BED BATH & BEYOND INC
Form 10-Q
October 07, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934**

For the quarterly period ended August 29, 2009

Commission File Number 0-20214

BED BATH & BEYOND INC.

(Exact name of registrant as specified in its charter)

New York	**11-2250488**
(State of incorporation)	(IRS Employer Identification No.)

650 Liberty Avenue, Union, New Jersey 07083

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: **908/688-0888**

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 o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x | Accelerated filer o

Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company o

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

Number of shares outstanding of the issuer s Common Stock:

Class	**Outstanding at August 29, 2009**
Common Stock - $0.01 par value	262,685,710

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BED BATH & BEYOND INC. AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION

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BED BATH & BEYOND INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(in thousands, except per share data)

(unaudited)

	August 29, 2009	February 28, 2009
Assets		
Current assets:		
Cash and cash equivalents	$ 1,035,601	$ 668,209
Short term investment securities	43,125	2,000
Merchandise inventories	1,755,377	1,642,339
Other current assets	289,101	250,251
Total current assets	3,123,204	2,562,799
Long term investment securities	157,193	221,134
Property and equipment, net	1,111,971	1,148,435
Other assets	343,070	336,475
Total assets	$ 4,735,438	$ 4,268,843
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	$ 682,936	$ 514,734
Accrued expenses and other current liabilities	264,066	247,508
Merchandise credit and gift card liabilities	163,338	165,621
Current income taxes payable	29,159	25,105
Total current liabilities	1,139,499	952,968
Deferred rent and other liabilities	236,107	227,209
Income taxes payable	98,928	88,212
Total liabilities	1,474,534	1,268,389
Shareholders equity:		
Preferred stock - $0.01 par value; authorized - 1,000 shares; no shares issued or outstanding		
Common stock - $0.01 par value; authorized - 900,000 shares; issued 318,723 and 314,678 shares, respectively; outstanding 262,686 and 259,701 shares, respectively	3,187	3,147
Additional paid-in capital	945,272	878,568
Retained earnings	4,377,624	4,154,921
Treasury stock, at cost; 56,037 and 54,977 shares, respectively	(2,064,711)	(2,031,642)
Accumulated other comprehensive loss	(468)	(4,540)
Total shareholders equity	3,260,904	3,000,454
Total liabilities and shareholders equity	$ 4,735,438	$ 4,268,843

See accompanying Notes to Consolidated Financial Statements.

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BED BATH & BEYOND INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(in thousands, except per share data)

(unaudited)

	Three Months Ended		Six Months Ended	
	August 29, 2009	**August 30, 2008**	**August 29, 2009**	**August 30, 2008**
Net sales	$ 1,914,909	$ 1,853,892	$ 3,609,249	$ 3,502,383
Cost of sales	1,141,516	1,114,571	2,169,038	2,107,062
Gross profit	773,393	739,321	1,440,211	1,395,321
Selling, general and administrative expenses	551,362	551,900	1,075,876	1,089,081
Operating profit	222,031	187,421	364,335	306,240
Interest income	1,476	2,946	3,243	7,476
Earnings before provision for income taxes	223,507	190,367	367,578	313,716
Provision for income taxes	87,976	71,099	144,875	117,671
Net earnings	$ 135,531	$ 119,268	$ 222,703	$ 196,045
Net earnings per share - Basic	$ 0.53	$ 0.46	$ 0.87	$ 0.76
Net earnings per share - Diluted	$ 0.52	$ 0.46	$ 0.86	$ 0.76
Weighted average shares outstanding - Basic	257,814	256,726	257,378	256,680
Weighted average shares outstanding - Diluted	259,940	258,979	259,352	259,121

See accompanying Notes to Consolidated Financial Statements.

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BED BATH & BEYOND INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(in thousands, unaudited)

	Six Months Ended August 29, 2009	Six Months Ended August 30, 2008
Cash Flows from Operating Activities:		
Net earnings	$ 222,703	$ 196,045
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	89,746	87,138
Stock-based compensation	22,137	21,604
Tax benefit from stock-based compensation	(964)	266
Deferred income taxes	(13,943)	(17,565)
Other	(12)	155
(Increase) decrease in assets:		
Merchandise inventories	(113,038)	(193,332)
Trading investment securities	(4,071)	(1,740)
Other current assets	(32,756)	(34,906)
Other assets	302	(928)
Increase (decrease) in liabilities:		
Accounts payable	183,176	102,476
Accrued expenses and other current liabilities	19,123	(2,907)
Merchandise credit and gift card liabilities	(2,283)	(921)
Income taxes payable	11,318	(61)
Deferred rent and other liabilities	10,968	12,725
Net cash provided by operating activities	392,406	168,049
Cash Flows from Investing Activities:		
Redemption of available-for-sale investment securities	27,245	31,350
Capital expenditures	(67,631)	(106,711)
Investment in unconsolidated joint venture, including fees		(4,764)
Net cash used in investing activities	(40,386)	(80,125)
Cash Flows from Financing Activities:		
Proceeds from exercise of stock options	45,663	12,779
Excess tax benefit from stock-based compensation	2,778	4,394
Repurchase of common stock, including fees	(33,069)	(40,625)
Net cash provided by (used in) financing activities	15,372	(23,452)
Net increase in cash and cash equivalents	367,392	64,472
Cash and cash equivalents:		
Beginning of period	668,209	224,084
End of period	$ 1,035,601	$ 288,556

See accompanying Notes to Consolidated Financial Statements.

