscal 2005, $816,000 in fiscal 2006 and $129,000 in fiscal 2007.

Gross profit increased by $1.6 million, or 36.4%, to $6.1 million, or 50.0% of net revenues, for the three months ended September 30, 2003 from $4.5 million, or 35.4% of net revenues, for the three months ended September 30, 2002. The increase in gross profit in absolute dollars and as a percentage of net revenues for the three months ended September 30, 2003 was mainly attributable to a decrease in our inventory reserve of $914,000 and the decrease in amortization of purchased intangible assets charged to cost of revenues of $431,000. The decrease in the amortization of purchased intangible assets is primarily due to the impairment write-down of $3.9 million during the fourth quarter of fiscal 2003. The decrease in our inventory reserve is primarily due to the sale of products during the period for which reserves were previously recorded.

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 legal and accounting fees. Selling, general and administrative expenses decreased $1.2 million, or 14.8%, to $6.7 million, or 54.8% of net revenues, for the three months ended September 30, 2003 from $7.9 million, or 62.1% of net revenues, for the three months ended September 30, 2002. Selling, general and administrative expense decreased primarily due to reductions in headcount and facility costs as a result of our fiscal 2003 restructurings and the decrease in legal and other professional fees. The legal fees primarily relate to our defense of the shareholder lawsuits and the SEC investigation. Legal fees incurred in defense of the shareholder suits are reimbursable to the extent provided in our directors and officers liability insurance policies, and subject to the coverage limitations and exclusions contained in such policies. For the three months ended September 30, 2003, we have been reimbursed $325,000 of these expenses. We expect to receive additional reimbursements for legal fees

in the future.

RESEARCH AND DEVELOPMENT

Research and development expenses consist primarily of personnel-related costs of employees, as well as expenditures to third-party vendors for research and development activities. Research and development expenses decreased $446,000, or 18.4%, to $2.0 million, or 16.2% of net revenues, for the three months ended September 30, 2003 from $2.4 million, or 19.2% of net revenues, for the three months ended September 30, 2002. This decrease resulted primarily from our fiscal 2003 restructurings which resulted in the closing of the Hillsboro, Oregon; Milford, Connecticut; and Germany offices. Generally, research and development expenses are expected to increase during the remainder of fiscal 2004 as we increase headcount to support new product development.

STOCK-BASED COMPENSATION

Stock-based compensation generally represents the amortization of deferred compensation. We recorded no deferred compensation for the three months ended September 30, 2003 and recorded deferred compensation forfeitures of $78,000 for the three months ended September 30, 2003. Deferred compensation represents the difference between the fair value of the underlying common stock for accounting purposes and the exercise price of the stock options at the date of grant as well as the fair market value of the vested portion of non-employee stock options utilizing the Black-Scholes option pricing model. Deferred compensation also includes the value of employee stock options assumed in connection with our acquisitions calculated in accordance with current accounting guidelines. Deferred compensation is presented as a reduction of stockholders' equity and is amortized ratably over the respective vesting periods of the applicable options, which is generally four years.

Included in cost of revenues is stock-based compensation of $16,000 and $19,000 for the three months ended September 30, 2003 and 2002, respectively. Stock-based compensation included in operating expenses decreased $290,000, or 65.2%, to $155,000, or 1.3% of net revenues, for the three months ended September 30, 2003 from $445,000, or 3.5% of net revenues, for the three months ended September 30, 2002. The decrease in stock-based compensation for the three months ended September 30, 2003 is primarily attributable to the restructuring plans whereby options for which deferred compensation has been recorded are forfeited for terminated employees. Additionally, the decrease is due to the acceleration of approximately $239,000 of stock-based compensation in January 2003 as a result of our completion of an offer whereby employees holding options to purchase our common stock were given the opportunity to cancel certain of their existing options in exchange for the opportunity to receive new options. At September 30, 2003, a balance of $446,000 remains and will be amortized as follows: $343,000 for the remainder of fiscal 2004, $86,000 in fiscal 2005 and $17,000 in fiscal 2006.

