LANTRONIX INC
Form 10-K
September 19, 2008

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

# FORM 10-K

(Mark One)
S ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended June 30, 2008

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________ to ________

Commission File Number 1-16027

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

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

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

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

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, $0.0001 par value | The NASDAQ Stock Market LLC |

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes £ No S

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes £ No S

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. £

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

| Large accelerated filer £ | Accelerated filer £ | Non-accelerated filed £ | Smaller reporting company S |
|---|---|---|---|

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

The aggregate market value of the registrant's common stock held by non-affiliates based upon the closing sales price of the common stock on December 31, 2007, as reported by the NASDAQ Capital Market, was approximately $21,060,000. Shares of common stock held by each current executive officer and director and by each person who is known by the registrant to own 5% or more of the outstanding common stock have been excluded from this computation in that such persons may be deemed to be affiliates of the registrant. Share ownership information of certain persons known by the registrant to own greater than 5% of the outstanding common stock for purposes of the preceding calculation is based solely on information on Schedule 13G filed with the Securities and Exchange Commission and is as of December 31, 2007. This determination of affiliate status is not a conclusive determination for other purposes.

As of September 15, 2008, there were 60,497,876 shares of the Registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Part III of this Form 10-K incorporate information by reference from portions of the registrant's 2008 Definitive Proxy Statement to be filed not later than 120 days after the close of the 2008 fiscal year.

LANTRONIX, INC.
ANNUAL REPORT ON FORM 10-K
For the Fiscal Year Ended June 30, 2008

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## FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the federal securities laws. Statements that are not purely historical should be considered forward-looking statements. Often they can be identified by the use of forward-looking words and phrases, such as "intend," "may," "will," "could," "project," "anticipate," "expect," "estimate," "co "potential," "plan," "forecasts," and the like. Statements concerning current conditions may also be forward-looking if they imply a continuation of current conditions. Examples of forward-looking statements include, but are not limited to, statements concerning industry trends, anticipated demand for our products, the impact of pending litigation, our overall business strategy, market acceptance of new products, future customer and sales developments, manufacturing forecasts, including the potential benefits of our contract manufacturers sourcing and supplying raw materials, the significant role of original equipment manufacturers in our business, the future cost and potential benefits of our research and development efforts and liquidity and cash resources forecasts.

Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Readers are urged to carefully review the cautionary statements made by the Company in this report concerning risks and other factors that may affect the Company's business and operating results, including those made in this report under the caption "Risk Factors," in Part I, Item 1A and elsewhere in this report as well as the Company's other reports filed with the Securities and Exchange Commission ("SEC"). We may from time to time make additional forward-looking statements in our filings with the SEC, in our reports to our stockholders and elsewhere. Readers are cautioned not to place undue reliance on these forward-looking statements. We do not undertake any obligation to update any forward-looking statement that may be made from time to time by us or on our behalf.

# PART I

## ITEM 1. BUSINESS

### Overview

We design, develop and market devices that make it possible to access, manage, control and configure electronic products over the Internet or other networks. We are a leader in providing innovative networking solutions. We were initially formed as “Lantronix,” a California corporation, in June 1989. We reincorporated as “Lantronix, Inc.,” a Delaware corporation, in May 2000.

We have a history of providing devices that enable information technology (“IT”) equipment to network using standard protocols for connectivity, including Ethernet and wireless. Our first device was a terminal server that allowed “dumb” terminals to connect to a network. Building on the success of our terminal servers, in 1991 we introduced a complete line of print servers that enabled users to inexpensively share printers over a network. Since then, we have continually refined our core technology and have developed additional innovative networking solutions that expand upon the business of providing our customers network connectivity. With the expansion of networking and the Internet, our technology focus has been increasingly broad and has expanded beyond IT equipment, so that our device solutions provide a product manufacturer with the ability to network its products within the industrial, service and commercial markets referred to as machine-to-machine (“M2M”) networking.

Our primary products and technology have focused on “device enablement” solutions that enable individual electronic products to be connected to a network and the data center market for “device management” solutions that connect or bridge groups of devices onto the network for the primary purpose of remote access. We are expanding our device management solutions to address applications outside the data center and have recently launched new products to help manage equipment at remote branch offices and a new product category that provides a reliable, single point of control and data flow management for potentially thousands of networked devices. Together, the device enablement and device management product lines constitute our growth strategy and make up our “device networking business.” In addition, we continue to sell certain older legacy “non-core” products which we expect to exit. Products within the non-core category include print servers, visualization (optically-based video extenders), serial terminal servers and serial cards for servers. Expansion of our business is directed at our device networking business and we no longer invest research and development or marketing resources in our non-core product lines.

Today, our solutions include fully integrated hardware and software devices, as well as software tools, to develop related customer applications. Because we deal with network connectivity, we provide solutions to extremely broad market segments, including information technology, security, industrial, retail, medical, building automation, transportation and others. Our technology is used to provide networking capabilities to products such as building heating ventilation and air conditioning systems, elevators, process control equipment, vending machines, thermostats, security cameras, RF ID readers, bar code scanners, scales, temperature sensors, blood analyzers, turnstiles, card readers, point of sale terminals, audio-visual projectors, time clocks, and virtually any product that has some form of electronic control capability.

We sell our products through a global network of distributors, resellers and manufacturer representatives, systems integrators, value-added resellers (“VARs”) and original equipment manufacturers (“OEMs”). In addition, we sell directly to select accounts.

Our common stock is currently traded on the NASDAQ Capital Market under the symbol LTRX.

Our worldwide headquarters is located in Irvine, California, and we have sales offices in France, Japan and Hong Kong. We also have employees (primarily sales) working from home offices in other areas of the world, including Germany, the United Kingdom, Japan and the Netherlands.

We provide information regarding our company and our products on our Internet website, www.lantronix.com.

Our Strategy

Our business strategy is based on our proven capability to develop fully integrated device enablement and remote connection solutions that increase the value of our customers' products and services by making it easy to access and monitor devices over the Internet or private local network. Our technology is easy to integrate and typically provides our customer's device with compatibility with industry-wide standards such as Ethernet, the Internet, WiFi, standard web browsers and enterprise security standards. By using our device enablement technology, customers can reduce basic data connection costs, reduce maintenance and repair costs, create differentiation based on better service and can create new revenue sources from device related services.



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This strategy is accomplished by providing our customers with hardware and software that connect devices to a network and intelligently manage and control them. With our 19 years of networking expertise, knowledge of industry trends and our capability to develop solutions based on open industry-standards, we believe we have been able to anticipate our customers' device networking technology requirements and offer solutions that enable them to achieve their connectivity objectives. By providing a complete solution of hardware and integrated software, we have been able to provide "turnkey" solutions for network enabling a device, eliminating the need for our customers to build expensive design and manufacturing expertise in-house. This results in savings to the customer both in terms of financial investment and time.

The following describes our M2M device networking product lines:

- Device Enablement – We offer an array of embedded and external device enablement solutions that enable integrators and manufacturers of electronic and electro-mechanical products to add network connectivity, manageability and control. Our customers' products emanate from a wide variety of applications within the M2M market, from blood analyzers that relay critical patient information directly to a hospital's information system, to simple devices such as time clocks, allowing the user to obtain information from these devices and to improve how they are managed and controlled. We also offer products such as multi-port device servers that enable devices outside the data center to cost effectively share the network connection and convert various protocols to industry standard interfaces such as Ethernet and the Internet.

- Device Management – We offer off-the-shelf appliances such as console servers, digital remote keyboard, video, mouse extenders, and power control products that enable IT professionals to remotely connect, monitor and control network infrastructure equipment, distributed branch office equipment and large groups of servers using highly secure out-of-band management technology. In addition, we offer off-the-shelf appliances that enable IT professionals to reliably, remotely and simply monitor, configure and manage multiple devices from a single point of control.

The following describes our non-core product line:

- Non-core – Over the years, we have innovated or acquired various product lines that are no longer part of our primary, core markets described above. In general, these non-core businesses represent decreasing markets and we minimize research and development in these product lines. Included in this category are terminal servers, visualization solutions, legacy print servers, software and other miscellaneous products. We have announced the end-of-life for almost all of our non-core products and expect a steep decline in non-core revenues in fiscal 2009 while we complete the exit of this product category.

Products

Device Enablement Solutions

Device networking is the technology that enables connectivity within a multitude of commercial and industrial vertical markets such as security, building automation, medical, industrial automation, point-of-sale and many others. We provide manufacturers, integrators and users with device enablement solutions that in some applications include the technology for products to be connected, managed and controlled over networks using standard protocols for connectivity, including wired Ethernet and WiFi wireless. As common, everyday products leverage the power of network connectivity, manufacturers and users are realizing the benefits of networking. Our device enablement solutions represent complete engineered solutions that dramatically shorten a manufacturer's development time to implement network connectivity, provide competitive advantages with new features, greatly reducing engineering and marketing risks. Our hardware solutions include large scale integration ("LSI") chips, embedded modules (embedded

web servers) for mounting into our customer's product (completed circuit boards or intelligent connectors with electronic components and the necessary connectors and software), and external hardware modules (device servers) with one or two ports that can be connected to the customer's product by cables. Embedded and external hardware modules incorporate a real-time operating system and application software required to make the devices effective. We also offer application- and industry-specific solutions for certain markets such as industrial device servers.

Our device servers allow a wide range of equipment to be quickly network-enabled without the need for intermediary gateways, workstations or PCs. Our device servers and web servers eliminate the high cost of ownership associated with networking, which frequently would otherwise require using PCs and workstations to perform connectivity and remote management functions. Our solutions contain high-performance processors capable of not only controlling the attached device, but in many cases are also capable of accumulating data and status. The accumulated data can then be formatted by the device server and presented to users via SNMP or e-mail. Our device servers have a built-in HTTP server, making them easy to manage using any standard Web browser.

In 2003, we introduced our XPort® embedded web server, which represented an improvement in technology and a reduction in physical size and price for this type of functionality. The thumb-sized XPort® is a self-contained network communications server and miniaturized web server enclosed within a rugged RJ-45 connector package, which can be embedded in virtually any electronic product. Products incorporating XPort® often have their own IP address on a network and can be configured to be accessible from any web browser, including a wireless PC or Internet-enabled cell phone, from anywhere in the world. The XPort® can serve up Internet-standard web pages, initiate e-mails for notifications or alerts, and can be configured to run other applications as defined and developed by the device manufacturer. XPort® makes it simple for a product manufacturer to connect, because the XPort® includes a complete, integrated solution with a 10/100 Base-T Ethernet connection, a reliable and proven operating system, an embedded web server, flexible firmware, a full TCP/IP protocol stack, and optional encryption. The relatively low price of the XPort®, and the speed and ease with which a manufacturer can design the device into its products, can make many products more attractive by cost-effectively providing network connectivity.

In March 2004, we introduced WiPort™, a wireless (and wired) embedded web server with substantially the same functionality as XPort®, but with an 802.11 standard wireless configuration for embedded application in products and situations where a wired Ethernet environment is not available or practical.

In August 2004, we introduced WiBox®, an external wireless device server. WiBox® dual-port device servers enable users to connect equipment to 802.11b/g networks via serial or Ethernet, quickly and easily. By merging wireless networking and Lantronix device server technology, WiBox® simplifies connectivity to devices in applications where mobility is required or cabling is impractical.

In January 2007, we introduced the XPort® Direct™, an embedded networking device gateway module and the latest offering in our XPort® family. The XPort® Direct™ embedded device gateway is a complete, miniaturized communications subsystem targeted at applications that need to move commands, status and information over IP networks or the Internet, to or from remote devices. The XPort® Direct™ is designed to bring Ethernet and Internet connectivity to new high-volume, cost-sensitive applications in commercial and consumer markets.

In February 2007, we introduced the IntelliBox®-I/O 2100, a fully programmable external device server, which automates the task of managing remote equipment and associated reporting. Powered by Lantronix EventTrak™ technology, the IntelliBox® enables customers to connect their industrial, commercial, medical, retail and security equipment to IP networks and the Internet to automatically monitor and respond to events in real-time with no human intervention.

In April 2007, we introduced the MatchPort™ b/g, our third generation, full-featured, secure, embedded wireless (802.11 b/g) networking device server module. With the MatchPort™ b/g, OEM manufacturers can easily design-in standards compliant, secure 802.11 b/g wireless connectivity giving their products mobility and remote management capabilities. MatchPort™ b/g is suited for a variety of vertical applications including telematics/transportation, security access control, building/industrial automation, medical, retail/POS and power/utilities metering.

We also offer products such as multi-port device servers that enable devices outside the data center to cost effectively share the network connection and convert various protocols to industry standard interfaces such as Ethernet and the Internet.

In July 2007, we introduced the expansion of our Industrial Device Networking product offerings with a new family of industrial Ethernet switches. The XPress-Pro SW™ series complements our current XPress line of industrial device servers by adding a line of five and eight-port managed and unmanaged hardened Ethernet switches.

In January 2008, we introduced the MatchPort(r) Pro, a networking solution for data sensitive, regulatory, and IT-driven applications that demand the safest and most reliable technology such as medical records, financial transactions, and government data. In addition, MatchPort b/g Pro features SmartRoam, a breakthrough technology from Lantronix that provides users a higher degree of reliability and mobility when moving throughout a building, warehouse, or even across campus-wide networks.