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BED BATH & BEYOND INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

1) Basis of Presentation

The accompanying consolidated financial statements have been prepared without audit. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals and elimination of intercompany balances and transactions) necessary to present fairly the financial position of Bed Bath & Beyond Inc. and subsidiaries (the Company) as of August 29, 2009 and February 28, 2009 and the results of its operations for the three and six months ended August 29, 2009 and August 30, 2008, respectively, and its cash flows for the six months ended August 29, 2009 and August 30, 2008, respectively.

The accompanying unaudited consolidated financial statements are presented in accordance with the requirements for Form 10-Q and consequently do not include all the disclosures normally required by U.S. generally accepted accounting principles (GAAP). Reference should be made to Bed Bath & Beyond Inc. s Annual Report on Form 10-K for the fiscal year ended February 28, 2009 for additional disclosures, including a summary of the Company s significant accounting policies, and to subsequently filed Forms 8-K.

The Company exhibits less seasonality than many other retail businesses, although sales levels are generally higher in August, November and December, and generally lower in February and October.

The Company has evaluated subsequent events through October 7, 2009, the filing date of this Form 10-Q with the Securities and Exchange Commission (SEC).

2) Recent Accounting Pronouncements

In December 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) SFAS 132(R)-1, Employers Disclosures about Postretirement Benefit Plan Assets. FSP SFAS 132(R)-1 amends Statement of Financial Accounting Standards (SFAS) No. 132 (revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits an amendment of FASB Statements No. 87, 88 and 106. FSP SFAS 132(R)-1 requires more detailed disclosures about the assets of a defined benefit pension or other postretirement plan. FSP SFAS 132(R)-1 is effective for fiscal years ending after December 15, 2009. The Company does not believe FSP SFAS 132(R)-1 will have a material impact on its consolidated financial statements.

In April 2009, the FASB issued FSP SFAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, which amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments and Accounting Principles Board (APB) Opinion No. 28, Interim

Financial Reporting. This FSP requires the annual disclosures about the fair value of financial instruments required by SFAS No. 107 to be presented in interim financial statements. The Company adopted FSP SFAS 107-1 and APB 28-1 during the second quarter of fiscal 2009. The adoption of FSP SFAS 107-1 and APB 28-1 did not have a material impact on the Company s consolidated financial statements (See Fair Value Measurements, Note 3).

In April 2009, the FASB issued FSP SFAS 115-2 and SFAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, which modifies the recognition requirements for other-than-temporary impairments of debt securities and enhances existing disclosures with respect to other-than-temporary impairments of debt and equity securities. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The Company adopted FSP SFAS 115-2 and SFAS 124-2 during the second quarter of fiscal 2009. The adoption of FSP SFAS 115-2 and SFAS 124-2 did not have a material impact on the Company s consolidated financial statements (See Investment Securities, Note 5).

In April 2009, the FASB issued FSP SFAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, which provides guidance for determining fair value when there is no active market or where the price inputs being used represent distressed sales, and also amends the interim and annual disclosure requirements of SFAS No. 157, Fair Value Measurements. The Company adopted FSP SFAS 157-4 during the second quarter of fiscal 2009. The adoption of FSP SFAS 157-4 did not have a material impact on the Company s consolidated financial statements (See Fair Value Measurements, Note 3).

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In May 2009, the FASB issued SFAS No. 165, Subsequent Events. SFAS No. 165 was issued in order to establish principles and requirements for reviewing and reporting subsequent events and requires disclosure of the date through which subsequent events are evaluated and whether the date corresponds with the time at which the financial statements were available for issue or were issued. The Company adopted SFAS No. 165 during the second quarter of fiscal 2009. The adoption of SFAS No. 165 did not have a material impact on the Company s consolidated financial statements (See Basis of Presentation, Note 1).

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles-a replacement of FASB Statement No. 162, which established the FASB Accounting Standards Codification (Codification) as the exclusive source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the SEC are also considered sources of authoritative GAAP for SEC registrants. The Codification supersedes all existing non-SEC accounting and reporting standards, however it does not change current GAAP. SFAS No. 168 is effective for interim and annual periods ending after September 15, 2009. The Company does not believe SFAS No. 168 will have a material impact on its consolidated financial statements.

3) Fair Value Measurements

The Company adopted SFAS No. 157, Fair Value Measurements, for financial assets and liabilities on March 2, 2008 and for non-financial assets and liabilities on March 1, 2009. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The adoption of SFAS No. 157 for financial and non-financial assets and liabilities did not have a material impact on the Company s consolidated financial statements.

Under SFAS No. 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e. the exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various valuation approaches, including quoted market prices and discounted cash flows. SFAS No. 157 also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from independent sources. Unobservable inputs are inputs that reflect a company s judgment concerning the assumptions that market participants would use in pricing the asset or liability developed based on the best information available under the circumstances. The fair value hierarchy is broken down into three levels based on the reliability of inputs as follows:

- Level 1 Valuations based on quoted prices in active markets for identical instruments that the Company is able to access. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

- Level 2 Valuations based on quoted prices in active markets for instruments that are similar, or quoted prices in markets that are not active for identical or similar instruments, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

- Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

As of August 29, 2009, the Company s financial assets utilizing Level 1 inputs include long term investment securities traded on active securities exchanges. The Company did not have any financial assets utilizing Level 2 inputs. Financial assets utilizing Level 3 inputs included short term and long term investments in auction rate securities consisting of preferred shares of closed end municipal bond funds and securities collateralized by student loans, and a related put option (See Investment Securities, Note 5).