AMORTIZATION OF PURCHASED INTANGIBLE ASSETS

Purchased intangible assets primarily include existing technology, patents and trademarks and are amortized on a straight-line basis over the estimated useful lives of the respective assets, ranging from one to five years. We obtained independent appraisals of the fair value of tangible and intangible assets acquired in order to allocate the purchase price. The amortization of purchased intangible assets decreased $84,000, or 36.8%, to $144,000, or 1.2% of net revenues, for the three months ended September 30, 2003 from $228,000, or 1.8% of net revenues, for the three months ended September 30, 2002. In

addition, approximately $597,000 and $1.0 million of amortization of purchased intangible assets has been classified as cost of revenues for the three months ended September 30, 2003 and 2002, respectively. The decrease in amortization of purchased intangible assets is primarily due to the impairment write-down of $2.4 million during the fourth quarter of fiscal 2003. At September 30, 2003, the unamortized balance of purchased intangible assets that will be amortized to future operating expense was $284,000, of which $217,000 will be amortized in the remainder of fiscal 2004, $65,000 in fiscal 2005 and $2,000 in fiscal 2006.

RESTRUCTURING CHARGES

On September 12, 2002, we announced a restructuring plan to prioritize our initiatives around the growth areas of our business, focus on profit contribution, reduce expenses, and improve operating efficiency. This restructuring plan included a worldwide workforce reduction, consolidation of excess facilities and other charges. We recorded restructuring costs totaling $4.9 million, which were classified as operating expenses in the condensed consolidated statement of operations for the three months ended September 30, 2002. This restructuring plan resulted in the reduction of approximately 50 regular employees worldwide. We recorded workforce reduction charges of approximately $1.2 million related to severance and fringe benefits for the terminated employees. We recorded charges of approximately $3.7 million related to the consolidation of excess facilities, relating primarily to lease terminations, non-cancelable lease costs, write-off of leasehold improvements and termination of a contractual obligation. The restructuring costs will be substantially paid in cash over the next five years. The remaining restructuring reserve is related to facility lease terminations and a contractual settlement. There was no restructuring charge recorded for the three months ended September 30, 2003.

INTEREST INCOME (EXPENSE), NET

Interest income (expense), net consists primarily of interest earned on cash, cash equivalents and marketable securities. Interest income (expense), net was $24,000 and $192,000 for the three months ended September 30, 2003 and 2002, respectively. The decrease is primarily due to lower average investment balances and interest rates. Additionally, the decrease in the average investment balance is due to increased legal and other professional fees resulting from our financial statement restatements in fiscal 2002 and defense of our lawsuits. Also, the decrease is due to the settlement of the Milford lease obligation included in our restructuring charge, the purchase of a joint interest in intellectual property from Gordian, our acquisition of Stallion and to fund current operations.

OTHER INCOME (EXPENSE), NET

Other income (expense), net was $(170,000) and $(90,000) for the three months ended September 30, 2003 and 2002, respectively. The increase in other expense is primarily attributable to our share of the losses from our investment in Xanboo.

PROVISION FOR INCOME TAXES-EFFECTIVE TAX RATE

We utilize the liability method of accounting for income taxes as set forth in FASB Statement No. 109, "Accounting for Income Taxes." Our effective tax rate was (1)% for both the three month periods ended September 30, 2003 and 2002. The federal statutory rate was 34% for both periods. Our effective tax rate associated with the income tax expense for both the three month periods ended

September 30, 2003 and 2002, was lower than the federal statutory rate primarily due to the increase in valuation allowance, as well as the amortization of stock-based compensation for which no current year tax benefit was provided. In October 2003, the Internal Revenue Service completed its audit of our federal income tax returns for the years ended June 30, 1999, 2000 and 2001. As a result, we will be required to pay approximately $500,000 in tax and interest to the Internal Revenue Service and the California Franchise Tax Board, in fiscal 2004. We accrued for this liability in prior fiscal periods.

IMPACT OF ADOPTION OF NEW ACCOUNTING STANDARDS

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, Consolidation of Variable Interest Entities ("FIN 46"). FIN 46 requires the primary beneficiary of a variable interest entity ("VIE") to consolidate the entity and also requires majority and significant variable interest investors to provide certain disclosures. A VIE is an entity in which the equity investors do not have a controlling interest, equity investors participate in losses or residual interests of the entity on a basis that differs from its ownership interest, or the equity investment at risk is insufficient to finance the entity's activities without receiving additional subordinated financial support from the other parties. For arrangements entered into with VIEs created prior to January 31, 2003, the provisions of FIN 46 are required to be adopted at the beginning of the first interim or annual period beginning after December 15, 2003. We are currently reviewing our investments and other arrangements to determine whether any of its investee companies are VIEs. We do not expect to identify any significant VIEs that would be consolidated, but may be required to make additional disclosures.