Device Management Solutions

Our device management solutions are single and muti-port products (up to 48 ports) that primarily 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 and terminal servers.



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

Our console servers provide system administrators and network managers a 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 in Unix, Linux servers and on special purpose data center equipment such as environmental monitoring/control systems, communications switches and storage devices. With remote access, system downtime can be reduced, improving business efficiency. Our console servers provide IT professionals with peace-of-mind through extensive security features, and in some cases, provisions for dial-in access via modem. These solutions are provided in various configurations and can manage up to 48 devices from one console server.

In addition, our ManageLinx™ device management solutions provide M2M service organizations with the tools they need to remotely connect many network-enabled devices. These enterprise level solutions provide secure connectivity making it simple to maintain, configure, monitor and control large device networking deployments. ManageLinx™ will be entering initial customer testing in fiscal 2008

In September 2005, we introduced SecureLinx™ Management Appliance, our first management appliance for the data center market. This product enables IT administrators to aggregate and manage an entire complex of multiple console serves, remote KVM servers and power devices used in multiple racks of equipment.

In March 2007, we introduced SecureLinx Spider™, our IP-based “Distributed KVM” remote server management solution. The SecureLinx Spider™ is a cable-friendly, single port, KVM to IP converter small enough to be held in one hand. The SecureLinx Spider™ compresses video, keyboard and mouse signals, sending them over the network or Internet to a remote PC or handheld device running industry-standard Web browsers.

Non-core Businesses: Visualization Solutions, Print Servers and Other Legacy Products

Over a period of years, primarily as a result of product technology acquired through acquisitions, we have product categories that no longer represent the focus of future research and development and expansion; in other cases these products are legacy products developed and sold in the past, but are no longer part of our strategic focus. We have announced the end-of-life for almost all of our non-core products and expect a steep decline in non-core revenues in fiscal 2009 while we complete the exit of this product category.

We offer visualization solutions that provide switching and optical extension of high performance video, audio, keyboard and mouse over long distances within a building or campus environment. Products include video display extenders, analog KVM extension systems and matrix hubs. Our analog remote KVM products provide a valuable solution for extending and sharing audio, video, keyboard and mouse signals among many users and over optical cable without loss of resolution. KVM products enable a single keyboard, monitor and mouse to be switched between multiple computers, providing immediate access and control from a single location. The customers for these devices typically are companies that need to isolate users from the core computing center for security reasons, or require high speed video sources to be shared among many users. Our visualization solutions can be found in government agencies and at customers involved with large scale simulation and display applications. We announced the end of life of these visualization products and exited this product line in 2007.

Early in our business history, we provided external print servers that connect various printers to a network for shared printing tasks. Over the years, we have updated and continue to provide print servers that work with a myriad of operating systems and network configurations. The requirement for external print servers is decreasing, as printer

manufacturers have incorporated networking hardware and software as part of many printers. We intend to exit this product line.

We acquired a line of low-cost products that we market under the “Stallion” brand. Stallion products include a variety of network servers and a range of multi-port serial I/O cards. We intend to exit this product line.

Various other small categories of our legacy business are included in the non-core category, such as software revenues and other product lines we have discontinued or that are being de-emphasized.

The following table presents net revenues by product line. Definitions of these families have been modified slightly from time to time, and the data has been revised to conform to the current definitions:

| Product Line | Primary Product Function | Years Ended June 30, 2008 | 2007 |
|---|---|---|---|
| | | (In thousands) | |
| Device enablement | Enable electronic products to become network enabled. | $ 44,993 | $ 39,734 |
| Device management | Allow the user to control equipment by way of a network using a wide range of protocols. This category includes console servers and remote digital KVM. | 8,694 | 8,866 |
| Total device networking | | 53,687 | 48,600 |
| Non-core | Includes terminal servers, visualization solutions, legacy print servers, serial board, software and miscellaneous products. | 3,899 | 6,706 |
| Total net revenues | | $ 57,586 | $ 55,306 |

Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards (“SFAS”) No. 131, “Disclosures about Segments of an Enterprise and Related Information,” establishes standards for disclosures about operating segments in annual consolidated financial statements. It also establishes standards for related disclosures about products and services, geographic areas and major customers. We operate in one segment, networking and Internet connectivity.

Customers

Distributors

Our principal customers are our distributors, which account for the largest percentage of our net revenues. Distributors resell our products to a wide variety of end customers, including consumers, corporate customers and VARs. We sell to a group of thirteen major distributors, some of which operate from multiple warehouses. Our major distributors in the Americas region include: Ingram Micro, Tech Data, KMJ Communications, Arrow Electronics, Inc and Symmetry Electronics. In Europe, the Middle East and Africa (“EMEA”) region, we distribute to the following major distributors: Sphinx Computer Vertriebs GmbH, Jade Communications, LTD, Atlantik Systems GmbH, transtec AG (a related party due to common ownership by our largest stockholder), Astradis Elecktronik GmbH and Acal plc. In the Asia Pacific region, we distribute to the following major distributors: Nissin Systems, Co., Ltd and PowerCorp Pty Ltd.

OEM Manufacturers

We have established a broad range of OEM customers in various industries, such as industrial automation, medical, security, building automation, consumer and audiovisual. To shorten the development cycle and add network connectivity to a product, OEMs can use our external devices to network-enable their installed base of products, while board-level embedded modules are typically used in new product designs. Our capabilities and solutions enable OEMs to focus on their core competencies, resulting in reduced research and development costs, fewer integration problems and faster time to market.

End User Businesses

We have a broad range of end user customers in various vertical markets such as retail, universities/education, manufacturing, healthcare/hospitals and financial/banking. End user businesses require solutions that are simple to install, set up and operate, and can provide immediate results. Generally, these customers need to connect to a diverse range of products and equipment, without modifying existing software and systems.

Our external device enablement solutions enable end users to quickly, securely and easily connect their devices and equipment to networks, extending the life of existing investments. We provide a number of support services including telephone-based sales and technical support as well as a wide array of Internet-based resources. In many cases, the customer simply has to call in to obtain assistance in identifying which networking device would be most appropriate for their need. After buying the devices from us or one of our distributors, a customer often only has to plug a cable from their device to our external device, and then plug our device into their network.

Customer Concentrations

The following table presents sales to our significant customers and a related party as a percentage of net revenues:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Top five customers (1) | 38% | 34% |
| Tech Data | 13% | 8% |
| Ingram Micro | 8% | 12% |
| Related party | 2% | 2% |

(1) Includes Ingram Micro and Tech Data.

No other customer represented more than 10% of our annual net revenues during these fiscal years. An international customer, transtec AG, is a related party due to common ownership by our largest stockholder and Lantronix director, Bernhard Bruscha.

The following table presents our net revenues by geographic region:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Americas | 57.6% | 63.2% |
| EMEA | 28.9% | 25.3% |
| Asia Pacific | 13.5% | 11.5% |
| Total | 100.0% | 100.0% |

Information concerning our customer concentrations and sales by geographic region can be found in Part IV, Item 15 of this Annual Report on Form 10-K and is presented in footnote 13 to our notes of our consolidated financial statements. Please see Part I, Item 1A “Risk Factors” below for a discussion of the risks associated with foreign sales.

Sales and Marketing

We maintain both an inside and a field sales force to provide management and support to our worldwide network of selling partners. Over the past several years, we have expanded our network of sales partners and have developed an indirect sales model, using manufacturers’ representatives, VARs and other resellers throughout the world. We have sales managers in major regions throughout the world to manage our relationship with our sales partners, identify and develop major new sales opportunities and increase penetration at existing high potential accounts. We implement marketing programs, tools and services specifically geared to drive demand for our products.

The following table presents the number of our employees that participate in sales and marketing activities:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Sales and marketing | 66 | 66 |

We believe that our multi-channel approach provides several advantages. We can engage the customers and end users through their channel of choice, making our solutions available from a variety of sources. We can concentrate on developing new relationships at accounts that we believe represent our largest opportunities while our sales partners continue to identify new incremental opportunities and service existing customers.

Our device enablement solutions are principally sold to manufacturers by our worldwide OEM sales force and our group of manufacturers’ representatives. We have continued to expand our use of manufacturers’ representatives and other resellers, leveraging their established relationships to bring our device enablement solutions to a greater number of customers within the OEM market.

We market and sell our device management solutions and select external device enablement solutions through information technology resellers, industry-specific system integrators, VARs and directly to end user organizations. Resellers and integrators will often obtain our products through distributors. These distributors supply our products to a broad range of VARs, system integrators, direct marketers, government resellers and e-commerce resellers. In turn, these distributor customers market, sell, install and, in most cases, support our solutions to the end users.

Manufacturing

A key element of our operations strategy is to outsource manufacturing to produce reliable, high quality products at competitive prices and to achieve on-time delivery to our customers. This practice enables us to concentrate our resources on engineering, sales and marketing.

We utilize contract manufacturers primarily located in the U.S., China, Malaysia and Taiwan. Our contract manufacturers source raw materials, components and integrated circuits, in accordance with our pre-determined specifications and forecasts, and perform printed circuit board assembly, final assembly, functional testing and quality control. We believe this arrangement decreases our capital requirements and provides better raw material and component pricing, enhancing our gross margins and operating margins. Please see Part I, Item 1A "Risk Factors" below for a discussion of the risks associated with contract manufacturing.

Research and Development

Our research and development efforts are focused on the development of technology and products that will enhance our competitive position in the markets we serve. Products are developed in-house and through outside research and development resources, which may be sourced on an OEM basis.

The following table presents the number of our employees that participate in research and development activities and our research and development expenses:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (Dollars in thousands) | |
| Number of employees | 41 | 45 |
| Research and development expenses | $ 6,944 | $ 7,362 |

Developer Relations

Recruiting, informing and participating with third-party developers are integral parts of our ongoing strategy. We encourage, enable and support others in the development of vertical applications using our hardware, firmware and software products. With their help and investment in creating additional applications and markets for our products, we improve our ability to secure a defensible market position and loyal customers.

Competition

The markets in which we compete are dynamic and highly competitive. As these markets grow and develop, we expect competition to intensify. The following sets forth a partial list of current and potential competitors by techology:

Device Network-enabling Technologies

Companies such as Digi International, Inc., DPAC Technologies Corp., Echelon Corporation, Freescale Semiconductor, Inc., Moxa Technologies, MRV Communications, Inc., Quatech, Inc., Raritan, Rose Electronics, Sena Technologies Inc., Wind River Systems, Inc., and ZiLOG, Inc.

Equipment for Device management Solutions

Companies such as Avocent Corporation, Cisco Systems, Inc., Digi International, Inc., Moxa Technologies, MRV Communications, Inc., Open Gear and Perle Systems.

The principal competitive factors that affect the market for our products are:

- product quality, technological innovation, compatibility with standards and protocols, reliability, functionality, ease of use and compatibility;
- product pricing;
- potential customers’ awareness and perception of our products and of network-enabling technologies; and
- the customer’s decision to make versus buy.

Intellectual Property Rights

We have developed proprietary methodologies, tools, processes and software in connection with delivering our services. We have not historically relied on patents to protect our proprietary rights, although we have recently begun to build a patent portfolio. We have historically relied on a combination of copyright, trademark, trade secret laws and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights.

On May 2, 2006, we entered into a six-year patent cross-license and litigation dismissal agreement with Digi International, Inc. ("Digi"). The cross-license includes all pre-existing patents (not including design patents) held by us and Digi. In addition, the cross-license covers all future patents (not including design patents) during the six-year cross-license term.

Gordian, Inc. ("Gordian") developed certain intellectual property used in our micro serial server line of products. These products represented and continue to represent a significant portion of our net revenues. An agreement with Gordian gives us joint ownership of the Gordian intellectual property that is embodied in the products Gordian designed for us.

United States and Foreign Government Regulation

Many of our products and the industries in which they are used are subject to federal, state or local regulation in the U.S. In addition, our products are exported worldwide. Therefore, we are subject to the regulation of foreign governments. For example, wireless communication is highly regulated in both the U.S. and elsewhere. Some of our products employ encryption technology; the export of some encryption software is restricted. At this time our activities comply with existing laws, but we cannot determine whether future, more restrictive laws, if enacted, would adversely affect us. Please see Part I, Item 1A "Risk Factors" below for risks associated with foreign operations.

Environmental Matters

Federal, state and local regulations impose various environmental controls on the storage, handling, discharge and disposal of chemicals and gases used in our manufacturing processes. Our company quality manual requires all subcontractors and raw material suppliers to be ISO14001 certified. State agencies require us to report usage of environmentally hazardous materials and we have retained the appropriate personnel to help ensure compliance with all applicable environmental regulations. We actively manage and monitor compliance through our internal auditing program. We believe that our activities conform to present environmental regulations; however, increasing public attention has been focused on the environmental impact of semiconductor operations and these regulations may require us to fund remedial action regardless of fault.

In addition, the use and disposal of electronics is under increasing scrutiny and various countries have begun to adopt regulations such as the European Union's Waste Electrical and Electronic Equipment ("WEEE") and the Reduction of the use of certain Hazardous Substances in electrical and electronic equipment ("RoHS") directives, which could require us to both redesign our products to comply with the standards and develop compliance administration systems. We expect additional countries and locations to adopt similar regulations in the future which may be more stringent than the current regulations. Currently however, we believe the majority of our commercial products are compliant with these emerging regulations.