To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the Company s degree of judgment exercised in determining fair value is greatest for instruments categorized in Level 3. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, SFAS No. 157 requires that an asset or liability be classified in its entirety based on the lowest level of input that is significant to the measurement of fair value.

SFAS No. 157 requires that the valuation techniques used by the Company must be consistent with at least one of the

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three possible approaches: the market approach, income approach and/or cost approach. The Company s Level 1 valuations are based on the market approach and consist primarily of quoted prices for identical items on active securities exchanges. The Company s Level 3 valuations of auction rate securities are based on the income approach, specifically, discounted cash flow analyses which utilize significant inputs based on the Company s estimates and assumptions. Inputs include current coupon rates and expected maturity dates.

The following table presents the valuation of the Company s financial assets as of August 29, 2009 measured at fair value on a recurring basis by the input levels prescribed by SFAS No. 157:

(in millions)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Unobservable Inputs (Level 3)	Total
Short term - trading securities:			
Auction rate securities	$	$ 41.2	$ 41.2
Short term - put option		1.9	1.9
Long term - available-for-sale securities:			
Auction rate securities		146.6	146.6
Long term - trading securities:			
Nonqualified deferred compensation plan assets	10.5		10.5
Total	$ 10.5	$ 189.7	$ 200.2

The following table presents the changes in the Company s financial assets that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3):

(in millions)	Auction Rate Securities	Put Option	Total Significant Unobservable Inputs (Level 3)
Balance on February 28, 2009, net of temporary valuation adjustment	$ 212.8	$ 1.8	$ 214.6
Change in temporary valuation adjustment included in accumulated other comprehensive loss	0.3		0.3
Unrealized loss included in earnings (1)	(0.1)		(0.1)
Change in valuation of Put Option		0.1	0.1
Redemptions at par	(25.2)		(25.2)
Balance on August 29, 2009, net of temporary valuation adjustment	$ 187.8	$ 1.9	$ 189.7

(1) Represents the amount of total losses for the period included in earnings relating to assets still held on August 29, 2009.

Fair Value of Financial Instruments

The Company s financial instruments include cash and cash equivalents, investment securities, accounts payable and certain other liabilities. The Company s investment securities consist primarily of auction rate securities which are stated at their approximate fair value. The book value of all financial instruments is representative of their fair values.

4) Cash and Cash Equivalents

Included in cash and cash equivalents are credit and debit card receivables from banks, which typically settle within 5 business days, of $64.3 million and $51.8 million as of August 29, 2009 and February 28, 2009, respectively.

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5) Investment Securities

The Company s investment securities as of August 29, 2009 and February 28, 2009 are as follows:

(in millions)	August 29, 2009	February 28, 2009
Available-for-sale securities:		
Short term	$	$ 2.0
Long term	146.6	171.4
Trading securities:		
Short term	41.2	
Long term	10.5	47.8
Held-to-maturity securities:		
Long term	0.1	0.1
Put option:		
Short term	1.9	
Long term		1.8
Total investment securities	$ 200.3	$ 223.1

Auction Rate Securities

As of August 29, 2009 and February 28, 2009, the Company s available-for-sale investment securities represented approximately $148.9 million and approximately $176.0 million par value of auction rate securities, respectively, less temporary valuation adjustments of approximately $2.3 million and $2.6 million, respectively. Since these valuation adjustments are deemed to be temporary, they are recorded in accumulated other comprehensive loss, net of a related tax benefit, and did not affect the Company s earnings. These securities at par are invested in preferred shares of closed end municipal bond funds, which are required, pursuant to the Investment Company Act of 1940, to maintain minimum asset coverage ratios of 200%. All of these available-for-sale investments carried triple-A credit ratings from one or more of the major credit rating agencies as of August 29, 2009 and February 28, 2009, and none of them are mortgage-backed debt obligations. The Company believes that the unrealized losses are temporary and reflect the investments current lack of liquidity. As of August 29, 2009 and February 28, 2009, the Company s available-for-sale investments have been in a continuous unrealized loss position for 12 months or more. Due to their lack of liquidity, the Company classified $146.6 million and $171.4 million of these investments as long term investment securities at August 29, 2009 and February 28, 2009, respectively.