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 $8.9 million at September 30, 2003. Marketable securities are income yielding securities which can be readily converted to cash. Marketable securities consist of obligations of U.S. Government agencies, state, municipal and county government notes and bonds and totaled $4.6 million at September 30, 2003. Long-term investments primarily consist of an equity security of a privately held company, Xanboo, and totaled $5.2 million at September 30, 2003.

Our operating activities used cash of $701,000 for the three months ended September 30, 2003. We incurred a net loss of $3.0 million, which includes the following adjustments: benefit from inventory reserve of $914,000, amortization of purchased intangible assets of $741,000, depreciation of $504,000, amortization of stock-based compensation of $171,000, equity losses from unconsolidated businesses of $209,000 and a provision for doubtful accounts of $142,000. The changes in our operating assets consist of a decrease in inventory

of $813,000, decrease in contract manufacturer receivable of $679,000, decrease in prepaid expenses and other assets of $1.4 million and an increase in other current liabilities of $640,000 which was reduced by a decrease in the balance due to Gordian of $1.0 million and a decrease in accounts payable of $1.1 million. The decrease in the balance due to Gordian is due to payments in accordance with the agreement. The decrease in prepaid expenses and other current assets is primarily due to the Gordian payment whereby we maintained a

time deposit for $1.0 million. The decrease in inventory is primarily attributable to a concentrated effort by management to reduce inventory levels. The increase in other current liabilities is primarily due to the issuance of stock in satisfaction of the $1.5 million Dunstan settlement. On September 15, 2003, 1,726,703 shares were issued following a fairness determination by the state court in Oregon. The decrease in contract manufacturer receivables is due to improved collections. The decrease in accounts payable is due to the timing of payments to our suppliers.

Cash provided by investing activities was $2.1 million for the three months ended September 30, 2003 compared with a $8.6 million use of cash for the three months ended September 30, 2002. We received $2.2 million in proceeds from the sales of marketable securities. We also used $84,000 to purchase property and equipment.

Cash provided by financing activities was $163,000 for the three months ended September 30, 2003, primarily related to the purchase by the employee stock purchase plan. Cash provided by financing activities was $9,000 for the three months ended September 30, 2002.

In January 2002, we entered into a two-year line of credit with a bank in an amount not to exceed $20.0 million. Borrowings under the line of credit bear interest at either (i) the prime rate or (ii) the LIBOR rate plus 2.0%. We were required to pay a $100,000 facility fee of which $50,000 was paid upon the closing and $50,000 was to be paid. We are also required to pay a quarterly unused line fee of .125% of the unused line of credit balance. Since establishing the line of credit, we have twice reduced the amount of the line, modified customary financial covenants, and adjusted the interest rate to be charged on borrowings to the prime rate plus .50%, and eliminated the LIBOR option. Effective July 25, 2003, we further modified this line of credit, reducing the revolving line to $5.0 million, and adjusting the customary affirmative and negative covenants. We are also required to maintain certain financial ratios as defined in the agreement. The agreement has an annual revolving maturity date that renews on the effective date. The renewal $50,000 facility fee was reduced to $12,500 and was paid. Prior to any advances being made under the line of credit, the bank is required to complete a field examination to determine its borrowing base. To date, we have not borrowed against this line of credit. We are currently in compliance with the revised financial covenants of the July 25, 2003 amended line of credit. Pursuant to our line of credit, we are restricted from paying any dividends. We have secured two deposits totaling approximately $365,000 under our line of credit.

The following table summarizes our contractual payment obligations and commitments:

	REMAINDER OF FISCAL YEAR	FISCAL YEARS				
	2004	2005	2006	2007	2008	TOTAL
Operating leases.	$1,302	$1,348	$ 493	$ 336	$ 202	$3,681
Convertible note payable. . .	867	-	-	-	-	867
Other contractual obligations	205	-	-	-	-	205
Total	$2,374	$1,348	$ 493	$ 336	$ 202	$4,753

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In October 2003, the Internal Revenue Service completed its audit of our federal income tax returns for the years ended June 30, 1999, 2000 and 2001. As a result, we will be required to pay approximately $500,000 in tax and interest to the Internal Revenue Service and the California Franchise Tax Board, in fiscal 2004. We accrued for this liability in prior fiscal periods.