While we have not experienced any materially adverse effects on our operations from environmental regulations, there can be no assurance that changes in such regulations will not impose the need for additional capital equipment or other requirements. We have already invested significant resources into developing compliance tracking systems, and further investments may be required. Any failure by us to adequately restrict the discharge of hazardous substances

could subject us to future liabilities or could cause our manufacturing operations to be suspended.

Employees

We have never experienced a work stoppage, none of our employees are currently represented by a labor union, and we consider our employee relations to be good.

The following table presents our part- and full-time employees:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| Research and development | 41 | 45 |
| Sales and marketing | 66 | 66 |
| Operations | 20 | 21 |
| General and administrative | 30 | 29 |
| Total employees | 157 | 161 |

During the first fiscal quarter ended September 30, 2008, we implemented a second restructuring plan. As part of the second restructuring plan, an additional 28 employees from all ranks and across all functional groups of Lantronix are expected to be terminated.

Backlog

Normally, we manufacture our products in advance of receiving firm product orders from our customers based upon our forecasts of worldwide customer demand. Most customer orders are placed on an as-needed basis and may be canceled or rescheduled by the customer without significant penalty. Accordingly, backlog as of any particular date is not necessarily indicative of our future sales. Because most of our business is on an as-needed basis we do not rely on backlog as a metric of our operations.

Available Information

Our annual report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to reports filed or furnished pursuant to Section 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), are available free of charge on our website at www.lantronix.com shortly after we electronically file such material with, or furnish it to, the SEC. The public may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. The SEC also maintains a website at www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that file electronically. We assume no obligation to update or revise forward looking statements in this Form 10-K, whether as a result of new information, future events or otherwise, unless we are required to do so by law.

Executive Officers of the Registrant

The following table presents the names, ages and positions held by all our executive officers. There are no family relationships between any director or executive officer and any other director or executive officer of Lantronix. Executive officers serve at the discretion of the board of directors.

| Name | Age | Position |
|---|---|---|
| Jerry D. Chase | 48 | President and Chief Executive Officer |
| Reagan Y. Sakai | 49 | Chief Financial Officer and Secretary |

JERRY D. CHASE has served as our President and Chief Executive Officer since February 2008. From September 2004 to July 2007, Mr. Chase was president, chief executive officer and a board member for Terayon Communication

Systems, a public cable, telecom and satellite supplier of digital video networking applications. From 2001 to August 2004, Mr. Chase served as the chairman and chief executive officer of Thales Broadcast & Multimedia ("TBM"), a telecom and test equipment supplier, and from 1998 to 2001 was president and chief executive officer of the U.S. subsidiary of TBM. Mr. Chase began his career as a Pilot and Operations Officer in the U.S. Marine Corps, where he built a strong foundation for leadership, process and crisis management. Following the Marine Corps, he attended Harvard Business School, where he received his MBA.

REAGAN Y. SAKAI has served as our Chief Financial Officer and Secretary since November 2006. Mr. Sakai has 25 years of increasingly responsible financial and management experience, most recently as CFO for HyPerformix Corporation, a private software company based in Austin, Texas. Earlier, he was CFO for VIEO Corporation, an early-stage software company, and before that, he was CFO of Crossroads Systems Corporation, a public data storage routing company, where he oversaw the company's highly successful IPO in October 1999. Earlier in his career, Mr. Sakai held various financial positions with Exabyte Corporation, Maxtor Corporation, McDATA Corporation, and StorageTek Corporation. Mr. Sakai holds a BS degree and an MBA from the University of Colorado at Boulder.

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 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.

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 expectations of future net revenues. If we were to experience a reduction in revenues in a quarter, we would likely be unable to adjust our short-term expenditures. If this were to occur, our operating results for that fiscal quarter would be harmed. If our operating results in future fiscal quarters fall below the expectations of market analysts and investors, the price of our common stock would likely fall. Other factors that might cause our operating results to fluctuate on a quarterly basis include:

- changes in the mix of net revenues attributable to higher-margin and lower-margin products;
- customers' decisions to defer or accelerate orders;
- variations in the size or timing of orders for our products;
- 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; and
- changes in demand for devices that incorporate our products.

Our common stock may be delisted, which could significantly harm our business.

Our common stock is currently listed on The Nasdaq Capital Market under the symbol "LTRX." We currently are not in compliance with the $1.00 minimum bid price requirement for inclusion in The Nasdaq Capital Market; however, we have until December 22, 2008, to regain compliance. If our common stock is delisted from The Nasdaq Capital

Market, some or all of the following could be reduced, harming our investors:

- the liquidity of our common stock;
- the market price of our common stock;
- the number of institutional investors that will consider investing in our common stock;
- the number of investors in general that will consider investing in our common stock;
- the number of market makers in our common stock;
- the availability of information concerning the trading prices;
- the number of broker-dealers willing to execute trades in shares of our common stock; and
- our ability to obtain financing for the continuation of our operations.

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

The number and timing of sales to our distributors have been difficult for us to predict. While our distributors are customers in the sense they buy our products, they are also part of our product distribution system. Some 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 revenues:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Top five customers (1) | 38% | 34% |
| Tech Data | 13% | 8% |
| Ingram Micro | 8% | 12% |
| Related party | 2% | 2% |

(1) Includes Ingram Micro and Tech Data.

The loss or deferral of one or more significant customers in a quarter could harm our operating results. We have in the past, and might in the future, lose one or more major customers. If we fail to continue to sell to our major customers in the quantities we anticipate, or if any of these customers terminate our relationship, our reputation, the perception of our products and technology in the marketplace, 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 revenues to decrease and could cause our stock price to decline.

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 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 recent directive in the European Union bans 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 had begun demanding 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 revenues

might not grow at the rate we anticipate, or could decline.

Delays in deliveries or quality problems with our component suppliers could damage our reputation and could cause our net revenues 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 components or 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. When this happens, we attempt to purchase sufficient inventory to meet our needs until a substitute component can be incorporated into our products. Nonetheless, we might be unable to purchase sufficient components to meet our demands, or we might incorrectly forecast our demands, and purchase too many or too few components. In addition, our products use components that have, in the past, been subject to market shortages and substantial price fluctuations. From time to time, we have been unable to meet our orders because we were unable to purchase necessary components for our products. We do not have long-term supply arrangements with many 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. We have recently redesigned many of our products to comply with the new environmental regulation such as the Reduction of Hazardous Substances (“RoHS”) directive. These regulations are relatively new for our supply chain and interruptions in parts supply due to the additional complexities and limited number of second source supply choices could adversely impact our business.

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 revenues and harm our results of operations.

We do not have long-term agreements with our contract manufacturers or suppliers. If any of these subcontractors or suppliers ceased doing business with us, we may 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 could damage our customer relationships and materially and adversely affect our business, financial condition or results of operations.

Environmental regulations such as the Waste Electrical and Electronic Equipment (“WEEE”) and RoHS directives 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 and RoHS directives 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; however alternative designs may have an adverse effect on our gross profit margin. If we cannot develop compliant products timely or properly administer our compliance programs, our revenues 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 revenues 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 revenues from these products will be sufficient to justify our investment in research and development. In addition, if we do not invest sufficiently in research and development, we may be unable to maintain our competitive position. Our investment in research and development may decrease, which may put us at a competitive disadvantage compared to our competitors and adversely affect our market position.

We expect the average selling prices of our products to decline and material costs to increase, which could reduce our net revenues, gross margins and profitability.

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 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 resulting in lower gross margins. We also may be unable to adjust our prices 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 may 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. For example, we recently concluded multiple securities lawsuits with our stockholders and litigation with a former executive officer. We may have an obligation to continue to indemnify the former executive officer and defend him in the litigation regarding the securities violation with which he has been charged. There is a risk that our insurance carriers may not reimburse us for such costs. Any lawsuit may involve complex questions of fact and law and may require the expenditure of significant funds and the diversion of other resources. The results of litigation are inherently uncertain, and adverse outcomes are possible.

Our products may contain undetected software or hardware errors or defects that could lead to an increase in our costs, reduce our net revenues 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 may have to refund the purchase price for the units. We do not have a long history with which to assess the risks of unexpected product failures or defects for our device server product line. Regardless of the amount of testing we undertake, some errors might be discovered only after a product has been installed and used by customers. Any errors discovered after commercial release could result in loss of net revenues and claims against us. Significant product warranty claims against us could harm our business, reputation and financial results and cause the price of our stock to decline.

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. For example, Jabil Circuit, Inc. acquired Varian, Inc. in March 2005 and closed the facility that manufactured our products. We transferred this production to another contract manufacturer. Moreover, 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 revenues 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 revenues or we may be unable to fulfill customer orders, thus reducing net revenues 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 our sales within geographic regions:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Americas | 57.6% | 63.2% |
| EMEA | 28.9% | 25.3% |
| Asia Pacific | 13.5% | 11.5% |
| Total | 100.0% | 100.0% |

We expect that international revenues will continue to represent a significant portion of our net revenues in the foreseeable future. Doing business internationally involves greater expense and many 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 revenues 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 in the U.S. and 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 profitability.

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

We hold a significant 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 our reserve for excess and obsolete inventory:

| | June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Finished goods | $ 5,707 | $ 7,848 |
| Raw materials | 1,836 | 2,653 |
| Inventory at distributors | 2,008 | 1,876 |
| Large scale integration chips * | 809 | 1,530 |
| Inventories, gross | 10,360 | 13,907 |
| Reserve for excess and obsolete inventory | (2,322) | (2,926) |
| Inventories, net | $ 8,038 | $ 10,981 |

* This item is sold individually and 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, key technical, marketing and sales employees. We are also 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 revenues 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 revenues 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 revenues could decline and our business could be harmed.



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

Substantial litigation regarding intellectual property rights exists 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. In addition, we paid Digi $600,000 as part of the settlement. 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 building a patent portfolio. In May 2006, we entered into a 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 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. Beginning with our annual report on Form 10-K for our fiscal year ending June 30, 2008, we were 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. Beginning with our annual report on Form 10-K for our fiscal year ending June 30, 2010, our independent registered public accounting firm will issue a report assessing the effectiveness of our internal controls.

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 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

We lease a building in Irvine, California, that comprises our corporate headquarters and includes administration, sales, marketing, research and development, warehouse and order fulfillment functions. During fiscal 2005, we extended the lease for our Irvine facility until July 2010. In addition, we have sales offices in France, Japan and Hong Kong. Our leased facilities comprise an aggregate of approximately 55,000 square feet of which our Irvine facility represents the majority.

We believe our existing facilities are adequate to meet our needs. If additional space is needed in the future, we believe that suitable space will be available on commercially reasonable terms.

ITEM 3. LEGAL PROCEEDINGS

The legal proceedings as required by this item are incorporated by reference from Part IV, Item 15 of this Form 10-K and are presented under footnotes 10 and 11 to our notes to our consolidated financial statements.

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

No matters were submitted to a vote of our security holders during the fourth fiscal quarter ended June 30, 2008.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Price Range of Common Stock

Our common stock was traded on the NASDAQ National Market under the symbol "LTRX" from our initial public offering on August 4, 2000 through October 22, 2002. On October 23, 2002 our listing was changed to the NASDAQ SmallCap Market, which has since been renamed the NASDAQ Capital Market. The number of holders of record of our common stock as of September 15, 2008 was approximately 76. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock:

| | High | Low |
|---|---|---|
| Year Ended June 30, 2008 | | |
| First Quarter | $ 1.43 | $ 0.99 |
| Second Quarter | 1.14 | 0.76 |
| Third Quarter | 0.96 | 0.49 |
| Fourth Quarter | 1.00 | 0.61 |
| Year Ended June 30, 2007 | | |
| First Quarter | $ 2.13 | $ 1.29 |
| Second Quarter | 1.78 | 1.36 |
| Third Quarter | 1.90 | 1.57 |
| Fourth Quarter | 1.61 | 1.24 |

We believe that a number of factors, including but not limited to quarterly fluctuations in results of operations, may cause the market price of our common stock to fluctuate significantly. See Part II, Item 7 of this Form 10-K.

Dividend Policy

We have never declared or paid cash dividends on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future, and we intend to retain any future earnings for use in the expansion of our business and for general corporate purposes.

Recent Sales of Unregistered Securities

We did not repurchase any of our common stock during the fourth fiscal quarter of 2008. Since July 1, 2003, we have issued the following unregistered securities:

In June 2006, we issued an aggregate of 84,053 shares of our common stock in connection with the settlement of securities claims brought by former stockholders of Synergetic Micro Systems, Inc. These shares were issued pursuant to the exemption provided by Section 3(a)(10) of the Securities Act.

In March 2008, we issued warrants to purchase 1,079,615 shares of our common stock in connection with our settlement of the Class Action lawsuit. These securities were issued pursuant to the exemption provided by Section 3(a)(10) of the Securities Act.

## ITEM 6. SELECTED FINANCIAL DATA

Not applicable.

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes thereto included elsewhere in this report. In addition to historical information, the discussion in this report contains forward-looking statements that involve risks and uncertainties. Actual results could differ materially from those anticipated by these forward-looking statements due to factors including, but not limited to, those factors set forth under Part I, Item 1A "Risk Factors" and elsewhere in this report.