As of August 29, 2009 and February 28, 2009, the Company s trading investment securities included approximately $41.2 million at fair value ($43.1 million at par) and $41.4 million at fair value ($43.2 million at par), respectively, of auction rate securities which are invested in securities collateralized by student loans. As of August 29, 2009 and February 28, 2009, these securities were more than 100% collateralized with approximately 90% of such collateral in the aggregate being guaranteed by the United States government. All of these trading investment securities also carried triple-A ratings from one or more of the major credit rating agencies as of August 29, 2009 and February 28, 2009. During the first six months of fiscal 2009, the Company recognized a pre-tax unrealized loss of approximately $0.1 million in the consolidated statement of earnings to reflect the decrease in the fair value of these securities. In the third quarter of fiscal 2008, the Company entered into an agreement (the Agreement) with the investment firm that sold the Company these securities. By entering into the Agreement, the Company (1) received the right (Put Option) to sell these auction rate securities back to the investment firm at par, at its sole discretion, anytime during the period from

June 30, 2010 through July 2, 2012, and (2) gave the investment firm the right to purchase these auction rate securities or sell them on the Company s behalf at par anytime after the execution of the Agreement through July 2, 2012. The Company elected to measure the Put Option under the fair value option of SFAS No. 159 and recorded it as a long term investment. As of August 29, 2009, the fair value of the Put Option was approximately $1.9 million and during the first six months of fiscal 2009, the Company recorded pre-tax income of approximately $0.1 million to reflect the increase in its fair value. The recording of the change in fair value of the Put Option and these securities resulted in no net impact to the consolidated statement of earnings for the first six months of fiscal 2009. The Company anticipates that any future changes in the fair value of the Put Option will be offset by the changes in the fair value of the related auction rate securities with no material impact to the consolidated statement of earnings.

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Because the Company intends to exercise its Put Option right as soon as practicably possible within one year, these securities of $41.2 million and the related Put Option of $1.9 million were classified as short term investment securities as of August 29, 2009.

During the six months ended August 29, 2009, approximately $27.2 million of auction rate securities were redeemed at par.

Other trading investment securities

The Company s other trading investment securities, which are provided as investment options to the participants of the nonqualified deferred compensation plan, are stated at fair market value. The values of these trading investment securities included in the table above are approximately $10.5 million and $6.4 million as of August 29, 2009 and February 28, 2009, respectively.

6) Property and Equipment

As of August 29, 2009 and February 28, 2009, included in property and equipment, net is accumulated depreciation and amortization of $1.1 billion.

7) Stock-Based Compensation

The Company records stock-based compensation under the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), which requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. Currently, the Company s stock-based compensation relates to restricted stock awards and stock options. The Company s restricted stock awards are considered nonvested share awards as defined under SFAS No. 123R.

Stock-based compensation expense for the three and six months ended August 29, 2009 was approximately $11.1 million ($6.7 million after tax or $0.03 per diluted share) and approximately $22.1 million ($13.4 million after tax or $0.05 per diluted share), respectively. Stock-based compensation expense for the three and six months ended August 30, 2008 was approximately $11.2 million ($7.0 million after tax or $0.03 per diluted share) and approximately $21.6 million ($13.5 million after tax or $0.05 per diluted share), respectively. In addition, the amount of stock-based compensation cost capitalized for the six months ended August 29, 2009 and August 30, 2008 was approximately $0.6 million.

Incentive Compensation Plans

The Company currently grants awards under the Bed Bath & Beyond 2004 Incentive Compensation Plan (the 2004 Plan). The 2004 Plan is a flexible compensation plan that enables the Company to offer incentive compensation through stock options, restricted stock awards, stock appreciation rights and performance awards, including cash awards. Under the 2004 Plan, grants are determined by the Compensation Committee for those awards granted to executive officers and by an appropriate committee for all other awards granted. Awards of stock options and restricted stock generally vest in five equal annual installments beginning one to three years from the date of grant. The Company generally issues new shares for stock option exercises and restricted stock awards.

As of August 29, 2009, unrecognized compensation expense related to the unvested portion of the Company s stock options and restricted stock awards was $34.4 million and $113.3 million, respectively, which is expected to be recognized over a weighted average period of 3.0 years and 4.8 years, respectively.

Stock Options

Stock option grants are issued at fair market value on the date of grant and generally become exercisable in five equal annual installments beginning one to three years from the date of grant. Option grants for stock options issued prior to May 10, 2004 expire ten years after the date of grant. Option grants for stock options issued since May 10, 2004 expire eight years after the date of grant. All option grants are nonqualified.

The fair value of the stock options granted was estimated on the date of the grant using a Black-Scholes option-pricing model that uses the assumptions noted in the following table. During the first quarter of fiscal 2009, the Company granted approximately 0.7 million stock options. No stock options were granted during the second quarter of fiscal 2009.

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Black-Scholes Valuation Assumptions (1)	Six Months Ended August 29, 2009	August 30, 2008
Weighted Average Expected Life (in years) (2)	6.3	6.1
Weighted Average Expected Volatility (3)	40.39%	34.13%
Weighted Average Risk Free Interest Rates (4)	2.45%	3.17%
Expected Dividend Yield		

(1) Forfeitures are estimated based on historical experience.

(2) The expected life of stock options is estimated based on historical experience.

(3) Expected volatility is based on the average of historical and implied volatility. The historical volatility is determined by observing actual prices of the Company s stock over a period commensurate with the expected life of the awards. The implied volatility represents the implied volatility of the Company s call options, which are actively traded on multiple exchanges, had remaining maturities in excess of twelve months, had market prices close to the exercise prices of the employee stock options and were measured on the stock option grant date.

(4) Based on the U.S. Treasury constant maturity interest rate whose term is consistent with the expected life of the stock options.

Changes in the Company s stock options for the six months ended August 29, 2009 were as follows:

(Shares in thousands)	Number of Stock Options	Weighted Average Exercise Price
Options outstanding, beginning of period	17,482	$ 32.418.