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

RISK FACTORS

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

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

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

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

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

- customers' decisions to defer or accelerate orders;

- variations in the size or timing of orders for our products;
- short-term fluctuations in the cost or availability of our critical components;
- changes in demand for our products 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 products.

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

Government Investigation

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

Class Action Lawsuits

On May 15, 2002, Stephen Bachman filed a class action complaint entitled Bachman v. Lantronix, Inc., et al., No. 02-3899, in the U.S. District Court for the Central District of California against us and certain of our current and former officers and directors alleging violations of the Securities Exchange Act of 1934 and seeking unspecified damages. Subsequently, six similar actions were filed in the same court. Each of the complaints purports to be a class action lawsuit brought on behalf of persons who purchased or otherwise acquired our common stock during the period of April 25, 2001 through May 30, 2002, inclusive. The complaints allege that the defendants caused us to improperly recognize revenue and make false and misleading statements about our business. Plaintiffs further allege that the defendants materially overstated our reported financial results, thereby inflating our stock price during our securities offering in July 2001, as well as facilitating the use of our common stock as consideration in acquisitions. The complaints have subsequently been consolidated into a single action and the court has appointed a lead plaintiff. The lead plaintiff filed a consolidated amended complaint on January 17, 2003. The amended complaint now purports to be a class action brought on behalf of

persons who purchased or otherwise acquired our common stock during the period of August 4, 2000 through May 30, 2002, inclusive. The amended complaint continues to assert that we and the individual officer and director defendants violated the 1934 Act, and also includes alleged claims that we and these officers and directors violated the Securities Act of 1933 arising from our Initial Public Offering in August 2000. We filed a motion to dismiss the additional allegations on March 3, 2003. The Court has taken the motion under submission. We have not yet answered the complaint, discovery has not commenced,

and no trial date has been established.

Derivative Lawsuit

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

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

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

On September 6, 2002, Steven Cotton, our former CFO and COO, filed a complaint entitled Cotton v. Lantronix, Inc., et al., No. 02CC14308, in the Superior Court of the State of California, County of Orange. The complaint alleges claims for breach of contract, breach of the covenant of good faith and fair dealing, wrongful termination, misrepresentation, and defamation. The complaint seeks unspecified damages, declaratory relief, attorneys' fees and costs. Discovery has not commenced and no trial date has been established.

We filed a motion to dismiss on October 16, 2002, on the grounds that Mr. Cotton's complaints are subject to the binding arbitration provisions in Mr. Cotton's employment agreement. On January 13, 2003, the Court ruled that five of the six counts in Mr. Cotton's complaint are subject to binding arbitration. The court is staying the sixth count, for declaratory relief, until the underlying facts are resolved in arbitration. No arbitration date has been set.

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

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

Suit filed by Lantronix Against Logical Solutions, Inc.

On March 25, 2003, we filed in Connecticut state court (Judicial District of New Haven) a complaint entitled Lantronix, Inc. and Lightwave Communications, Inc. v. Logical Solutions, Inc., et. al. This is an action for unfair and deceptive trade practices, unfair competition, unjust enrichment, conversion, misappropriation of trade secrets and tortuous interference with contractual

rights and business expectancies. We seek preliminary and permanent injunctive relief and damages. The individual defendants are all former employees of Lightwave Communications, a company that we acquired in June 2001. The Court held a non-jury trial October 10-17, 2003; closing arguments are set for November 14, 2003.

Other

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

The pending lawsuits involve complex questions of fact and law and likely will continue to require the expenditure of significant funds and the diversion of other resources to defend. We are unable to determine the outcome of its outstanding legal proceedings, claims and litigation involving us, our

subsidiaries, directors and officers and cannot determine the extent to which these results may have a material adverse effect on our business, results of operations and financial condition taken as a whole. The results of litigation are inherently uncertain, and adverse outcomes are possible. We are unable to estimate the range of possible loss from outstanding litigation, and no amounts have been provided for such matters in the consolidated financial statements.