### Overview

We design, develop and market devices that make it possible to access, manage, control and configure electronic devices over the Internet and other networks. We are a leader in providing innovative networking solutions. We were initially formed as "Lantronix," a California corporation, in June 1989. We reincorporated as "Lantronix, Inc.," a Delaware corporation in May 2000. Our products are sold to distributors, OEMs, VARs, and systems integrators, as well as directly to end users.

### Fiscal Year 2008 Financial Highlights and Other Information

A summary of the key factors and significant events which impacted our financial performance during the fiscal year ended June 30, 2008 are as follows:

- Net revenues were $57.6 million for the fiscal year ended June 30, 2008, an increase of $2.3 million, or 4.1%, compared to $55.3 million for the fiscal year ended June 30, 2007. The increase was primarily the result of a $5.1 million, or 10.5%, increase in our device networking product lines offset by a $2.8 million, or 41.9%, decrease in our non-core product lines.

- Gross profit as a percentage of net revenues was 50.5% for the fiscal year ended June 30, 2008 compared to 51.2% for the fiscal year ended June 30, 2007. The decrease in gross profit margin percentage was primarily attributable to an increase in certain inventory reserves in connection with a review of our product offerings as part of our effort to simplify our product portfolio by discontinuing slow-moving and non-strategic products.

- Loss from operations was $2.6 million, or 4.5%, of net revenues for the fiscal year ended June 30, 2008 compared to $2.4 million, or 4.4%, for the fiscal year ended June 30, 2007. The loss from operations for the fiscal year ended June 30, 2008 included a restructuring charge of $757,000.

- Net loss was $2.5 million, or $0.04 per basic and diluted share, for the fiscal year ended June 30, 2008, compared to $1.7 million, or $0.03 per basic and diluted share, for the fiscal year ended June 30, 2007. The net loss for the fiscal year ended June 30, 2008 included a restructuring charge of $757,000. The net loss for the fiscal year ended June 30, 2007 included a gain on the sale of long-term investment of $700,000.

- Cash and cash equivalents were $7.4 million as of June 30, 2008 compared to $7.6 million as of June 30, 2007.

- Net accounts receivable were $4.2 million as of June 30, 2008 compared to $3.4 million as of June 30, 2007. Annual days sales outstanding (“DSO”) in receivables were 24 days for the fiscal year ended June 30, 2008 as compared to 21 days for the fiscal year ended June 30, 2007. 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 to distributors).

- Net inventories were $8.0 million as of June 30, 2008 compared to $11.0 million as of June 30, 2007. Annual inventory turns were 3.0 for the fiscal year ended June 30, 2008 as compared to 2.8 for the fiscal year ended June 30, 2007.

Recent Accounting Pronouncements

In September 2006 the FASB issued SFAS 157, "Fair Value Measurements" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008 the FASB approved FASB Staff Position 157-2, "Effective Date of FASB Statement No. 157," which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. We are currently evaluating the impact, if any, that SFAS 157 may have on our future consolidated financial statements related to non-financial assets and liabilities.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants and the SEC did not or are not believed by us to have a material impact on our present or future consolidated financial statements.

Critical Accounting Policies and Estimates

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

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

Revenue Recognition

We do not recognize revenue until all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; our price to the buyer is fixed or determinable; and collectibility is reasonably assured. A significant portion of our sales are made to distributors under agreements which contain a limited right to return unsold product and price protection provisions. Therefore, the recognition of net revenues and related cost of revenues from sales to distributors are deferred until the distributor resells the product. Net revenues from certain smaller distributors for which point-of-sale information is not available, is recognized approximately one month after the shipment date. This estimate approximates the timing of the sale of the product by the distributor to the end user.

When product revenues are recognized, we establish an estimated allowance for future product returns based on historical returns experience; when price reductions are approved, we establish an estimated liability for price protection payable on inventories owned by product resellers. Should actual product returns or pricing adjustments exceed our estimates, additional reductions to revenues would result.

Our products typically carry a one- or two-year warranty. In addition, certain products that were sold prior to August 2003 carry a five-year warranty. Although we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, use of materials or service delivery costs that differ from our

estimates. As a result, additional warranty reserves could be required, which could reduce gross margins. Additionally, we sell extended warranty services, which extend the warranty period for an additional one to three years, depending upon the product. Warranty net revenues are recognized ratably over the warranty service period.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Our allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts, the aging of accounts receivable, our history of bad debts and the general condition of the industry. If a major customer's credit worthiness deteriorates, or our customers' actual defaults exceed our historical experience, our estimates could change and impact our reported results.

We also maintain a reserve for uncertainties relative to the collection of officer notes receivable. Factors considered in determining the level of this reserve include the value of the collateral securing the notes, our ability to effectively enforce collection rights and the ability of the former officers and Lantronix director to honor their obligations.

Inventory Valuation

Our policy is to value inventories at the lower of cost or market on a part-by-part basis. This policy requires us to make estimates regarding the market value of our inventories, including an assessment of excess and obsolete inventories. We determine excess and obsolete inventories based on an estimate of the future sales demand for our products within a specified time horizon, generally three to twelve months. The estimates we use for demand are also used for near-term capacity planning and inventory purchasing and are consistent with our revenue forecasts. In addition, specific reserves are recorded to cover risks in the area of end of life products, inventory located at our contract manufacturers, deferred inventory in our sales channel and warranty replacement stock.

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

Valuation of Deferred Income Taxes

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

Goodwill and Purchased Intangible Assets

The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development. The amounts and useful lives assigned to intangible assets impact future amortization. If the assumptions and estimates used to allocate the purchase price are not correct, purchase price adjustments or future asset impairment charges could be required.

We perform goodwill impairment tests on an annual basis, and more frequently if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Goodwill impairment testing requires us to compare the fair value of each reporting unit to its carrying amount, including goodwill, and record an impairment charge if the carrying amount of a reporting unit exceeds its estimated fair value. The determination of a reporting unit’s fair value requires significant judgment and is based on management’s best estimate, which generally considers the unit’s expected future earnings. If actual results are not consistent with our assumptions and judgments used in estimating fair value, we may be exposed to additional goodwill impairment losses. As of June 30, 2008, we have $9.5 million of goodwill reflected in our consolidated balance sheet.

We evaluate purchased intangible assets when indicators of impairment, such as reductions in demand or significant economic slowdowns, are present. Reviews are performed to determine whether the carrying values of these assets are impaired based on a comparison to the undiscounted expected future cash flows. If the comparison indicates that there is impairment, the expected future cash flows using a discount rate based upon our weighted average cost of capital is used to estimate the fair value of the assets. Impairment is based on the excess of the carrying amount over the fair

value of those assets. Significant management judgment is required in the forecast of future operating results that is used in the preparation of expected discounted cash flows. It is reasonably possible that the estimates of anticipated future net revenues, the remaining estimated economic lives of the products and technologies, or both, could differ from those used to assess the recoverability of our purchased intangible assets. In the event they are lower, additional impairment charges or shortened useful lives of certain purchased intangible assets could be required. As of June 30, 2008, we have approximately $382,000 of purchased intangible assets reflected in our consolidated balance sheet.

Fiscal Years Ended June 30, 2008 and 2007

Net Revenues by Product Line

The following table presents net revenues by product line:

| | Years Ended June 30, | | | | Change | |
|---|---|---|---|---|---|---|
| | 2008 | % of Net Revenues | 2007 | % of Net Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Device enablement | $ 44,993 | 78.1% | $ 39,734 | 71.9% | $ 5,259 | 13.2% |
| Device management | 8,694 | 15.1% | 8,866 | 16.0% | (172) | (1.9%) |
| Device networking | 53,687 | 93.2% | 48,600 | 87.9% | 5,087 | 10.5% |
| Non-core | 3,899 | 6.8% | 6,706 | 12.1% | (2,807) | (41.9%) |
| Net revenues | $ 57,586 | 100.0% | $ 55,306 | 100.0% | $ 2,280 | 4.1% |

The increase in net revenues for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily a result of an increase in net revenues from our device enablement products offset by a decrease in our non-core and device management products. The increase in our device enablement products for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily due to an increase in sales of our embedded and external device enablement products. We are no longer investing in the development of our non-core product lines and we expect net revenues related to these products to continue to decline in the future as we focus our investment in our device networking product lines.

Net Revenues by Geographic Region

The following table presents net revenues by geographic region:

| | Years Ended June 30, | | | | Change | |
|---|---|---|---|---|---|---|
| | 2008 | % of Net Revenues | 2007 | % of Net Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Americas | $ 33,167 | 57.6% | $ 34,950 | 63.2% | $ (1,783) | (5.1%) |
| EMEA | 16,644 | 28.9% | 14,002 | 25.3% | 2,642 | 18.9% |
| Asia Pacific | 7,775 | 13.5% | 6,354 | 11.5% | 1,421 | 22.4% |
| Net revenues | $ 57,586 | 100.0% | $ 55,306 | 100.0% | $ 2,280 | 4.1% |

The decrease in net revenues in the Americas region for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily attributable to a decrease in sales of non-core and device management products offset by an increase in sales of device enablement products. The increase in net revenues in the EMEA ("Europe, Middle East and Africa") region for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily due to an increase in sales of our device enablement products. The increase in net revenues in the Asia Pacific region for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily attributable to an increase in sales of device enablement products.

Net Revenues by Significant Customer

The following table presents net revenues by significant customer and a related party as a percentage of net revenues:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Top five customers (1) | 38% | 34% |
| Tech Data | 13% | 8% |
| Ingram Micro | 8% | 12% |
| Related party | 2% | 2% |

(1) Includes Ingram Micro and Tech Data.

An international customer, transtec AG, is a related party due to common ownership by our largest stockholder and Lantronix director, Bernhard Bruscha.

Gross Profit

Gross profit represents net revenues less cost of revenues. Cost of revenues consisted primarily of the cost of raw material components, subcontract labor assembly from contract manufacturers, manufacturing overhead, amortization of purchased intangible assets, establishing or relieving inventory reserves for excess and obsolete products or raw materials, warranty costs, royalties and share-based compensation.

The following table presents gross profit:

| | Years Ended June 30, | | | | Change | |
|---|---|---|---|---|---|---|
| | 2008 | % of Net Revenues | 2007 | % of Net Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Gross profit | $ 29,068 | 50.5% | $ 28,342 | 51.2% | $ 726 | 2.6% |

The decrease in gross profit margin percentage for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily attributable to an increase in certain inventory reserves in connection with a review of our product offerings as part of our effort to simplify our product portfolio by discontinuing slow-moving and non-strategic products.

Selling, General and Administrative

Selling, general and administrative expenses consisted of personnel-related expenses including salaries and commissions, share-based compensation, facility expenses, information technology, trade show expenses, advertising and professional legal and accounting fees offset by reimbursement of legal fees from insurance proceeds.

The following table presents selling, general and administrative expenses:

| | Years Ended June 30, | | | | Change | |
|---|---|---|---|---|---|---|
| | 2008 | % of Net Revenues | 2007 | % of Net Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Personnel-related expenses | $ 13,663 | | $ 12,521 | | $ 1,142 | 9.1% |
| Professional fees & outside services | 2,569 | | 2,704 | | (135) | (5.0%) |
| Advertising and marketing | 2,959 | | 3,234 | | (275) | (8.5%) |
| Facilities | 1,600 | | 2,042 | | (442) | (21.6%) |
| Share-based compensation | 847 | | 922 | | (75) | (8.1%) |
| Depreciation | 368 | | 288 | | 80 | 27.8% |
| Other | 1,886 | | 1,532 | | 354 | 23.1% |
| Selling, general and administrative | $ 23,892 | 41.5% | $ 23,243 | 42.0% | $ 649 | 2.8% |

In order of significance, the increase in selling, general and administrative expense for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily due to: (i) an increase in personnel-related expenses as a result of severance charges related to the departure of the former president and chief executive officer and other former employees; offset by (ii) a decrease in facilities expenses as a result of lower insurance and other allocated facility costs, (iii) a decrease in advertising and marketing spending due to the timing of product launches and more focused marketing spending and (iv) a decrease in professional fees & outside services.

Research and Development

Research and development expenses consisted 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 research and development expenses:

| | Years Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | | % of Net | | % of Net | Change | |
| | 2008 | Revenues | 2007 | Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Personnel-related expenses | $ 5,102 | | $ 5,308 | | $ (206) | (3.9%) |
| Facilities | 876 | | 666 | | 210 | 31.5% |
| Professional fees & outside services | 209 | | 519 | | (310) | (59.7%) |
| Share-based compensation | 341 | | 378 | | (37) | (9.8%) |
| Depreciation | 57 | | 41 | | 16 | 39.0% |
| Other | 359 | | 450 | | (91) | (20.2%) |
| Research and development | $ 6,944 | 12.1% | $ 7,362 | 13.3% | $ (418) | (5.7%) |

The decrease in research and development expenses for the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily due to: (i) a decrease in professional fees & outside services and (ii) a decrease in personnel-related expenses.

Restructuring Charges

The following table presents restructuring charges:

| | Years Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | | % of Net | | % of Net | Change | |
| | 2008 | Revenues | 2007 | Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Restructuring charge | $ 757 | 1.3% | $ - | 0.0% | $ 757 | 0.0% |

During the fourth fiscal quarter ended June 30, 2008, we implemented a restructuring plan to optimize our organization to better leverage existing customer and partner relationships to drive revenue growth and profitability. As part of the restructuring plan, 10 employees from the senior-level ranks of the sales, marketing, operations and engineering groups were terminated.