Comprehensive Income (Loss)

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

	Three Months Ended September 30, 2010 (In thousands)	2009
Net loss	$ (678)	$ (499)
Other comprehensive income (loss):		
Change in translation adjustments, net of taxes of $0	-	47
Total comprehensive loss	$ (678)	$ (452)

9. Litigation

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

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

Cautionary Statement

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

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

Overview

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

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

Products and Solutions

Device Enablement Solutions

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

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

Device Management Solutions

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

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

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

Other Products

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

Financial Highlights and Other Information for the Fiscal Quarter Ended September 30, 2010

The following is a summary of the key factors and significant events that impacted our financial performance during the fiscal quarter ended September 30, 2010:

- Net revenue was $12.2 million for the fiscal quarter ended September 30, 2010, an increase of $1.2 million or 11.3%, compared to $11.0 million for the fiscal quarter ended September 30, 2009. The increase was primarily the result of a $1.1 million, or 13.1%, increase in sales of our device enablement product lines and a $155,000, or 7.7%, increase in sales of our device management product lines, in both cases primarily due to increased unit sales.

- Gross profit margin was 51.1% for the fiscal quarter ended September 30, 2010, compared to 52.2% for the fiscal quarter ended September 30, 2009. The decrease in gross profit margin as a percent of net revenue was due to a change in product mix during the quarter, an increase in freight costs due to expediting charges relating to component and product shortages, transitional costs associated with the implementation of third-party logistics providers in Los Angeles and Hong Kong for inventory management, and an increase in payroll costs. Although payroll costs were higher during the three months ended September 30, 2010, they actually returned to normal levels due to the suspension of a company-wide furlough program that was in effect during the three months ended September 30, 2009.

- Loss from operations was $667,000 for the fiscal quarter ended September 30, 2010, compared to $406,000 for the fiscal quarter ended September 30, 2009. The loss from operations in the current fiscal quarter was negatively impacted by approximately $200,000 in legal and consulting expenses related to the proxy contest initiated by a dissident director and shareholder.

    - Net loss was $678,000, or $0.07 per basic and diluted share, for the fiscal quarter ended September 30, 2010, compared to $499,000, or $0.05 per basic and diluted share, for the fiscal quarter ended September 30, 2009. The net loss in the current fiscal quarter was negatively impacted by approximately $200,000 in legal and consulting expenses related to the proxy contest.

- Cash and cash equivalents were $10.5 million as of September 30, 2010, an increase of $383,000, compared to $10.1 million as of June 30, 2010.

- Net accounts receivable were $1.8 million as of September 30, 2010, an increase of $423,000, compared to $1.3 million as of June 30, 2010. Days sales outstanding (“DSO”) in receivables were 11 days for the fiscal quarter ended September 30, 2010 compared to 15 days for the fiscal quarter ended June 30, 2010. Our accounts receivable and DSO are primarily affected by the timing of shipments within a quarter, our collections performance and the fact that a significant portion of our revenues are recognized on a sell-through basis (upon shipment from distributor inventories rather than as goods are shipped by us to distributors).

- Net inventories were $7.5 million as of September 30, 2010, compared to $6.9 million as of June 30, 2010. Inventory turns were 3.3 turns for the fiscal quarter ended September 30, 2010 compared to 3.5 turns for the fiscal quarter ended June 30, 2010.

Critical Accounting Policies and Estimates

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

Recent Accounting Pronouncements

In September 2009, the FASB reached a consensus on Accounting Standards Update (“ASU”) 2009-13, Revenue Recognition (Topic 605) – Multiple-Deliverable Revenue Arrangements (“ASU 2009-13”) and ASU 2009-14, Software (Topic 985) – Certain Revenue Arrangements That Include Software Elements (“ASU 2009-14”). ASU 2009-13 modifies the requirements that must be met for an entity to recognize revenue from the sale of a delivered item that is part of a multiple-element arrangement when other items have not yet been delivered. ASU 2009-13 eliminates the requirement that all undelivered elements must have either: (1) vendor-specific objective evidence ("VSOE") or (2) third-party evidence ("TPE") before an entity can recognize the portion of an overall arrangement consideration that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. Overall arrangement consideration will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. The residual method of allocating arrangement consideration has been eliminated. ASU 2009-14 modifies the software revenue recognition guidance to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. These new updates are effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We adopted the provisions of this quidance effective July 1, 2010, which did not have a material impact on our financial statements.

Consolidated Results of Operations

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

	Three Months Ended September 30, 2010	2009
Net revenues	100.0%	100.0%
Cost of revenues	48.9%	47.8%
Gross profit	51.1%	52.2%
Operating expenses:		
Selling, general and administrative	41.4%	42.2%
Research and development	15.0%	13.6%
Amortization of purchased intangible assets	0.1%	0.2%
Total operating expenses	56.5%	55.9%
Loss from operations	(5.5%)	(3.7%)
Interest expense, net	(0.2%)	(0.4%)
Other income (expense), net	0.2%	(0.3%)
Loss before income taxes	(5.4%)	(4.5%)
Provision for income taxes	0.1%	0.1%
Net loss	(5.6%)	(4.6%)