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

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

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

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

For example, in July 2001, Digi International, Inc., filed a complaint

alleging that we directly and/or indirectly infringed upon a Digi Patent. Following extensive and costly pre-trial preparation, we settled the matter with Digi in November 2002. From time to time in the future we could encounter other disputes over rights and obligations concerning intellectual property. We cannot assume that we will prevail in intellectual property disputes regarding infringement, misappropriation or other disputes. Litigation in which we are accused of infringement or misappropriation might cause a delay in the introduction of new products, require us to develop non-infringing technology, require us to enter into royalty or license agreements, which might not be available on acceptable terms, or at all, or require us to pay substantial damages, including treble damages if we are held to have willfully infringed. In addition, we have obligations to indemnify certain of our customers under some circumstances for infringement of third-party intellectual property rights. If any claims from third-parties were to require us to indemnify customers under our agreements, the costs could be substantial, and our business could be harmed. If a successful claim of infringement were made against us and we could not develop non-infringing technology or license the infringed or similar technology on a timely and cost-effective basis, our business could be significantly harmed.

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

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

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FOUR OF THE FORMER STOCKHOLDERS OF LIGHTWAVE COMMUNICATIONS ARE OPERATING A BUSINESS THAT COMPETES WITH US. IF WE ARE UNSUCCESSFUL IN OUR PENDING LITIGATION AGAINST THIS COMPANY, AND THESE FORMER LIGHTWAVE STOCKHOLDERS, OUR BUSINESS MAY BE HARMED

In June 2001, we acquired Lightwave Communications. Since that time, four of the founding stockholders and executive officers of Lightwave, as well as several other former employees of Lightwave, have begun operating a business that competes with us. Because these individuals held senior positions at Lightwave, and were exposed to confidential information about Lightwave, as well as Lantronix, if we are unsuccessful in our litigation against them, we may suffer substantial harm.

We filed this suit to protect the value of the assets we bought in the Lightwave acquisition. If the court refuses to enjoin their use of our confidential information, the former employees will be able to compete against

us in our markets for console servers, KVM and video display extenders.

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 recorded deferred compensation forfeitures of $78,000 for the three months ended September 30, 2003. At September 30, 2003, a balance of $446,000 remains and will be amortized as follows: $343,000 for the remainder of fiscal 2004, $86,000 in fiscal 2005 and $17,000 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 HAVE EXCESS INVENTORIES AND THERE IS A RISK WE MAY BE UNABLE TO DISPOSE OF THEM.

Our products and therefore our inventories are subject to technological risk at any time either new products may enter the market or prices of competitive products may be introduced with more attractive features or at lower prices than ours. There is a risk that we may be unable to sell our inventory in a timely manner to avoid their becoming obsolete. As of September 30, 2003, our inventories including raw materials, finished goods and inventory at distributors were valued at $11.8 million and we had reserved $5.7 million against these inventories. As of June 30, 2003, our inventories, including raw materials, finished goods and inventory at distributors were valued at $14.0 million and we had reserved $8.0 million against these inventories. In the event we are required to substantially discount our inventory or are unable to sell our inventory in a timely manner, our operating results could be substantially harmed.

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

We outsource substantially all of our manufacturing to four third-party manufacturers, Varian, Inc., Irvine Electronics, Technical Manufacturing Corp. and Uni Precision Industrial Ltd. Our reliance on these third-party manufacturers exposes us to a number of significant risks, including:

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

- lack of guaranteed production capacity or product supply; and

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

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

expenses, risk material delays, or encounter other unexpected issues. For example, in the third quarter of fiscal 2003 we encountered product shortages related to the transition to a third-party manufacturer. This product shortage contributed to our net revenues falling below our publicly announced estimates.

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

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

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

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

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

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

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

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

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

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

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

We have in the past and may continue in the future to acquire businesses, client lists, products or technologies that we believe complement or expand our existing business. 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, a developer of client-side software applications. In August 2002, we acquired Stallion, an Australian based provider of solutions that enable Internet access, remote access and serial connectivity. 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;

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- 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, 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. 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 may 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 in Xanboo. As of September 30, 2003, we hold a 15.3% ownership interest with a net book value of $5.2 million, in Xanboo. This investment is speculative in nature, and there is risk that we could lose part or all of our investment.