Interest Expense, Net

The following table presents interest expense, net:

| Years Ended June 30, | | | | | |
|---|---|---|---|---|---|
| | % of Net | | % of Net | Change | |
| 2008 | Revenues | 2007 | Revenues | $ | % |
| (In thousands, except percentages) | | | | | |
| $ (150) | (0.3%) | $ (13) | (0.0%) | $ (137) | 1053.8% |

Interest
expense, net

The increase in interest expense, net, is primarily due to interest expense related to the addition of capital leases during the fiscal year ended June 30, 2008 and lower yields on cash deposits.

Other Income, Net

The following table presents other income, net:

| | Years Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | | % of Net | | % of Net | Change | |
| | 2008 | Revenues | 2007 | Revenues | $ | % |
| | (In thousands, except percentages) | | | | | |
| Other income, net | $ 120 | 0.2% | $ 749 | 1.4% | $ (629) | (84.0%) |

Other income, net, for the fiscal year ended June 30, 2008 is primarily due to $104,000 of income recognized on the sale of marketable securities. Other income, net, for the fiscal year ended June 30, 2007 is primarily due to $700,000 of income recognized on the sale of our investment in Xanboo.

Provision (Benefit) for Income Taxes

On July 1, 2007, we adopted Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109" ("FIN 48"). In connection with the adoption of FIN 48, we recognized an adjustment of approximately $226,000 to the beginning balance of accumulated deficit on our consolidated balance sheet. Our continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. As of June 30, 2008, we had recorded $153,000 of uncertain tax positions including approximately $75,000 of accrued interest and penalties related to these uncertain tax positions.

At July 1, 2007, our fiscal 2001 through fiscal 2008 tax years remain open to examination by the Federal and state taxing authorities. However, we have net operating losses ("NOLs") beginning in fiscal 2001 which 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:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Effective tax rate | 4.5% | 2.0% |

We utilize the liability method of accounting for income taxes as set forth in Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." The tax benefit is the result of a reduction in estimated foreign taxes and penalties. The federal statutory rate was 34% for all periods. The difference between our effective tax rate and the federal statutory rate resulted primarily from the effect of our domestic losses recorded without a 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 net deferred tax assets for the fiscal years ended June 30, 2008 and 2007. As of June 30, 2008, we had net operating loss carryovers of $76.5 million and $43.8 million for federal and California income tax purposes, respectively. The federal and California net operating loss carryovers begin to expire in fiscal years 2021 and 2013, respectively.

Liquidity and Capital Resources

Liquidity

Since inception through fiscal 2008, we have financed our operations primarily through the issuance of common stock and operating activities. We refer to the sum of cash and cash equivalents and marketable securities as "cash" for the purposes of discussing our cash balance and liquidity.

The following table presents details of our working capital and cash:

| | June 30, | | Increase |
|---|---|---|---|
| | 2008 | 2007 | (Decrease) |
| | | (In thousands) | |
| Working capital | $ 5,686 | $ 5,587 | $ 99 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents | $ 7,434 | $ 7,582 | $ | (148) |
| Marketable securities | - | 97 | | (97) |
| Total cash, cash equivalents and marketable securities | $ 7,434 | $ 7,679 | $ | (245) |

Working capital increased and cash balances decreased from the prior year primarily as a result of a decrease in accounts payable and an increase in accounts receivable partially offset by a decrease in net inventories and an increase in restructuring reserves, other liabilities and accrued payroll. In addition, the change in our cash balance is significantly impacted by our cash management activities, which included the timing of cash payments to our vendors and the timing of cash receipts from our customers.

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 twelve months. Our future capital requirements will depend on many factors, including the timing and amount of our net revenues, research and development, expenses associated with any strategic partnerships or acquisitions and infrastructure investments, and expenses related to government investigations and 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 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 May 2006, we entered into a two-year secured revolving Loan and Security Agreement ("Line of Credit") with a bank, which provides for borrowings up to $5.0 million. The borrowing capacity is limited to eligible accounts receivable as defined under the Line of Credit. As of June 30, 2008, we had no borrowings against the Line of Credit.

In August 2008, we amended the Line of Credit, which provides for a three-year $2 million Term Loan and a two-year $3 million Revolving Credit Facility. The Term Loan was funded during August 2008 and is payable in 36 equal installments of principal and monthly accrued interest.

Borrowings under the Term Loan and Revolving Credit Facility bear interest at the greater of 6.25% or prime rate plus 1.25% per annum. If we achieve two consecutive quarters of positive EBITDAS (as defined in the Line of Credit) greater than $1.00, and only for so long as we maintain EBITDAS greater than $1.00 at the end of each subsequent fiscal quarter, then the borrowings under the Term Loan and Revolving Credit Facility will bear interest at the greater of 5.75% or prime rate plus 0.75% per annum.

The following table presents our available borrowing capacity and outstanding letters of credit, which were used to secure equipment leases, deposits for a building lease, foreign value added tax account deposits and security deposits:

| | June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Available borrowing capacity | $ 3,163 | $ 3,462 |
| Outstanding letters of credit | $ 732 | $ 1,280 |

As of June 30, 2008, approximately $801,000 of our cash was held in foreign subsidiary bank accounts. This cash is 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 is subject to approval by the foreign location board of directors.

Cash Flows

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

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Net cash provided by (used in): | | |
| Net loss | $ (2,508) | $ (1,723) |
| Adjustments to reconcile net loss to cash provided by (used in) operating activities | 3,104 | 1,291 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (826) | (350) |
| Inventories | 2,539 | (2,881) |
| Contract manufacturers' receivable | 594 | (221) |
| Prepaid expenses and other current assets | 27 | 7 |
| Other assets | 4 | 5 |
| Accounts payable | (3,340) | 3,152 |
| Accrued payroll and related expenses | 164 | 397 |
| Accrued settlements | - | (400) |
| Warranty reserve | (104) | (247) |

| | | | | |
|---|---|---|---|---|
| Restructuring reserve | | (13) | | (80) |
| Other liabilities | | 486 | | 58 |
| Net cash provided by (used in) operating activities | | 127 | | (992) |
| Net cash (used in) provided by investing activities | | (579) | | 208 |
| Net cash provided by financing activities | | 106 | | 565 |
| Effect of foreign exchange rate changes on cash | | 198 | | 72 |
| Decrease in cash and cash equivalents | $ | (148) | $ | (147) |

Operating activities provided cash during the fiscal year ended June 30, 2008. This was primarily the result of non-cash reconciling items offset by a net operating loss and cash used by operating assets and liabilities. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash used in operating activities included: (i) a decrease accounts payable as a result of the timing of cash payments to vendors; (ii) a decrease in inventories as a result of a $2.1 million decrease in finished goods inventory and a $721,000 decrease in large scale integration chips, which are sold individually and embedded in our products; (iii) changes in accounts receivable and contract manufacturers' receivable as a result of the timing of collections; and (iv) an increase in accrued payroll and related expenses due to the timing of our fiscal year end payroll. The non-cash reconciling items that had a significant impact on net loss included share-based compensation of $1.3 million, restructuring charge of $757,000, depreciation and amortization of $654,000 and provision for inventories of $404,000 partially offset by a gain on the sale of investment of $104,000.

Operating activities used cash during the fiscal year ended June 30, 2007. This was primarily the result of a net operating loss and cash used by operating assets and liabilities offset by non-cash reconciling items. In order of significance, the changes in operating assets and liabilities which had a significant impact on the cash used in operating activities included (i) an increase in inventories as a result of an increase in large scale integration chips, which are sold individually and embedded in our products and incremental inventories to support the launch of new products; (ii) payment of accrued settlements; (iii) an increase in accounts receivable as a result of increased sales from the prior year; offset by an increase in (iv) accounts payable as a result of the timing of cash payments to vendors; and (v) an increase in accrued payroll and related expenses due to the timing of our fiscal year end payroll. The non-cash reconciling items that had a significant impact on net loss included share-based compensation of $1.4 million and depreciation and amortization of $473,000 partially offset by a gain on the sale of a long-term investment of $700,000.

Investing activities used cash during the fiscal year ended June 30, 2008. This was primarily due to cash used in the purchase of property and equipment offset by net proceeds received in connection with a sale of an investment.

Investing activities provided cash during the fiscal year ended June 30, 2007. This was primarily due to net proceeds received in connection with the partial sale of our equity interest in Xanboo of $700,000 offset by cash used in the purchase of property and equipment.

Financing activities provided cash during the fiscal year ended June 30, 2008. This was primarily due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by payments on capital lease obligations.

Financing activities provided cash during the fiscal year ended June 30, 2007. This was primarily due to proceeds from the sale of common shares through employee stock option exercises and the Employee Stock Purchase Plan offset by payments on capital lease obligations.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of June 30, 2008 and 2007.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our financial statements, related notes thereto and supplementary data required by this item are incorporated by reference from Part IV, Item 15 of this Form 10-K and are presented beginning on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. 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 year. 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 June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management’s Report on Internal Control Over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and the board of directors regarding the effectiveness of our internal control processes over the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We have assessed the effectiveness of our internal controls over financial reporting as of June 30, 2008. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on our assessment, we believe that, as of June 30, 2008, our internal control over financial reporting is effective based on those criteria.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to the rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

ITEM 9B. OTHER INFORMATION

None.

# PART III

Certain information required by Part III is included in our 2008 Definitive Proxy Statement (or "Proxy Statement) and is incorporated herein by reference. The Proxy Statement will be filed pursuant to Regulation 14A of the Exchange Act not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The names of our executive officers and their ages, titles and biographies as of the date hereof are set forth in Part I, Item 1 in the section entitled "Executive Officers of the Registrant" above, and are incorporated herein by reference.

The following information is included in our Proxy Statement and is incorporated herein by reference:

- Information regarding our directors is set forth under the proposal "Election of Directors."

- Information regarding our Audit Committee and designated "audit committee financial experts" is set forth under "Election of Directors — Audit Committee."

- Information regarding Section 16(a) beneficial ownership reporting compliance is set forth Other Information — Section 16(a) Beneficial Ownership Reporting Compliance."

- Information on our code of business conduct and ethics for directors, officers and employees (or "Code of Ethics") is set forth under "Election of Directors — Code of Ethics and Complaint Procedure."

We have adopted the Code of Ethics, which applies to all of our directors, officers, and employees. The Code of Ethics operates as a tool to help our directors, officers, and employees understand and adhere to the high ethical standards we expect. Our Code of Ethics can be found on our website at www.lantronix.com. We intend to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or waiver from, a provision of the Code of Ethics by posting such information on our website at the address specified above.

## ITEM 11. EXECUTIVE COMPENSATION

Information regarding executive compensation is incorporated herein by reference to the sections in the Proxy Statement under the headings "Compensation Discussion and Analysis," "Compensation Committee Interlocks and Insider Participation in Compensation Decisions," "Compensation Committee Report," "Executive Officers," "Summary Compensation Table," "Grant of Plan Based Awards," "Outstanding Equity Awards," "Option Exercises and Stock Vested," "Pension Benefits," and "Nonqualified Deferred Compensation."

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information regarding security ownership of certain beneficial owners, directors and executive officers is set forth under "Election of Directors" and "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement and is incorporated herein by reference.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information regarding certain relationships and related transactions is set forth under "Election of

Directors” and Other Information — Related Party Transactions” in the Proxy Statement and is incorporated herein by reference.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information regarding principal auditor fees and services is set forth under the proposal “Ratification of Appointment of Independent Registered Public Accountants” in the Proxy Statement and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1. Consolidated Financial Statements

The following financial statements of the Company and related Report of Independent Registered Public Accounting Firm is filed as part of this Annual Report on Form 10-K.


| | Page |
|---|---|
| Report of Independent Registered Public Accounting Firm, McGladrey & Pullen, LLP | F-2 |
| Consolidated Balance Sheets as of June 30, 2008 and 2007 | F-3 |
| Consolidated Statements of Operations for the fiscal years ended June 30, 2008 and 2007 | F-4 |
| Consolidated Statements of Stockholders’ Equity for the fiscal years ended June 30, 2008 and 2007 | F-5 |
| Consolidated Statements of Cash Flows for the fiscal years ended June 30, 2008 and 2007 | F-6 |
| Notes to Consolidated Financial Statements | F-7 – F-27 |


2. Exhibits

The exhibits listed on the accompanying index to exhibits immediately following the financial statements are filed as part of, or hereby incorporated by reference into, this Form 10-K.

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Lantronix, Inc.
Irvine, California

We have audited the consolidated balance sheets of Lantronix, Inc. as of June 30, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lantronix, Inc. as of June 30, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

As described in Note 1 to the consolidated financial statements, effective July 1, 2007 the Company changed its method of accounting for uncertainty in income taxes.

We were not engaged to examine management's assertion about the effectiveness of Lantronix, Inc.'s internal control over financial reporting as of June 30, 2008 included in the accompanying Management's Report on Internal Control Over Financial Reporting and, accordingly, we do not express an opinion thereon.