Comparison of the Fiscal Quarters Ended September 30, 2010 and 2009

Net Revenue by Product Line

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

	Three Months Ended September 30, 2010	% of Net Revenue	2009	% of Net Revenue	Change $	%
	(In thousands, except percentages)					
Device enablement	$ 9,883	81.1%	$ 8,740	79.8%	$ 1,143	13.1%
Device management	2,158	17.7%	2,003	18.3%	155	7.7%
Device networking	12,041	98.8%	10,743	98.1%	1,298	12.1%
Non-core	151	1.2%	211	1.9%	(60)	(28.4%)
Net revenue	$ 12,192	100.0%	$ 10,954	100.0%	$ 1,238	11.3%

The increase in net revenue for the three months ended September 30, 2010, compared to the three months ended September 30, 2009 was the result of an increase in net revenue from our device enablement and device management product lines, partially offset by a decrease in net revenue from our non-core product lines. The increase in net revenue from our device enablement product line was due to an increase in unit sales of some of our embedded device enablement products, in particular our XPort and ASIC product families, partially offset by a decrease in unit sales of some of our external device enablement products, in particular our WiBox and MSS product families. The increase in net revenue from our device management product line was due to an increase in unit sales of our SLS, SCS and DSM product families.

Net Revenue by Geographic Region

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

	Three Months Ended September 30,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Americas	$ 6,571	53.9%	$ 6,251	57.1%	$ 320	5.1%
EMEA	3,531	29.0%	2,909	26.6%	622	21.4%
Asia Pacific	2,090	17.1%	1,794	16.3%	296	16.5%
Net revenue	$ 12,192	100.0%	$ 10,954	100.0%	$ 1,238	11.3%

The increase in net revenue for the three months ended September 30, 2010 compared to the three months ended September 30, 2009 reflects increased unit sales across all geographic regions. The increase in net revenue from the Americas region was due to an increase in unit sales of our device management and device enablement product lines. The increase in net revenue from the Europe, Middle East and Africa (the “EMEA”) region was due to an increase in unit sales in our device enablement product lines, partially offset by a decrease in unit sales of our device management product lines. The increase in net revenue in the Asia Pacific region was due to an increase in unit sales of our device management and device enablement product lines.

Gross Profit

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

The following table presents fiscal quarter gross profit:

	Three Months Ended September 30,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Gross profit	$ 6,227	51.1%	$ 5,717	52.2%	$ 510	8.9%

The decrease in gross profit as a percent of net revenue (referred to as “gross margin”) for the three months ended September 30, 2010, compared to the three months ended September 30, 2009 was due to a change in product mix during the quarter primarily related to an increase in unit sales of embedded device enablement products, an increase in freight costs due to expediting charges relating to component and product shortages, transitional costs associated with the implementation of third-party logistics providers in Los Angeles and Hong Kong for inventory management, and an increase in payroll costs. Although payroll costs were higher during the three months ended September 30, 2010, they actually returned to normal levels due to the suspension of a company-wide furlough program that was in effect during the three months ended September 30, 2009.

Selling, General and Administrative

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

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

	Three Months Ended September 30,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 2,557		$ 2,398		$ 159	6.6 %
Professional fees and outside services	806		616		190	30.8 %
Advertising and marketing	450		458		(8)	(1.7 %)
Facilities	257		328		(71)	(21.6 %)
Share-based compensation	408		423		(15)	(3.5 %)
Depreciation	165		133		32	24.1 %
Bad debt expense	1		(5)		6	120.0 %
Other	409		269		140	52.0 %
Selling, general and administrative	$ 5,053	41.4%	$ 4,620	42.2%	$ 433	9.4 %

In order of significance, the increase in selling, general and administrative expenses for the three months ended September 30, 2010, compared to the three months ended September 30, 2009 was primarily due to: (i) an increase in professional fees and outside services due to increased legal and consulting expenses as a result of the proxy contest, (ii) an increase in personnel-related expenses, and (iii) an increase in other expenses due to an increase in state franchise tax and travel expenses. As noted above, higher payroll costs reflect a return to normal levels following cessation of a company-wide furlough program.

We estimate that professional fees for the proxy contest could range between $300,000 to $500,000 during the three months ended December 31, 2010. This will likely result in larger net losses.

Research and Development

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

The following table presents fiscal quarter research and development expenses:

	Three Months Ended September 30,				Change	
	2010	% of Net Revenue	2009	% of Net Revenue	$	%
	(In thousands, except percentages)					
Personnel-related expenses	$ 1,123		$ 973		$ 150	15.4 %
Facilities	267		244		23	9.4 %
Professional fees and outside	191		48		143	297.9 %

services										
Share-based compensation		150			127			23		18.1 %
Depreciation		12			16			(4)		(25.0 %)
Other		80			77			3		3.9 %
Research and development	$	1,823	15.0%	$	1,485	13.6%	$	338		22.8 %

In order of significance, the increase in research and development expenses for the three months ended September 30, 2010, compared to the three months ended September 30, 2009 was primarily due to: (i) an increase in personnel-related expenses (for the reason stated above) and (ii) an increase in professional fees and outside services related to development projects for upcoming product releases. Research and development expenses could increase as we continue to invest in new development efforts.