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

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

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

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

OUR ENTRY INTO, AND INVESTMENT IN, THE HOME NETWORK MARKET HAS RISKS INHERENT IN RELYING ON ANY EMERGING MARKET FOR FUTURE GROWTH.

The success of our Premise SYS software and our investment in Xanboo are dependent on the development of a market for home networking. It is possible this home network market may develop slowly, or not at all, or that others could enter this market with superior product offerings that would impair our own success. We could lose some or all of our investment, or be unsuccessful in achieving significant revenues and therefore profitability, in these initiatives. If this were to occur, our operating results could be harmed, and our stock price could decline.

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

For the three months ended September 30, 2003, we incurred $2.0 million in

research and development expenses, which comprised 16.2% 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 39.6% of our net revenues for the three months ended September 30, 2003. One customer. Ingram Micro, Inc., accounted for approximately 13.4% and 10.5% of our net revenues for the three months ended September 30, 2003 and 2002, respectively. Another customer, Tech Data Corporation, accounted for approximately 10.3% and 9.7% of our net revenues for the three months ended September 30, 2003 and 2002, respectively. Accounts receivable attributable to these two domestic customers accounted for approximately 12.2% and 16.0% of total accounts receivable at September 30, 2003 and June 30, 2003, respectively. The number and timing of sales to our distributors have been difficult for us to predict. The loss or deferral of one or more significant sales in a quarter could harm our operating results. We have in the past, and might in the future, lose one or more major customers. If we fail to continue to sell to our major customers in the quantities we anticipate, or if any of these customers terminate our relationship, our reputation, the perception of our products and technology in the marketplace and the growth of our business could be harmed. The demand for our products from our OEM, VAR and systems integrator customers depends primarily on their ability to successfully sell their products that incorporate our device networking solutions technology. Our sales are usually completed on a purchase order basis and we have no long-term purchase commitments from our customers.

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

WE HAVE ESTABLISHED CONTRACTS AND OBLIGATIONS THAT WERE IMPLEMENTED WHEN WE ANTICIPATED HIGHER REVENUES AND ACTIVITIES.

We have several agreements that obligate us to facilities or services that are in excess of our current requirements and are at higher rates than could be obtained today. It may be necessary that we sublease or otherwise negotiate settlement of our obligations rather than perform on them as we originally expected. If we are unable to negotiate a favorable resolution to these contracts, we may be required to pay the entire cost of our obligations under the agreement, which could harm our business.

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 prices of components or our overhead costs increase. If this were to occur, our gross margins would decline. In addition, we may not be able to reduce the cost to manufacture our products to keep up with the decline in prices.

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 work with open

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

OUR INTELLECTUAL PROPERTY PROTECTION MIGHT BE LIMITED.

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

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

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

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

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

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

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 22.2% and 22.6% of net revenues for the three months ended September 30, 2003 and 2002, respectively. Net revenues from Europe represented 17.8% and 18.7% of our net revenues for the three months ended September 30, 2003 and 2002, 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;

- differing labor regulations;
- compliance with a wide variety of complex regulatory requirements;
- changes in a country's or region's political or economic conditions;
- greater difficulty in staffing and managing foreign operations; and
- increased financial accounting and reporting burdens and complexities.

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

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 DISCLOSURES ABOUT MARKET RISK

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

INTEREST RATE RISK

Our exposure to interest rate risk is limited to the exposure related to our cash and cash equivalents, marketable securities and our credit facilities, which is tied to market interest rates. As of September 30, 2003 and June 30, 2003, we had cash and cash equivalents of $8.9 million and $7.3 million, respectively, which consisted of cash and short-term investments with original maturities of ninety days or less, both domestically and internationally. As of September 30, 2003 and June 30, 2003, we had marketable securities of $4.6 million and $6.8 million, respectively, consisting of obligations of U.S. Government agencies, state, municipal and county government notes and bonds. We believe our marketable securities will decline in value by an insignificant amount if interest rates increase, and therefore would not have a material effect on our financial condition or results of operations.

FOREIGN CURRENCY RISK

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

INVESTMENT RISK

As of September 30, 2003 and June 30, 2003, we had a net investment of $5.2 million and $5.4 million, respectively, in Xanboo, a privately held company which can still be considered in the start-up or development stages. This investment is inherently risky as the market for the technologies or products they have under development are typically in the early stages and may never materialize. There is a risk that we could lose part or all of our investment.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures.