/s/ McGladrey & Pullen, LLP

Irvine, California
September 16, 2008

LANTRONIX, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

| | June 30, 2008 | June 30, 2007 |
|---|---|---|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 7,434 | $ 7,582 |
| Marketable securities | - | 97 |
| Accounts receivable (net of allowance for doubtful accounts of $173 and $105 at June 30, 2008 and 2007, respectively) | 4,166 | 3,411 |
| Inventories, net | 8,038 | 10,981 |
| Contract manufacturers' receivable | 676 | 1,270 |
| Prepaid expenses and other current assets | 566 | 578 |
| Total current assets | 20,880 | 23,919 |
| | | |
| Property and equipment, net | 2,271 | 1,911 |
| Goodwill | 9,488 | 9,488 |
| Purchased intangible assets, net | 382 | 485 |
| Officer loans (net of allowance of $3,115 at June 30, 2008 and 2007) | 94 | 129 |
| Other assets | 50 | 26 |
| Total assets | $ 33,165 | $ 35,958 |
| | | |
| Liabilities and stockholders' equity | | |
| Current Liabilities: | | |
| Accounts payable | $ 7,684 | $ 11,017 |
| Accrued payroll and related expenses | 2,203 | 1,993 |
| Warranty reserve | 342 | 446 |
| Restructuring reserve | 744 | - |
| Accrued settlements | - | 1,068 |
| Other current liabilities | 4,221 | 3,808 |
| Total current liabilities | 15,194 | 18,332 |
| Long-term liabilities | 210 | 256 |
| Long-term capital lease obligations | 515 | 142 |
| | | |
| Commitments and contingencies | | |
| | | |
| Stockholders' equity: | | |
| Preferred stock, $0.0001 par value; 5,000,000 shares authorized; none issued and outstanding | - | - |
| Common stock, $0.0001 par value; 200,000,000 shares authorized; 60,312,363 and 59,879,488 shares issued and outstanding at June 30, 2008 and 2007, respectively | 6 | 6 |
| Additional paid-in capital | 187,626 | 184,953 |
| Accumulated deficit | (170,907) | (168,173) |
| Accumulated other comprehensive income | 521 | 442 |
| Total stockholders' equity | 17,246 | 17,228 |

| | | | | |
|---|---|---|---|---|
| Total liabilities and stockholders' equity | $ | 33,165 | $ | 35,958 |

See accompanying notes.

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LANTRONIX, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| Net revenue (1) | $ 57,586 | $ 55,306 |
| Cost of revenue | 28,518 | 26,964 |
| Gross profit | 29,068 | 28,342 |
| Operating expenses: | | |
| Selling, general and administrative | 23,892 | 23,243 |
| Research and development | 6,944 | 7,362 |
| Restructuring charge | 757 | - |
| Litigation settlement cost | - | 90 |
| Amortization of purchased intangible assets | 72 | 72 |
| Total operating expenses | 31,665 | 30,767 |
| Loss from operations | (2,597) | (2,425) |
| Interest expense, net | (150) | (13) |
| Other income, net | 120 | 749 |
| Loss before income taxes | (2,627) | (1,689) |
| Provision (benefit) for income taxes | (119) | 34 |
| Net loss | $ (2,508) | $ (1,723) |
| | | |
| Net loss per share (basic and diluted) | $ (0.04) | $ (0.03) |
| | | |
| Weighted average shares (basic and diluted) | 60,134 | 59,603 |
| | | |
| (1) Includes net revenue from related party | $ 974 | $ 1,073 |

See accompanying notes.

LANTRONIX, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except share data)

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|---|---|---|---|---|---|---|
| Balance at June 30, 2006 | 59,204,172 | $ 6 | $ 182,857 | $ (166,450) | $ 365 | $ 16,778 |
| Stock options exercised | 344,393 | - | 346 | - | - | 346 |
| Employee stock purchase plan | 330,923 | - | 361 | - | - | 361 |
| Share-based compensation | - | - | 1,389 | - | - | 1,389 |
| Components of comprehensive loss: | | | | | | |
| Translation adjustments | - | - | - | - | 68 | 68 |
| Change in net unrealized income on investment | - | - | - | - | 9 | 9 |
| Net loss | - | - | - | (1,723) | - | (1,723) |
| Comprehensive loss | - | - | - | - | - | (1,646) |
| Balance at June 30, 2007 | 59,879,488 | $ 6 | $ 184,953 | $ (168,173) | $ 442 | $ 17,228 |
| Stock options exercised | 129,396 | - | 75 | - | - | 75 |
| Employee stock purchase plan | 303,479 | - | 254 | - | - | 254 |
| Share-based compensation | - | - | 1,287 | - | - | 1,287 |
| Issuance of warrants in connection with shareholder settlement | - | - | 1,057 | - | - | 1,057 |
| Cumulative effect to prior year accumulated deficit related to the adoption of FIN 48 | - | - | - | (226) | - | (226) |
| Components of comprehensive loss: | | | | | | |
| Translation adjustments | - | - | - | - | 176 | 176 |
| Change in net unrealized income on investment | - | - | - | - | 7 | 7 |
| Reclassification adjustment for net realized gain on sale of investment | | | | | (104) | (104) |
| Net loss | - | - | - | (2,508) | - | (2,508) |
| Comprehensive loss | - | - | - | - | - | (2,429) |
| Balance at June 30, 2008 | 60,312,363 | $ 6 | $ 187,626 | $ (170,907) | $ 521 | $ 17,246 |

See accompanying notes.

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

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| Operating activities | | |
| Net loss | $ (2,508) | $ (1,723) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Share-based compensation | 1,287 | 1,389 |
| Restructuring charge | 757 | - |
| Depreciation | 551 | 386 |
| Provision for inventories | 404 | 13 |
| Gain on sale of investment | (104) | (700) |
| Amortization of purchased intangible assets | 103 | 87 |
| Provision for doubtful accounts | 71 | 26 |
| Provision for former director loan | 35 | - |
| Litigation settlement costs | - | 90 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (826) | (350) |
| Inventories | 2,539 | (2,881) |
| Contract manufacturers' receivable | 594 | (221) |
| Prepaid expenses and other current assets | 27 | 7 |
| Other assets | 4 | 5 |
| Accounts payable | (3,340) | 3,152 |
| Accrued payroll and related expenses | 164 | 397 |
| Accrued settlements | - | (400) |
| Warranty reserve | (104) | (247) |
| Restructuring reserve | (13) | (80) |
| Other liabilities | 486 | 58 |
| Net cash provided by (used in) operating activities | 127 | (992) |
| Investing activities | | |
| Purchases of property and equipment, net | (683) | (492) |
| Proceeds from sale of marketable securities | 104 | - |
| Proceeds from sale of long-term investment | - | 700 |
| Net cash (used in) provided by investing activities | (579) | 208 |
| Financing activities | | |
| Net proceeds from issuances of common stock | 329 | 707 |
| Payment of capital lease obligations | (223) | (142) |
| Net cash provided by financing activities | 106 | 565 |
| Effect of foreign exchange rate changes on cash | 198 | 72 |
| Decrease in cash and cash equivalents | (148) | (147) |
| Cash and cash equivalents at beginning of period | 7,582 | 7,729 |
| Cash and cash equivalents at end of period | $ 7,434 | $ 7,582 |
| Supplemental disclosure of cash flow information | | |
| Interest paid | $ 193 | $ 136 |
| Income taxes paid | $ 103 | $ 30 |

See accompanying notes.

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LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2008

1. Summary of Significant Accounting Policies

The Company

Lantronix, Inc. (the "Company"), incorporated in California in June 1989 and re-incorporated in the State of Delaware in May 2000, is engaged primarily in the design and distribution of networking and Internet connectivity products on a worldwide basis. The actual assembly and a portion of the engineering of the Company's products are outsourced to third parties.

The Company has incurred losses from operations and has reported negative operating cash flows. As of June 30, 2008, the Company had an accumulated deficit of $170.9 million and cash and cash equivalents and marketable securities of $7.4 million. The Company has no material financial commitments other than operating and capital lease agreements and inventory purchase orders. The Company believes that its existing cash and cash equivalents, and any cash generated from operations, will be sufficient to fund its working capital requirements, capital expenditures and other obligations through the next twelve months. Long term the Company may face significant risks associated with the successful execution of its business strategy and may need to raise additional capital in order to fund more rapid expansion, to expand its marketing activities, to develop new or enhance existing services or products, and to respond to competitive pressures or to acquire complementary services, businesses, or technologies. If the Company is not successful in generating sufficient cash flow from operations, it may need to raise additional capital through public or private financing, strategic relationships, or other arrangements.

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. At June 30, 2008, approximately $1.0 million of the Company's net tangible assets (primarily cash held in foreign bank accounts) were located outside the U.S. Such assets are unrestricted with regard to foreign liquidity needs, however, the ability of the Company to utilize such assets to satisfy liquidity needs outside of such foreign locations are subject to approval by the foreign location board of directors.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The industry in which the Company operates is characterized by rapid technological change and short product life cycles. As a result, estimates made in preparing the consolidated financial statements include the allowance for doubtful accounts, sales returns and allowances, inventory reserves, allowance for officer loans, strategic investments, goodwill and purchased intangible asset valuations, deferred income tax asset valuation allowances, warranty reserves, restructuring costs, litigation and other contingencies. To the extent there are material differences between estimates and the actual results, future results of operations will be affected.

Revenue Recognition

The Company does not recognize revenue until all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the Company's price to the buyer is fixed or

determinable; and collectibility is reasonably assured. A significant portion of the Company's sales are made to distributors under agreements which contain a limited right to return unsold product and price protection provisions. Therefore, the recognition of net revenues and related cost of revenues from sales to certain large distributors are deferred until the distributor resells the product. Net revenue from certain smaller distributors, for which point-of-sale or inventory information is not available, is recognized approximately one month after the shipment date. This estimate approximates the timing of the sale of the product by the distributor to the end user.

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

When product revenues are recognized, the Company establishes an estimated allowance for future product returns based on historical returns experience; when price reductions are approved, it establishes an estimated liability for price protection payable on inventories owned by distributors. Should actual product returns or pricing adjustments exceed the Company’s estimates, additional reductions to revenues could result.

Net revenues from the licensing of software is recognized at the time of shipment (or at the time of resale in the case of software products sold through distributors), provided the Company has vendor-specific objective evidence of the fair value of each element of the software offering and collectibility is probable. Additionally, the Company sells extended warranty services which extend the warranty period for an additional one to three years, depending upon the product. Warranty net revenues are recognized ratably over the warranty service period.

The following table presents our hardware and non-hardware sales as a percentage of total net revenues:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Hardware | 99.0% | 99.2% |
| Non-hardware | 1.0% | 0.8% |
| Total net revenues | 100.0% | 100.0% |

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company’s allowance for doubtful accounts is based on its assessment of the collectibility of specific customer accounts, the aging of accounts receivable, the Company’s history of bad debts and the general condition of the industry. Accounts that are deemed uncollectible are written off against the allowance for doubtful accounts. If a major customer’s creditworthiness deteriorates, or the Company’s customers’ actual defaults exceed its historical experience, such estimates could change and impact reported results.

The Company also maintains a reserve for uncertainties relative to the collection of officer notes receivable. Factors considered in determining the level of this reserve include the value of the collateral securing the notes, the Company’s ability to effectively enforce collection rights and the ability of the former officers and Lantronix director to honor their obligations.

Concentration of Credit Risk

The Company’s accounts receivable are primarily derived from revenues earned from customers located throughout North America, Europe and Asia. The Company performs ongoing credit evaluations of its customers’ financial condition and maintains allowances for potential credit losses. Credit losses have historically been within management’s expectations. The Company generally does not require collateral or other security from its customers. The Company invests its excess cash in deposits with major banks, in U.S. Government agencies, state, municipal and county government notes and bonds.

Fair Value of Financial Instruments

The Company’s financial instruments consist principally of cash, cash equivalents, marketable securities, accounts receivable, notes receivable, contract manufacturers’ receivable, accounts payable and accrued liabilities. The Company believes all of the financial instruments’ recorded values approximate current values because of the nature and short duration of these instruments.

Foreign Currency Translation

The financial statements of foreign subsidiaries whose functional currency is not the U.S. dollar have been translated to U.S. dollars in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 52, “Foreign Currency Translation.” Foreign currency assets and liabilities are valued in U.S. dollars at the end-of-period exchange rates. Revenues and expenses are translated at average exchange rates in effect during each period. Exchange gains and losses from foreign currency translations are reported as a component of accumulated other comprehensive income within stockholders’ equity. Exchange gains and losses from foreign currency transactions are recognized in the consolidated statement of operations and historically have not been material.

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and short-term investments with original maturities of 90 days or less.

Investments

Available-for-Sale Investments

The Company accounts for its investments in debt and equity securities with readily determinable fair values that are not accounted for under the equity method of accounting under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Management determines the appropriate classification of such securities at the time of purchase and reevaluates such classification as of each balance sheet date. The Company classifies its marketable securities as available-for-sale under SFAS 115. Marketable securities consist of equity securities. The specific identification method is used to determine the cost basis of securities disposed of. Unrealized gains and losses on the marketable securities are included as a separate component of accumulated other comprehensive income, net of tax.