Provision for Income Taxes

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

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

	Three Months Ended September 30, 2010	2009
Effective tax rate	3%	2%

We utilize the liability method of accounting for income taxes. The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from our domestic losses being recorded with a fully reserved tax benefit, as well as the effect of foreign earnings taxed at rates differing from the federal statutory rate. We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. As a result of our cumulative losses, we provided a full valuation allowance against our domestic net deferred tax assets for the fiscal quarters ended September 30, 2010 and 2009.

Liquidity and Capital Resources

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

	September 30, 2010	June 30, 2010	Increase (Decrease)
	(In thousands)		
Working capital	$ 8,677	$ 7,623	$ 1,054
Cash and cash equivalents	$ 10,458	$ 10,075	$ 383

In order of significance, our working capital as of September 30, 2010 increased as compared to June 30, 2010, primarily due to: (i) an increase in inventory due to the timing of shipments and inventory receipts, (ii) an increase in accounts receivable as a result of the timing of shipments and cash collections, and (iii) and increase in cash due to the proceeds from the amended term loan. This was partially offset by an increase in accounts payable related to the increase in inventory.

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

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

Borrowings under the Loan Agreement bear interest at the greater of 4.25% or prime rate plus 0.75% per annum. Upon entering into the Loan Agreement, we paid a fully earned, non-refundable commitment fee of $20,000 and will pay an additional $15,000 on September 28, 2011, the first anniversary of the effective date of the Loan Agreement.

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

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

	September 30, 2010	June 30, 2010
	(In thousands)	
Term Loan	$ 2,000	$ 778
Amount Available under the Revolving Line	$ 1,562	$ 1,031
Outstanding letters of credit	$ 343	$ 343

As of September 30, 2010 and June 30, 2010, approximately $433,000 and $400,000, respectively, of our cash was held by our foreign subsidiaries in foreign bank accounts. Such cash may be unrestricted with regard to foreign liquidity needs; however, our ability to utilize a portion of this cash to satisfy liquidity needs outside of such foreign locations may be subject to approval by the foreign subsidiaries' board of directors.

Cash Flows for the Three Months Ended September 30

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

	Three Months Ended September 30, 2010	2009
	(In thousands)	
Net cash provided by (used in):		
Net loss	$ (678)	$ (499)
Non-cash operating expenses, net	868	745
Changes in operating assets and liabilities:		
Accounts receivable	(424)	191
Contract manufacturers' receivable	(128)	406
Inventories	(640)	(28)
Prepaid expenses and other current assets	125	11
Other assets	(37)	(14)
Accounts payable	467	172
Accrued payroll and related expenses	68	(313)
Warranty reserve	(31)	-
Restructuring reserve	-	(45)
Other liabilities	(242)	(152)
Cash received related to tenant incentives	32	-
Net cash (used in) provided by operating activities	(620)	474
Net cash used in investing activities	(83)	(205)
Net cash (used in) provided by financing activities	1,037	(340)
Effect of foreign exchange rate changes on cash	49	54
Increase (decrease) in cash and cash equivalents	$ 383	$ (17)

Operating activities used cash during the three months ended September 30, 2010. This was the result of a net loss and cash used by operating assets and liabilities, partially offset by non-cash operating expenses. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash used by operating activities included (i) an increase in inventories mainly due to the Company sourcing components directly to ensure supply and (ii) an increase in accounts receivable due to the timing of collections and linearity of sales, partially offset by an increase in accounts payable due to the timing of payments to vendors and an increase in inventory.

Operating activities provided cash during the three months ended September 30, 2009. This was the result of cash provided by operating assets and liabilities and non-cash operating expenses, partially offset by a net loss. Significant non-cash items included share-based compensation and depreciation. In order of significance, the changes in operating assets and liabilities that had a significant impact on the cash provided by operating activities included (i) a decrease in inventories due to the timing of shipments and receipts, (ii) a decrease in accounts receivable due to the timing of collections and linearity of sales, and (iii) an increase in accounts payable, partially offset by (iv) a decrease in accrued payroll and related expenses due to the timing of payment periods and (v) a decrease in other liabilities mainly due to a decrease in customer prepayments.

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Investing activities used cash during the three months ended September 30, 2010 and 2009, due to the purchase of property and equipment.

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

Financing activities used cash during the three months ended September 30, 2009, due to (i) minimum tax withholding paid on behalf of employees related to the vesting of restricted shares and (ii) payments on capital lease obligations and the term loan; partially offset by proceeds received on the exercise of stock option grants.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

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

(b) Changes in internal controls over financial reporting

There have been no changes in our internal controls over financial reporting identified during the fiscal quarter that ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

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

We could be negatively affected as a result of actions of a dissident director and activist shareholders.

We received notice from TL Investment GmbH, which is solely owned by Lantronix director, Bernhard Bruscha, of its intention to nominate an alternate slate for election to our Board of Directors at our 2010 annual stockholders meeting. In addition, TL Investment GmbH is contesting our proxy. TL Investment GmbH beneficially owns approximately 39% of our outstanding common stock. Since TL Investment GmbH has launched a proxy contest, our business could be adversely affected because:

- responding to proxy contests and other actions by activist stockholders can be costly and time-consuming, could be disruptive to our operations and could divert the attention of management and our employees from operating the business. For example, in connection with the contested proxy, we incurred approximately $200,000 in expenses during the fiscal quarter ended September 30, 2010 and anticipate spending between $300,000 to $500,000 on the proxy contest during the fiscal quarter ended December 31, 2010;

- perceived uncertainties as to our future direction may impact our existing or potential collaborations or strategic relationships; and

- if individuals are elected to our Board of Directors with their own specific agenda for the Company, it may adversely affect our ability to effectively and timely implement our strategic plan.