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Our chief executive officer and our chief financial officer, after evaluating our "disclosure controls and procedures" (as defined in Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-14(c) and 15-d-14(c)) as of a date (the "Evaluation Date") within 90 days before the filing date of this Quarterly Report on Form 10-Q, have concluded that as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

(b) Changes in internal controls.

Prior to the evaluation date, we had identified material weaknesses in our disclosure controls and procedures and have taken corrective actions. In certain cases, we have identified disclosure control and procedural process improvements that have been implemented, and will continue to be implemented after the evaluation date. For example, we have revised our process controls that will facilitate timely Securities and Exchange Commission filings and have implemented additional training. We continue to study, plan, and implement process changes in anticipation of new requirements related to Sarbanes-Oxley legislation and SEC and Nasdaq rules.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Intellectual Property

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 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.

SEC Investigation

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

Class Action Lawsuits

On May 15, 2002, Stephen Bachman filed a class action complaint entitled Bachman v. Lantronix, Inc., et al., No. 02-3899, in the U.S. District Court for the Central District of California against us and certain of our current and former officers and directors alleging violations of the Securities Exchange Act of 1934 and seeking unspecified damages. Subsequently, six similar actions were filed in the same court. Each of the complaints purports to be a class action lawsuit brought on behalf of persons who purchased or otherwise acquired our common stock during the period of April 25, 2001 through May 30, 2002, inclusive. The complaints allege that the defendants caused us to improperly recognize revenue and make false and misleading statements about our business. Plaintiffs further allege that the defendants materially overstated our reported financial results, thereby inflating our stock price during our securities offering in July 2001, as well as facilitating the use of our common stock as consideration in acquisitions. The complaints have subsequently been consolidated into a single action and the court has appointed a lead plaintiff. The lead plaintiff filed a consolidated amended complaint on January 17, 2003. The amended complaint now purports to be a class action brought on behalf of persons who purchased or otherwise acquired our common stock during the period of August 4, 2000 through May 30, 2002, inclusive. The amended complaint continues to assert that we and the individual officer and director defendants violated the 1934 Act, and also includes alleged claims that we and these officers and directors violated the Securities Act of 1933 arising from our Initial Public Offering in August 2000. We filed a motion to dismiss the additional allegations on March 3, 2003. The Court has taken the motion under submission. We have not yet answered the complaint, discovery has not commenced, and no trial date has been established.

Derivative Lawsuit

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

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

Securities Claims and Employment Claims Brought by the Co-Founders of USSC

On August 23, 2002, a complaint entitled Dunstan v. Lantronix, Inc., et al., was filed in the Circuit Court of the State of Oregon, County of Multnomah, against us and certain of our current and former officers and directors by the cofounders of USSC. The complaint and subsequently filed arbitration demand alleged Oregon state law claims for securities violations, fraud, and negligence, as well as other claims related to our acquisition of USSC. Plaintiffs sought more than $14.0 million in damages, interest, attorneys' fees,

costs, expenses, and an unspecified amount of punitive damages. The parties

participated in a mediation on June 30, 2003, and subsequently reached an agreement to settle the dispute. Pursuant to the parties' settlement agreement, we released to the plaintiffs approximately $400,000 in cash and 49,038 shares of our common stock that had been held in an escrow since December 2000 as part of the acquisition of USSC. On September 15, 2003, we also issued to the plaintiffs 1,726,703 additional shares of our common stock worth approximately $1.5 million, which was recorded in our results of operations as litigation settlement costs for the year ended June 30, 2003. In exchange, the plaintiffs released all claims against all defendants.

Employment Suit Brought by Former CFO and COO Steven Cotton

On September 6, 2002, Steven Cotton, our former CFO and COO, filed a complaint entitled Cotton v. Lantronix, Inc., et al., No. 02CC14308, in the Superior Court of the State of California, County of Orange. The complaint alleges claims for breach of contract, breach of the covenant of good faith and fair dealing, wrongful termination, misrepresentation, and defamation. The complaint seeks unspecified damages, declaratory relief, attorneys' fees and costs. Discovery has not commenced and no trial date has been established.