Long-term Investments

Until the Company sold its remaining interest in its long-term investment in Xanboo Inc. ("Xanboo") in fiscal 2007, it accounted for it under the equity method based upon the Company's ability, through representation on Xanboo's board of directors, to exercise significant influence over its operations. Under the equity method of accounting, the Company's proportionate share of income or losses from the long-term investment, and any gain or loss on disposal, are recorded in other expense, net. The Company's proportionate share of losses are not recorded to the extent that they exceed the carrying value of the long-term investment.

Impairment of Investments

The Company periodically reviews its investments for which fair value is less than cost to determine if the decline in value is other-than-temporary. Additionally, the Company monitors its long-term investment for impairment and makes appropriate reductions in the carrying value if the Company determines that an impairment charge is required based primarily on the financial condition and near-term prospects of the investment. If the decline in value is judged to be other-than-temporary, the cost basis of the security is written down to fair value. The Company generally believes an other-than-temporary decline has occurred when the fair value of the investment is below the carrying value for two consecutive fiscal quarters, absent evidence to the contrary.

Inventories

Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. The Company provides reserves for excess and obsolete inventories determined primarily based upon estimates of future demand for the Company's products. Shipping and handling costs are classified as a component of cost of revenues in the consolidated statements of operations.

Inventory Sale and Purchase Transactions with Contract Manufacturers

Under certain circumstances, the Company sells raw materials to its contract manufacturers and subsequently repurchases finished goods from the contract manufacturers which contain such raw materials. Net sales of raw

materials to the contract manufacturers are eliminated from the Company's net revenues as the Company intends to repurchase the raw materials from the contract manufacturers in the form of finished goods. Raw materials sold to the contract manufacturers which the Company intends to purchase as part of finished goods are recorded on the Company's consolidated balance sheets as contract manufacturers' receivable.

Property and Equipment

Property and equipment are carried at cost. Depreciation is provided using the straight-line method over the assets' estimated useful lives ranging from three to five years. Depreciation and amortization of leasehold improvements are computed using the shorter of the remaining lease term or five years. Major renewals and betterments are capitalized, while replacements, maintenance and repairs, which do not improve or extend the lives of the respective assets, are expensed as incurred.



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LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Capitalized Internal Use Software Costs

The Company capitalizes the costs of computer software developed or obtained for internal use in accordance with AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Capitalized computer software costs consist of purchased software licenses and implementation costs. The capitalized software costs are being amortized on a straight-line basis over a period of three to five years.

Goodwill and Purchased Intangible Assets

Goodwill is recorded as the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), the Company tests goodwill for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the fourth fiscal quarter or more frequently if the Company believes indicators of impairment exist. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair values of the applicable reporting unit with its aggregate carrying value, including goodwill. The Company generally determines the fair value of its reporting unit using the market or income approach methodology of valuation that includes comparing to market values of similar companies, the discounted cash flow method as well as other generally accepted valuation methodologies. If the carrying amount of the reporting unit exceeds the reporting unit's fair value, the Company performs the second step of the goodwill impairment test to determine the amount of impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the affected reporting unit's goodwill with the carrying value of that goodwill.

During the fourth fiscal quarters ended June 30, 2008 and 2007, the Company completed its annual goodwill impairment tests in accordance with SFAS 142 as of April 1, 2008 and determined that no impairment was indicated as the estimated fair values exceeded their respective carrying values.

The Company accounts for long-lived assets, including other purchased intangible assets, in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), which requires impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present. Reviews are performed to determine whether the carrying value of an asset is impaired, based on comparisons to undiscounted expected future cash flows. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using (i) quoted market prices and/or (ii) discounted expected future cash flows utilizing a discount rate consistent with the guidance provided in FASB Concepts Statement No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements." Impairment is based on the excess of the carrying amount over the fair value of those assets.

Income Taxes

In accordance with SFAS 109, "Accounting for Income Taxes" (SFAS 109), income taxes are computed under the liability method. This method requires the recognition of deferred tax assets and liabilities for temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities. The impact on deferred taxes of changes in tax rates and laws, if any, are applied to the years during which temporary differences are expected to be settled and are reflected in the consolidated financial statements in the period of enactment. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized.

In June 2006, FASB issued FASB Interpretation No. ("FIN") 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes," by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Under FIN 48, the financial statement effects of a tax position should initially be recognized when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. A tax position that meets the more-likely-than-not recognition threshold should initially and subsequently be measured as the largest amount of tax benefit that has a more likely than not likelihood of being realized upon ultimate settlement with a taxing authority. The Company adopted FIN 48 effective July 1, 2007 and the provisions of FIN 48 have been applied to all income tax positions commencing from that date. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as income tax expense. The cumulative effect of applying the provisions of FIN 48 has been reported as an adjustment of $226,000 to the opening balance of our accumulated deficit as of July 1, 2007. As of June 30, 2008, the Company had recorded $153,000 of uncertain tax positions including approximately $75,000 of accrued interest and penalties related to these uncertain tax positions.

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Prior to the fiscal year ended June 30, 2008, the Company determined its tax contingencies in accordance with SFAS No. 5, "Accounting for Contingencies" ("SFAS 5"). The Company recorded estimated tax liabilities to the extent the contingencies were probable and could be reasonably estimated.

Share-Based Compensation

The Company accounts for share-based compensation in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). SFAS 123R requires companies to expense the estimated fair value of stock options and similar equity instruments issued to employees over the requisite service period. The Company records amortization of share-based compensation expense ratably over the requisite service period of the grant or as market conditions are achieved. The Company estimates forfeitures in its calculation of share-based compensation.

Net Income (Loss) Per Share

Net income (loss) per share (basic) is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the fiscal year. Net income (loss) per share (diluted) is calculated by adjusting the weighted average number of common shares outstanding, assuming any dilutive effects of options using the treasury stock method.

Research and Development Costs

Costs incurred in the research and development of new products and enhancements to existing products are expensed as incurred. The Company believes its current process for developing products is essentially completed concurrently with the establishment of technological feasibility. Software development costs incurred after the establishment of technological feasibility have not been material and, therefore, have been expensed as incurred.

Warranty

Upon shipment to its customers, the Company provides for the estimated cost to repair or replace products to be returned under warranty. The Company's products typically carry a one- to two-year warranty. In addition, certain products that were sold prior to August 2003 carry a five-year warranty. Although the Company engages in extensive product quality programs and processes, its warranty obligation is affected by product failure rates, use of materials or service delivery costs that differ from the Company's estimates. As a result, additional warranty reserves could be required, which could reduce gross margins. Additionally, the Company sells extended warranty services, which extend the warranty period for an additional one to three years depending upon the product.

Advertising Expenses

Advertising costs are expensed in the period incurred.

Comprehensive Income

SFAS No. 130, "Reporting Comprehensive Income," establishes standards for reporting and displaying comprehensive income (loss) and its components in the consolidated financial statements. Accumulated other comprehensive income includes foreign currency translation adjustments and unrealized gains on investments.

Segment Information

SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information,” establishes standards for the way companies report information about operating segments in annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas and major customers. The Company has only one reportable segment, networking and Internet connectivity.

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

Restructuring

SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" requires that costs, including severance costs, associated with exit or disposal activities be recorded at their fair value when a liability has been incurred. Adjustments for changes in assumptions are recorded in the period such changes become known.

Recent Accounting Pronouncements

In September 2006 the FASB issued SFAS 157, "Fair Value Measurements" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. In February 2008, the FASB approved FASB Staff Position 157-2, "Effective Date of FASB Statement No. 157," which delays the effective date of SFAS 157 for non-financial assets and liabilities to fiscal years beginning after November 15, 2008. We are currently evaluating the impact, if any, that SFAS 157 may have on our future consolidated financial statements related to non-financial assets and liabilities. SFAS 157 will impact the way the Company tests goodwill for impairment, but it is not known what impact, if any, this will have on our future consolidated financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

2. Supplemental Financial Information

Inventories

The following table presents details of the Company's inventories:

| | June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Finished goods | $ 5,707 | $ 7,848 |
| Raw materials | 1,836 | 2,653 |
| Inventory at distributors | 2,008 | 1,876 |
| Large scale integration chips * | 809 | 1,530 |
| Inventories, gross | 10,360 | 13,907 |
| Reserve for excess and obsolete inventory | (2,322) | (2,926) |
| Inventories, net | $ 8,038 | $ 10,981 |

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

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

Property and Equipment

The following table presents details of the Company's property and equipment:

| | June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Computer and office equipment | $ 3,410 | $ 2,639 |
| Furniture and fixtures | 1,118 | 1,069 |
| Production and warehouse equipment | 865 | 854 |
| Construction-in-progress | 165 | 78 |
| Property and equipment, gross | 5,558 | 4,640 |
| Less accumulated depreciation | (3,287) | (2,729) |
| Property and equipment, net | $ 2,271 | $ 1,911 |

The following table presents details of property and equipment recorded in connection with capital lease obligations:

| | June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Property and equipment | $ 632 | $ 413 |
| Less accumulated depreciation | (281) | (122) |
| Total | $ 351 | $ 291 |

The following table presents details of the unamortized costs capitalized as internal use software included in construction-in-progress and computer and office equipment:

| | June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Capitalized internal use software | $ 1,188 | $ 728 |

The following table presents the details of depreciation of capitalized internal use software:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Depreciation of capitalized internal use software | $ 140 | $ 89 |

Purchased Intangible Assets

The following table presents details of the Company's purchased intangible assets:

| | | June 30, 2008 | | | June 30, 2007 | | |
|---|---|---|---|---|---|---|---|
| | Useful Lives in Years | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| | | (In thousands) | | | | | |
| Existing technology | 1 - 5 | $ 7,259 | $ (7,149) | $ 110 | $ 7,259 | $ (7,119) | $ 140 |
| Patent/core technology | 6 | 839 | (567) | 272 | 839 | (494) | 345 |
| Total purchased intangible assets | | $ 8,098 | $ (7,716) | $ 382 | $ 8,098 | $ (7,613) | $ 485 |

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

The following table presents the amount of purchased intangible assets that the Company will amortize to cost of revenues over the next four fiscal years:

| | Years Ended June 30, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | Total |
| | (In thousands) | | | | |
| Amount remaining to be amortized | $ 183 | $ 73 | $ 73 | $ 53 | $ 382 |

Warranty Reserve

The following table presents details of the Company's warranty reserve:

| | June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Beginning balance | $ 446 | $ 693 |
| Charged to cost of revenues | 219 | 107 |
| Usage | (323) | (354) |
| Ending balance | $ 342 | $ 446 |

Other Liabilities

The following table presents details of the Company's other liabilities:

| | June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Current | | |
| Customer deposits and refunds | $ 1,535 | $ 1,187 |
| Deferred revenue | 401 | 155 |
| Capital lease obligations | 292 | 136 |
| Taxes payable | 230 | 241 |
| Reimbursable legal expense | 88 | 138 |
| Insurance payable | 38 | 264 |
| Enterprise resource planning implementation costs | - | 500 |
| Other | 1,637 | 1,187 |
| Total other current liabilities | $ 4,221 | $ 3,808 |
| | | |
| Long-term | | |
| Deferred revenue | $ 97 | $ 128 |
| Other | 113 | 128 |
| Total other long-term liabilities | $ 210 | $ 256 |

Advertising Expenses

The following table presents details of the Company’s advertising expenses:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Advertising expenses | $ 514 | $ 862 |

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

Interest Expense

The following table presents details of the Company's interest expense:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Interest expense | $ 193 | $ 136 |

Computation of Net Loss per Share

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

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands, except per share data) | |
| Numerator: | | |
| Net loss | $ (2,508) | $ (1,723) |
| Denominator: | | |
| Weighted-average shares outstanding | 60,234 | 59,603 |
| Less: Unvested common shares outstanding | (100) | - |
| Weighted average shares (basic and diluted) | 60,134 | 59,603 |
| Net loss per share (basic and diluted) | $ (0.04) | $ (0.03) |

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

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| Common stock equivalents | 4,035,504 | 2,605,689 |

Supplemental Cash Flow Information

The following table presents non-cash investing and financing transactions excluded from the consolidated statements of cash flows:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands) | |

| | | | | |
|---|---|---|---|---|
| Non-cash acquisition of property and equipment | $ | 726 | $ | 216 |

## 3. Investments

Marketable Securities

During the fiscal year ended June 30, 2008, the Company realized a specifically identified gain of $104,000 on the sale of its available-for-sale investment. There were no gross realized gains and losses related to the Company's available-for-sale investments during the fiscal year ended June 30, 2007.

Long-term Investments

On October 19, 2006, the Company sold its remaining interest in Xanboo for cash consideration of $700,000. The Company recorded the $700,000 cash payment as other income in the consolidated statements of operations for the fiscal year ended June 30, 2007.

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

## 4. Officer Loans

The Company has outstanding notes receivable from a former officer and a Lantronix former director primarily related to taxes on exercised stock options. These notes are non-recourse, secured by shares of common stock, and bear interest at rates ranging from 5.19% to 7.50% per annum. Principal and any unpaid interest are due upon any transfer or disposition of the secured common stock.

One of the note holders is a former Chief Executive Officer who assumed the role of Chief Technology and Strategy Officer of the Company effective May 30, 2002 and resigned from the Company effective September 1, 2002. During fiscal 2002, the Company reduced the carrying amount of the former officer's loans to zero by establishing a reserve for uncertainties relative to collection of the related notes receivable. Factors considered in determining the level of this reserve include the value of the collateral securing the notes, the ability of the Company to effectively enforce its collection rights and the ability of the former officer to honor his obligations to the Company.