We have a history of losses.

We incurred a net loss of approximately $678,000 for the three months ended September 30, 2010. There can be no assurance that we will net profits in future periods. In addition, while we were cash flow positive in the recently completed quarter, there can be no assurance that we will be cash flow positive in future periods. In the event we fail to achieve profitability in future periods, the value of our common stock may decline. In addition, if we are unable to maintain positive cash flows, we would be required to seek additional funding, which may not be available on favorable terms, if at all.

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

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

- changes in business and economic conditions, including the recent global economic recession;
- changes in the mix of net revenue attributable to higher-margin and lower-margin products;
- customers' decisions to defer or accelerate orders;
- variations in the size or timing of orders for our products;
- changes in demand for our products;
- fluctuations in exchange rates;
- defects and other product quality problems;
- loss or gain of significant customers;
- short-term fluctuations in the cost or availability of our critical components;
- announcements or introductions of new products by our competitors;

- effects of terrorist attacks in the U.S. and abroad;
- natural disasters in the U.S. and abroad;
- changes in demand for devices that incorporate our products; and
- our customers' decisions to integrate network access and control directly onto their own platforms.

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

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

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

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

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

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

	Three Months Ended September 30,	
	2010	2009
Top five customers (1)(2)	42.3%	37.6%
Tech Data	8.2%	10.8%
Ingram Micro	13.6%	7.9%

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Current or future litigation could adversely affect us.

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

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

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

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

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

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

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

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

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

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

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

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

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

	Three Months Ended September 30,					
	2010	% of Net Revenue	2009	% of Net Revenue	Change $	Change %
	(In thousands, except percentages)					
Americas	$ 6,571	53.9%	$ 6,251	57.1%	$ 320	5.1%
EMEA	3,531	29.0%	2,909	26.6%	622	21.4%
Asia Pacific	2,090	17.1%	1,794	16.3%	296	16.5%
Net revenue	$ 12,192	100.0%	$ 10,954	100.0%	$ 1,238	11.3%

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

- unexpected changes in regulatory requirements, taxes, trade laws and tariffs;
- reduced protection for intellectual property rights in some countries;
- differing labor regulations;
- compliance with a wide variety of complex regulatory requirements;

- fluctuations in currency exchange rates;
- changes in a country’s or region’s political or economic conditions;
- effects of terrorist attacks abroad;
- greater difficulty in staffing and managing foreign operations; and
- increased financial accounting and reporting burdens and complexities.

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

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

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

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

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

	September 30, 2010	June 30, 2010
	(In thousands)	
Finished goods	$ 4,708	$ 4,258
Raw materials	1,825	1,390
Inventory at distributors	1,955	1,924
Large scale integration chips *	237	516
Inventories, gross	8,725	8,088
Reserve for excess and obsolete inventory	(1,216)	(1,215)
Inventories, net	$ 7,509	$ 6,873

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

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

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

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

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

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

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

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

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

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

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

Substantial litigation regarding intellectual property rights occurs frequently in our industry. For example, in May 2006, we settled a patent infringement lawsuit with Digi in which we signed an agreement with Digi to cross-license each other’s patents for six years. There is a risk that we will not be able to negotiate a new cross-license agreement when the current cross-license agreement expires in May 2012. The results of litigation are inherently uncertain, and adverse outcomes are possible. Adverse outcomes may have a material adverse effect on our business, financial condition or results of operations.

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

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

- be time-consuming, costly and/or result in litigation;
- divert management's time and attention from developing our business;
- require us to pay monetary damages, including treble damages if we are held to have willfully infringed;

- require us to enter into royalty and licensing agreements that we would not normally find acceptable;
- require us to stop selling or to redesign certain of our products; or
- require us to satisfy indemnification obligations to our customers.

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

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

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

- laws and contractual restrictions might not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies;
- other companies might claim common law trademark rights based upon use that precedes the registration of our marks;
- other companies might assert other rights to market products using our trademarks;
- policing unauthorized use of our products and trademarks is difficult, expensive and time-consuming, and we might be unable to determine the extent of this unauthorized use;
- courts may determine that our software programs use open source software in such a way that deprives the entire programs of intellectual property protection; and
- current federal laws that prohibit software copying provide only limited practical protection from software pirates.

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

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

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

Business interruptions could adversely affect our business.

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

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

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

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

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

Item 6. Exhibits

Exhibit Number	Description of Document
10.1	Amendment to Loan and Security Agreement
10.2	2010 Inducement Equity Incentive Plan
10.3	2010 Inducement Equity Incentive Plan Stock Option Agreement
31.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of

	the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*

* Furnished, not filed.

SIGNATURES

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

	LANTRONIX, INC. (Registrant)	
Date: November 8, 2010	By:	/s/ Jerry D. Chase Jerry D. Chase President and Chief Executive Officer (Principal Executive Officer)
	By:	/s/ Reagan Y. Sakai Reagan Y. Sakai Chief Financial Officer and Secretary (Principal Financial Officer)

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