We filed a motion to dismiss on October 16, 2002, on the grounds that Mr. Cotton's complaints are subject to the binding arbitration provisions in Mr. Cotton's employment agreement. On January 13, 2003, the Court ruled that five of the six counts in Mr. Cotton's complaint are subject to binding arbitration. The court is staying the sixth count, for declaratory relief, until the underlying facts are resolved in arbitration. No arbitration date has been set.

Securities Claims Brought by Former Shareholders of Synergetic

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

Suit filed by Lantronix Against Logical Solutions, Inc.

On March 25, 2003, we filed in Connecticut state court (Judicial District of New Haven) a complaint entitled Lantronix, Inc. and Lightwave Communications, Inc. v. Logical Solutions, Inc., et. al. This is an action for unfair and deceptive trade practices, unfair competition, unjust enrichment, conversion, misappropriation of trade secrets and tortuous interference with contractual rights and business expectancies. We seek preliminary and permanent injunctive relief and damages. The individual defendants are all former employees of Lightwave Communications, a company that we acquired in June 2001. The Court held a non-jury trial October 10-17, 2003; closing arguments are set for November 14, 2003.

Other

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

Although we believe that the claims or any litigation arising therefrom will have no material impact on our business, all of the above matters are in either the pleading stage or the discovery stage, and we cannot predict their outcomes with certainty.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On August 23, 2002, a complaint entitled Dunstan v. Lantronix, Inc., et al., was filed in the Circuit Court of the State of Oregon, County of Multnomah, against us and certain of our current and former officers and directors by the cofounders of USSC. The complaint and subsequently filed arbitration demand alleged Oregon state law claims for securities violations, fraud, and negligence, as well as other claims related to our acquisition of USSC. Plaintiffs sought more than $14.0 million in damages, interest, attorney's fees, costs, expenses, and an unspecified amount of punitive damages. The parties participated in a mediation on June 30, 2003, and subsequently reached an agreement to settle the dispute. Pursuant to the parities' settlement agreement, we released to the plaintiffs approximately $400,000 in cash and 49,038 shares of our common stock that had been held in an escrow since December 2000 as part of the acquisition of USSC. On September 15, 2003, we also issued to the plaintiffs 1,726,703 additional shares of our common stock worth approximately

$1.5 million, which was recorded in our results of operations as litigation settlement costs for the year ended June 30, 2003. In exchange, the plaintiffs released all claims against all defendants.

In January 2002, we entered into a two-year line of credit with a bank in an amount not to exceed $20.0 million. Borrowings under the line of credit bear interest at either (i) the prime rate or (ii) the LIBOR rate plus 2.0%. We were required to pay a $100,000 facility fee of which $50,000 was paid upon the closing and $50,000 was to be paid. We are also required to pay a quarterly unused line fee of .125% of the unused line of credit balance. Since establishing the line of credit, we have twice reduced the amount of the line, modified customary financial covenants, and adjusted the interest rate to be charged on borrowings to the prime rate plus .50%, and eliminated the LIBOR option. Effective July 25, 2003, we further modified this line of credit, reducing the revolving line to $5.0 million, and adjusting the customary affirmative and negative covenants. We are also required to maintain certain financial ratios as defined in the agreement. The agreement has an annual revolving maturity date that renews on the effective date. The renewal $50,000 facility fee was reduced to $12,500 and was paid. Prior to any advances being made under the line of credit, the bank is required to complete a field examination to determine its borrowing base. To date, we have not borrowed against this line of credit. We are currently in compliance with the revised financial covenants of the July 25, 2003 amended line of credit. Pursuant to our line of credit, we are restricted from paying any dividends. We have secured two deposits totaling approximately $365,000 under our line of credit.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None

ITEM 5. OTHER INFORMATION

In accord with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002, the company is responsible for listing the non-audit services approved in the three months ended September 30, 2003, by the company's Audit Committee to be performed by the company's external auditor. Non-audit services are defined in the law as services other than those provided in connection with an audit or a review of the financial statements of the company. The Audit Committee did not engage the outside auditors in any non-audit related services in the three months ended September 30, 2003.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

EXHIBIT NUMBER	DESCRIPTION OF DOCUMENT
31.1	Certification of Principal Executive Officer.
31.2	Certification of Principal Financial Officer.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K
None.

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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 7th day of November, 2003.

LANTRONIX, INC.

By: /s/ James W. Kerrigan

JAMES W. KERRIGAN

CHIEF FINANCIAL OFFICER

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