## 5. Restructuring Charges

During the fourth fiscal quarter ended June 30, 2008, the Company implemented a restructuring plan to optimize Lantronix's reporting organization to better leverage existing customer and partner relationships to drive revenue growth and profitability. As part of the restructuring plan, 10 employees from the senior-level ranks of the sales, marketing, operations and engineering groups were terminated.

The following table presents a summary of the activity in the Company's restructuring reserve:

| | Severance Related Costs | Consolidation of Excess Facilities | Total |
|---|---|---|---|
| | (In thousands) | | |
| Restructuring reserve at June 30, 2006 | $ - | $ 80 | $ 80 |
| Cash payments | - | (80) | (80) |
| Restructuring reserve at June 30, 2007 | - | - | - |
| Restructuring charge | 757 | - | 757 |
| Cash payments | (13) | - | (13) |
| Restructuring reserve at June 30, 2008 | $ 744 | $ - | $ 744 |

During the first fiscal quarter ended September 30, 2008, the Company implemented a second restructuring plan. As part of the second restructuring plan, an additional 28 employees from all ranks and across all functional groups of the Company are expected to be terminated. In connection with the second restructuring plan, the Company expects to take a restructuring charge ranging from $400,000 to $800,000 during the first fiscal quarter ended September 30, 2008.

## 6. Lines of Credit and Convertible Note Payable

Line of Credit

In May 2006, the Company entered into a two-year secured revolving Loan and Security Agreement ("Line of Credit") with a bank, which provides for borrowings up to $5.0 million. The borrowing capacity is limited to eligible accounts receivable as defined under the Line of Credit. Borrowings under the Line of Credit bear interest at the prime rate plus 1.75% per annum. The Company is required to pay an unused line fee of 0.50% on the unused portion of the Line of Credit. In addition, the Company paid a fully earned, non-refundable commitment fee of $54,000 and paid an additional $54,000 on the first anniversary of the effective date of the Line of Credit.

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

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

The Company is subject to a number of covenants under the Line of Credit, pursuant to which, among other things, the Company has agreed that it will not, without the bank's prior written consent: (a) sell, lease, transfer or otherwise dispose, any of the Company's business or property, provided, however, that the Company may sell inventory in the ordinary course of business consistent with the provisions of the Line of Credit; (b) change the Company's business structure, liquidate or dissolve, or permit a change in beneficial ownership of more than 20% of the outstanding shares; (c) acquire, merge or consolidate with or into any other business organization; (d) incur any debts outside the ordinary course of the Company's business, except for permitted indebtedness, or grant any security interests in or permit a lien, claim or encumbrance upon all or any portion of the Company's assets, except in favor of or agreed to by the bank; (f) make any investments other than permitted investments; (g) make or permit any payments on any subordinated debt, except under the terms of existing subordinated debt or on terms acceptable to the bank, or amend any provision in any document related to the subordinated debt that would increase the amount thereof, or (h) become an "investment company" as such term is defined under the Investment Company Act of 1940. The Line of Credit also contains a number of affirmative covenants, including, among other things, covenants regarding the delivery of financial statements and notice requirements, accounts receivable, payment of taxes, access to collateral and books and records, maintenance of properties and insurance policies, and litigation by third parties.

The Line of Credit includes events of default that include, among other things, non-payment of principal, interest or fees, violation of affirmative and negative covenants, cross default to certain other indebtedness, material adverse change, material judgments, bankruptcy and insolvency events.

As of June 30, 2008, the Company had no borrowings against the Line of Credit.

In August 2008, the Company entered into an amendment to its Line of Credit, which provides for a three-year $2.0 million Term Loan and a two-year $3.0 million Revolving Credit Facility. The Term Loan was funded on August 26, 2008 and is payable in 36 equal installments of principal and monthly accrued interest.

Borrowings under the Term Loan and Revolving Credit Facility bear interest at the greater of 6.25% or prime rate plus 1.25% per annum. If the Company achieves two consecutive quarters of positive EBITDAS (as defined in the Loan Agreement) greater than $1.00, and only for so long as the Company maintains EBITDAS greater than $1.00 at the end of each subsequent fiscal quarter, then the borrowings under the Term Loan and Revolving Credit Facility will bear interest at the greater of 5.75% or prime rate plus 0.75% per annum. The Company paid a fully earned, non-refundable commitment fee of $35,000 and is required to pay an additional $35,000 on the first anniversary of the Effective Date.

Availability under the Lines of Credit

The following table presents the Company’s available borrowing capacity and outstanding letters of credit, which were used to secure equipment leases, deposits for a building lease, foreign value added tax account deposits and security deposits:

| | June 30, | |
|---|---|---|
| | 2008 | 2007 |
| | (In thousands) | |
| Available borrowing capacity | $ 3,163 | $ 3,462 |
| Outstanding letters of credit | $ 732 | $ 1,280 |

## 7. Stockholders' Equity

### Share-Based Plans

The Company has one active share-based plan under which non-qualified and incentive stock options have been granted to employees, non-employees and board members. In addition, the Company has granted restricted stock awards to an employee under this share-based plan. The Company also has an employee stock purchase plan for all eligible employees. The board of directors determines eligibility, vesting schedules and exercise prices for options and shares granted under the plans. The Company issues new shares to satisfy stock option exercises, restricted stock grants, and stock purchases under its share-based plans. No income tax benefit was realized from activity in the Company's share-based plans during the fiscal years ended June 30, 2008 and 2007.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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The following table presents a summary of the shares authorized for grant under each plan:

| | June 30, 2008 Shares Authorized for Grant |
|---|---|
| 2000 Stock Plan (“2000 Plan”) | 16,000,000 |
| 2000 Employee Stock Purchase Plan (“ESPP”) | 2,550,000 |
| Total shares authorized for grant | 18,550,000 |

Under the 2000 Plan, the number of shares available for issuance is increased annually on the first day of the calendar year by an amount of shares equal to the lesser of (i) 2,000,000 shares, (ii) 5% of the outstanding shares on such date or (iii) a lesser amount as determined by the board of the directors. As a result of the Company’s acquisitions, the Company assumed stock options granted under stock option plans established by each acquired company; no additional options will be granted under those plans. Share-based awards are generally granted with an exercise price equal to the market price of the Company’s stock at the date of grant. Option awards generally have a term of 10 years. Share-based award generally vest and become exercisable over a one- to four-year service period. In addition, the Company has granted share-based awards with market conditions whereby vesting is accelerated upon achieving certain stock price thresholds.

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

| | Years Ended June 30, | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (In thousands) | | | |
| Cost of revenues | $ | 99 | $ | 89 |
| Selling, general and administrative | | 847 | | 922 |
| Research and development | | 341 | | 378 |
| Total share-based compensation | $ | 1,287 | $ | 1,389 |

The following table presents a summary of share-based compensation for the Company’s share-based plans:

| | Years Ended June 30, | | | |
|---|---|---|---|---|
| | 2008 | | 2007 | |
| | (In thousands) | | | |
| Stock option | $ | 1,091 | $ | 1,095 |
| ESPP | | 192 | | 294 |
| Restricted stock | | 4 | | - |
| Total share-based compensation | $ | 1,287 | $ | 1,389 |

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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The following table presents a summary of remaining unrecognized share-based compensation expense for the Company's share-based plans:

| Vesting Condition | Remaining Unrecognized Compensation Cost (In thousands) | Remaining Years To Vest |
|---|---|---|
| Stock Option Awards: | | |
| Service based | $ 923 | |
| Market and service based | 843 | |
| All stock option awards | $ 1,766 | 2.6 |
| | | |
| Restricted Stock Awards: | | |
| Market and service based | $ 74 | 2.7 |

Stock Option Plans

The fair value of each stock option grant is estimated on the grant date using the Black-Scholes-Merton ("BSM") option-pricing formula. To the extent that the stock option grant includes market conditions, the Company uses a lattice model to estimate the fair value for each stock option grant. Expected volatilities are based on the historical volatility of the Company's stock price. The expected term of options granted subsequent to the adoption of SFAS 123R is derived using the simplified method as defined in the SEC's Staff Accounting Bulletin 107, "Implementation of FASB 123R." To the extent that stock option grants include market conditions and do not meet the rules for the simplified method, the Company uses a lattice model to estimate the expected term of stock options granted. The risk-free rate for periods within the contractual life of the stock option grant is based on the U.S. Treasury interest rates in effect at the time of grant.

The fair value of options granted was estimated using the following weighted-average assumptions for all of the Company's stock option plans:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Expected term (in years) | 5.98 | 6.23 |
| Expected volatility | 0.78 | 0.89 |
| Risk-free interest rate | 2.94% | 4.67% |
| Dividend yield | 0.00% | 0.00% |

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

| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| | (In thousands, except per share data) | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Balance at June 30, 2007 | 5,891,896 | $ | 1.65 | | | |
| Options granted | 4,760,721 | | 0.84 | | | |
| Options forfeited | (1,497,411) | | 1.39 | | | |
| Options expired | (509,258) | | 2.41 | | | |
| Options exercised | (129,396) | | 0.58 | | | |
| Balance at June 30, 2008 | 8,516,552 | $ | 1.22 | 7.8 | $ | 124 |
| Vested or expected to vest at June 30, 2008 | 7,797,569 | $ | 1.25 | 7.7 | $ | 124 |
| Options exercisable at June 30, 2008 | 3,638,296 | $ | 1.57 | 5.6 | $ | 122 |

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

The following table presents a summary of option grant-date fair value and intrinsic value information for all of the Company's stock option plans:

| | Years Ended June 30, 2008 | 2007 |
|---|---|---|
| | (In thousands, except per share data) | |
| Weighted-average grant-date fair value per share | $ 0.58 | $ 1.25 |
| Intrinsic value of options exercised | $ 65 | $ 212 |

Market-Based Share Awards

During the fiscal year ended June 30, 2008, the Company granted market-based option and restricted stock awards to certain employees and directors. The market-based share awards cliff vest over 3-years; however, the vesting may accelerate upon the Company's stock price reaching the following thresholds for 120 consecutive days: (i) 30% vests at $1.50; (ii) 30% vests at $2.50; and (iii) 40% vests at $4.00. The vesting percentages do not cumulate.

A lattice model was used to estimate the fair value and expected life for the market-based option awards. The following table presents a summary of option activity for the Company's market-based option awards:

| | Number of Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| | (In thousands, except per share data) | | | |
| Balance at June 30, 2007 | - | $ - | | |
| Options granted | 3,016,771 | 0.79 | | |
| Options forfeited | (240,000) | 0.77 | | |
| Options expired | - | - | | |
| Options exercised | - | - | | |
| Balance at June 30, 2008 | 2,776,771 | $ 0.79 | 9.7 | $ - |
| Vested or expected to vest at June 30, 2008 | 2,351,750 | $ 0.79 | 9.7 | $ - |
| Options exercisable at June 30, 2008 | - | $ - | - | $ - |

The fair value of market-based restricted stock is determined upon the closing trading price of the Company's shares on the grant date. A lattice model was used to estimate the expected life for the market-based restricted stock. The following table presents a summary of the vesting activity for the Company's market-based restricted shares:

| | Year Ended June 30, 2008 | |
|---|---|---|
| Nonvested Shares | Shares | Weighted-Average Grant-Date Fair Value |

| | | | |
|---|---|---|---|
| Nonvested outstanding at beginning of fiscal year | - | $ | - |
| Granted | 100,000 | | 0.83 |
| Vested | - | | - |
| Forfeited | - | | - |
| Nonvested outstanding at end of fiscal year | 100,000 | $ | 0.83 |

LANTRONIX, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
JUNE 30, 2008

Employee Stock Purchase Plan

The number of shares available for issuance is increased annually on the first day of the Company's fiscal year in an amount equal to the lesser of (i) 150,000 shares, (ii) 2% of the outstanding shares on such date or (iii) a lesser amount as determined by the board of directors. Under the 2000 Employee Stock Purchase Plan (or "ESPP"), each eligible employee may purchase common stock at each semi-annual purchase date (the last business day of February and August each year), but not more than 15% of the participant's compensation, as defined. The purchase payable per share will be equal to eighty-five percent (85%) of the lower of (i) the closing selling price per share of common stock on the employee's entry date into the two-year offering period in which that semi-annual purchase date occurs and (ii) the closing selling price per share of common stock on the semi-annual purchase date. Participants may discontinue their participation in the ESPP or may increase or decrease the rate of their payroll deductions during the ESPP offering period.

The following table presents a summary of activity under the Company's ESPP:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Shares available for issuance at beginning of fiscal year | 356,762 | 537,685 |
| Shares reserved for issuance | 150,000 | 150,000 |
| ESPP shares issued | (303,479) | (330,923) |
| Shares available for future issuance at end of fiscal year | 203,283 | 356,762 |

The fair value of ESPP shares was estimated using the following weighted-average assumptions:

| | Years Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Expected term (in years) | 0.5 to 2.0 | 0.5 to 2.0 |
| Expected volatility | 0.86 | 0.88 |
| Risk-free interest rate | 3.50% | 3.90% |
| Dividend yield | 0.00% | 0.00% |

The following table presents a summary of ESPP purchase price and intrinsic value information: