CASTELLE \CA\
Form 10-Q
August 11, 2004

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

FORM 10-Q

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

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

Commission File Number: 0-220-20

CASTELLE
(Exact name of Registrant as specified in its charter)

California	77-0164056
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

855 Jarvis Drive, Suite 100, Morgan Hill, California 95037 (Address of principal executive offices, including zip code)

(408) 852-8000
(Registrant's telephone number, including area code)

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

The number of shares of Common Stock outstanding as of July 28, 2004 was 3,600,703.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes __ No |X|

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FORM 10-Q
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PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

CASTELLE
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)
(in thousands)

	June 30, 2004	Dece
Assets:		
Current assets:		
Cash and cash equivalents	$ 4,842	
Accounts receivable, net of allowance for doubtful accounts of $37 and $39, respectively	975	
Inventories	1,465	
Prepaid expenses and other current assets	256	
Deferred taxes	307	
Total current assets	7,845	
Property and equipment, net	287	
Other non-current assets	103	
Deferred taxes, non-current	--	
Total assets	$ 8,235	
Liabilities and Shareholders' Equity:		
Current liabilities:		
Long-term debt, current portion	$ 14	
Accounts payable	418	
Accrued liabilities	1,519	
Deferred revenue	996	
Total current liabilities	2,947	
Long term debt, net of current portion	22	
Total liabilities	2,969	
Shareholders' equity:		
Common stock, no par value:		
Authorized: 25,000 shares		
Issued and outstanding: 3,600 and 3,425, respectively	27,430	
Accumulated deficit	(22,164)	
Total shareholders' equity	5,266	
Total liabilities and shareholders' equity	$ 8,235	

See accompanying notes to consolidated financial statements.

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CASTELLE
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three months ended		S
	June 30, 2004	June 30, 2003	June 30,
Net sales:			
Products	$ 2,090	$ 2,050	$ 4,1
Services	627	461	1,1
Total net sales	2,717	2,511	5,2
Cost of sales	592	573	1,2
Gross profit	2,125	1,938	4,0
Operating expenses:			
Research and development	428	429	8
Sales and marketing	892	760	1,6
General and administrative	508	509	9
Total operating expenses	1,828	1,698	3,50
Income from operations	297	240	5
Interest income, net	5	4	
Other expense, net	(10)	(14)	(
Income before provision for income taxes	292	230	5
Provision for income taxes	121	2	2
Net income	$ 171	$ 228	$ 3
Income per share:			
Net income per common share - basic	$ 0.05	$ 0.07	$ 0
Net income per common share - diluted	$ 0.04	$ 0.06	$ 0
Shares used in per share calculation - basic	3,573	3,200	3,
Shares used in per share calculation - diluted	4,428	4,138	4,

See accompanying notes to unaudited condensed consolidated financial statements.

CASTELLE
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six months ended	
	June 30, 2004	June 30
Cash flows from operating activities:		
Net income	$ 318	$
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on disposal of fixed assets	1	
Depreciation and amortization	103	
Provision for doubtful accounts and sales returns	(3)	(
Provision for excess and obsolete inventory	(210)	
Deferred taxes	219	
Changes in assets and liabilities:		
Accounts receivable	(99)	(
Inventories	(78)	
Prepaid expenses and other current assets	(122)	(
Accounts payable	104	(
Accrued liabilities	(240)	
Deferred revenue	87	
Net cash provided by operating activities	80	
Cash flows from investing activities:		
Purchase of property and equipment	(15)	
Net cash used in investing activities	(15)	
Cash flows from financing activities:		
Repayment of long-term debt	(9)	
Repurchase of common stock	-	
Proceeds from issuances of common stock,	172	
Net cash provided by financing activities	163	
Net increase in cash and cash equivalents	228	
Cash and cash equivalents at beginning of period	4,614	3,
Cash and cash equivalents at end of period	$ 4,842	$ 3,

See accompanying notes to unaudited condensed consolidated financial statements.

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CASTELLE
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Basis of Presentation:

The accompanying unaudited condensed consolidated financial statements include the accounts of Castelle and its wholly-owned subsidiary in the United Kingdom. These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions have been eliminated. In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation of our financial position, results of operations and cash flows at the dates and for the periods indicated have been included. Because all of the disclosures required by accounting principles generally accepted in the United States of America are not included in the accompanying condensed consolidated financial statements and related notes, they should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Form 10-K for the year ended December 31, 2003. The condensed balance sheet data as of December 31, 2003 was derived from our audited financial statements and does not include all of the disclosures required by accounting principles generally accepted in the United States of America. The results of operations for the periods presented are not necessarily indicative of results that we expect for any future period, or for the entire year.

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

We believe that our existing cash balances and anticipated cash flows from operations will be sufficient to meet our anticipated capital requirements for the next 12 months. If we have a need for additional capital resources, we may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products, if any, and changes in technology in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in us not being able to achieve our long-term business objectives. To the extent that additional capital is raised through the sale of additional equity or convertible debt securities, the issuance of such securities would result in additional dilution to our shareholders.

In addition, because we are dependent on a small number of distributors for a significant portion of the sales of our products, the loss of any of our major distributors or their inability to satisfy their payment obligations to us could have a significant adverse effect on our business, operating results and financial condition. In the first six months of 2004 and 2003, Ingram Micro and Tech Data, our two largest distributors, collectively represented approximately 47% and 48% of our net sales, respectively.

We do not currently have any material long-term supply contracts with any of our manufacturing subcontractors or component suppliers. We purchase finished products and

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components on a purchase order basis. We own all engineering, sourcing documentation, functional test equipment and tooling used in manufacturing our products and believe that we could shift product assembly to alternate suppliers if necessary. Certain key components of our products, including a modem chip set from Conexant, microprocessors from Motorola, integrated circuits from Intel and Kendin, are currently available from single sources. Other components of our products are currently available from only a limited number of sources. In addition, certain manufacturers have announced the end-of-life of certain standard off-the-shelf components which are being used by us in the manufacture of our FaxPress Products. However, we have purchased what we believe to be at least two years worth of supplies of these end-of-life components in an effort to assure an uninterrupted supply of FaxPress Products to our customers for the next two years, while we decide whether to re-engineer our Products with the manufacturers' suggested replacement parts, or develop new replacement products.

Certain reclassifications have been made to the prior period's financial statements to conform to the current period presentation.

2. Revenue Recognition:

We recognize revenue based on the provisions of Staff Accounting Bulletin No. 104 "Revenue Recognition" and Statement of Financial Accounting Standards ("SFAS") No. 48 "Revenue Recognition When Right of Return Exists."

Product revenue is recognized upon shipment if a signed contract or purchase order exists, the fee is fixed or determinable, collection of the resulting receivable is probable and product returns are reasonably estimable. Shipment generally occurs and title and risk of loss is transferred when the product is delivered to a common carrier.

We enter into agreements with some of our distributors that permit limited stock rotation rights. These stock rotation rights allow the distributor to return products for credit but require the purchase of additional products of equal value. Customers who purchase products directly from us also have limited return rights, which expire 30 days from product shipment. Revenues subject to stock rotation or other return rights are reduced by our estimates of anticipated exchanges and returns. We establish our returns allowance for distributors and direct customers based on historic return rates.

Pursuant to our agreements with distributors, we also protect our distributors' exposure related to the impact of price reductions. Price adjustments are recorded at the time price reductions are communicated to our distributors.

Revenue for transactions that include multiple elements such as hardware and post-contract customer support is allocated to each element based on its relative fair value and recognized for each element when the revenue recognition criteria have been met for such element. Fair value is generally determined based on the price charged when the element is sold separately.

We recognize revenue from support or maintenance contracts, including extended warranty and support programs, ratably over the period of the contract.

The following table sets forth net sales derived from products and services for the six months ended June 30, 2004 and for each of the three years in the period ended December 31, 2003.

	Three months ended	Twelve months ended		
	June 30, 2004	December 31, 2003	December 31, 2002	Dec
Net Sales:				
Products	$ 4,102	$ 8,337	$ 8,617	
Services	1,173	1,877	1,142	
Total net sales	$ 5,275	$10,214	$ 9,759	

We are unable to provide the cost of sales separately for products and services as our internal financial reporting systems did not track this information in the reported periods.

3. Net Income Per Share:

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for such period. Diluted net income per share reflects the potential dilution from the exercise or conversion of other securities into common stock that were outstanding during the period. Diluted net income per share excludes shares that are potentially dilutive if their effect is antidilutive. Dilutive potential shares consist of incremental common shares issuable upon exercise of stock options.

Basic and diluted net income per share is calculated as follows for the second quarter and first six months of 2004 and 2003 (in thousands, except per share amounts):

(in thousands, except per share amoun

	(Unaudited)			
	Three months ended		Six months en	
	June 30, 2004	June 30, 2003	June 30, 2004	June
Basic:				
Weighted average common shares outstanding	3,573	3,200	3,536	
Net income	$ 171	$ 228	$ 318	
Net income per common share - basic	$ 0.05	$ 0.07	$ 0.09	
Diluted:				
Weighted average common shares outstanding	3,573	3,200	3,536	
Common equivalent shares from stock options	855	938	903	
Shares used in per share calculation - diluted	4,428	4,138	4,439	
Net income	$ 171	$ 228	$ 318	
Net income per common share - diluted	$ 0.04	$ 0.06	$ 0.07	

The calculation of diluted shares outstanding for the three and six months ended June 30, 2004 excludes 25,205 shares of common stock issuable upon exercise of outstanding stock options, as their effect was antidilutive in the period. The calculation of diluted shares outstanding for the three and six months ended June 30, 2003 excludes 170,000 shares of common stock issuable upon exercise of outstanding stock options as their effect was antidilutive in the period.

4. Stock-Based Compensation

We account for our stock-based compensation plans using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Compensation cost for stock options, if any, is measured by the excess of the quoted market price of our stock at the date of grant over the amount an employee must pay to acquire the stock. SFAS No. 123, "Accounting for Stock-Based Compensation," established accounting and disclosure requirements using a fair-value based method of accounting for stock-based employee compensation plans.

Had compensation costs been determined consistent with SFAS No. 123, our net income, net of income taxes, would have been changed to the amounts indicated below (unaudited, in thousands, except per share data):

	Three months ended	Six months end

	June 30, 2004	June 30, 2003	June 30, 2004	June 3
Net Income - as reported	$ 171	$ 228	$ 318	$ 47
Fair value of stock-based compensation, net of taxes	(159)	(45)	(255)	(8
Net income - pro forma	12	183	63	38
Net income per share - basic - as reported	$ 0.05	$ 0.07	$ 0.09	$ 0.1
Net income per share - diluted - as reported	$ 0.04	$ 0.06	$ 0.07	$ 0.1
Net income per share - basic - pro forma	$ 0.00	$ 0.06	$ 0.02	$ 0.1
Net income per share - diluted - pro forma	$ 0.00	$ 0.04	$ 0.01	$ 0.1

We account for stock-based compensation arrangements with non-employees in accordance with Emerging Issues Task Force ("EITF") Abstract No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services. Accordingly, unvested options and warrants held by non-employees are subject to revaluation at each balance sheet date based on the then current fair market value.

5. Inventories:

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market and net of provisions for excess and obsolete inventory. Inventory details are as follows (unaudited, in thousands):

	June 30, 2004	December 31, 2003
Raw material	$ 966	$ 610
Work in process	1	-
Finished goods	498	567
Total inventory	$ 1,465	$ 1,177

6. Segment Information:

We have determined that we operate in one segment. Revenues by geographic area are determined by the location of the customer and are summarized as follows (unaudited, in thousands):

(Unaudited)

	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
United States	$2,305	$ 2,020	$ 4,435	$4,008
Europe	148	153	332	328
Pacific Rim	153	258	335	500
Rest of Americas, excluding United States	111	80	173	175
Total Revenues	$2,717	$ 2,511	$ 5,275	$5,011

Customers that individually accounted for greater than 10% of net sales are as follows (unaudited, in thousands):

	Quarter Ended				Six Months End		
	June 30, 2004		June 30, 2003		June 30, 2004		
Customer	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amo
A	$ 562	20%	$ 448	18%	$ 1,439	27%	$
B	$ 701	26%	$ 709	28%	$ 1,076	20%	$

7. Comprehensive Income:

Comprehensive income is the change in equity from transactions and other events and circumstances other than those resulting from investments by owners and distributions to owners. There are no significant components of comprehensive income excluded from net income, therefore, no separate statement of comprehensive income has been presented.

8. Commitments and Contingencies:

Contingencies
From time to time, we are involved in various legal proceedings in the ordinary course of business. We are not currently involved in any litigation, which, in our opinion, would have a material adverse effect on our business, operating results, cash flows or financial condition; however, there can be no assurance that any such proceeding will not escalate or otherwise become material to our business in the future.

Lease Commitments
The following represents combined aggregate maturities for all of our financing and commitments under operating and capital leases as of June 30, 2004 (unaudited, in thousands):

	Operating Leases	Capital Lease Obligations	Total Commitments
Six months ending December 31, 2004	$ 104	$ 8	$ 112
Year ending December 31, 2005	207	18	225
Year ending December 31, 2006	207	15	222
Year ending December 31, 2007	207	-	207
Year ending December 31, 2008	207	-	207
Year ending December 31, 2009	104	-	104
Total Commitments	$ 1,036	$ 41	$ 1,077
Less amount representing interest	-	(5)	(5)
Present value of lease obligations	$ 1,036	$ 36	$ 1,072

We have extended our building lease for a term of five years commencing on June 1, 2004 and expiring on May 31, 2009, with one conditional three-year renewal option, which if exercised, would extend the lease to May 31, 2012 commencing with rent at ninety-five percent of fair market value.

We lease certain of our equipment under various operating and capital leases that expire at various dates through 2006. The lease agreements frequently include renewal, escalation clauses and purchase provisions, and require us to pay taxes, insurance and maintenance costs. As of June 30, 2004, we had $36,000 outstanding under a loan and security agreement, which is subject to an interest rate of 12.8%.

As of June 30, 2004, we had a $3.0 million collateralized revolving line of credit with a bank, which was to expire in March 2005, pursuant to which we could borrow 100% against pledges of cash at the bank's prime rate. As of June 30, 2004, we had not drawn on this facility. On August 2, 2004, we secured from the same bank a new revolving line of credit to replace the previous credit facility. The new revolving line of credit provides for borrowings of up to $4.0 million and has a one year term. Borrowings under this line of credit agreement are collateralized by all of our assets and bear interest at the bank's prime rate plus 0.50%. Under the new facility we are required to maintain certain minimum cash and investment balances with the bank and meet certain other financial covenants. As of August 2, 2004, we have not drawn down on the line of credit and were in compliance with the terms of the agreement.

Product Warranties and Guarantor Arrangements

We offer warranties on certain products and record a liability for the estimated future costs associated with warranty claims, which is based upon historical experience and our estimate of the level of future costs. Warranty costs are reflected in the Statement of Operations as a Cost of Sales. A reconciliation of the changes in our warranty liability during the periods presented is as follows (in thousands):

	(Unaudited)			
	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Balance at beginning of period	$ 23	$ 33	$ 24	$ 34
Accruals for warranties issued during the period	1	4	1	33
Actual warranty expense	(2)	(6)	(3)	(36
Balance at end of period	$ 22	$ 31	$ 22	$ 31

As permitted under California law, and under the provisions of our articles of incorporation and by-laws, we are obligated to indemnify our officers and directors for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, we have a director and officer insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal.

We enter into standard indemnification agreements with our customers in the ordinary course of business. Pursuant to these agreements, we indemnify, hold harmless, and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our business partners or customers, in connection with any U.S. patent, or any copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual following execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have never incurred claims or costs to defend lawsuits or settle claims related to these indemnification agreements.

9. Stock Buyback:

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $2.3 million of our common stock and at a price not to exceed $1.20 per share, for cash in open market, negotiated or block transactions. The timing of such transactions will depend on market conditions, other corporate strategies and will be at the discretion of our management. No time limit was set for the completion of this program. At the time of the approval by the Board of Directors, we had approximately 4.8 million shares of common stock outstanding. During the fourth quarter of 2002, we repurchased from open market and negotiated transactions a total of approximately 1.6 million shares for approximately $1.8 million, at an average per share price of $1.10. During the first quarter of 2003, we repurchased from open market transactions a total of 46,500 shares for $49,000, at an average per share price of $1.04. We have not repurchased any shares since the first quarter of 2003, but intend to continue to execute our buyback program as we determine necessary. The approximate dollar value of shares that may yet be repurchased under the plan was $420,000 as of June 30, 2004.

10. Recent Accounting Pronouncements:

In December 2003, the Financial Accounting Standards Board ("FASB") issued a revised FASB interpretation No. 46, "Consolidation for Variable Interest Entities, an interpretation of ARB No. 51" ("FIN 46R"). The FASB published the revision to clarify and amend some of the original provisions of FIN 46, which was issued in January 2003, and to exempt certain entities from its requirements. A Variable Interest Entity ("VIE") refers to an entity subject to consolidation according to the provisions of the Interpretation. FIN 46R applies to entities whose equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support provided by any parties, including equity holders, or where the equity investors (if any) do not have a controlling financial interest. FIN 46R provides that if an entity is the primary beneficiary of a VIE, the assets, liabilities, and results of operations of the VIE should be consolidated in the entity's financial statements. In addition, FIN 46R requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE provide additional disclosures. The Company was required to adopt the provisions of FIN 46R in the Company's fiscal 2004 first quarter. The adoption of FIN 46R did not have a material impact on the Company's financial position or results of operations.

SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements that involve risks and uncertainties. Our operating results may vary significantly from quarter to quarter due to a variety of factors, including changes in our product and customer mix, constraints in our manufacturing and assembling operations, shortages or increases in the prices of raw materials and components, changes in pricing policy by us or our competitors, a slowdown in the growth of the networking market, seasonality, timing of expenditures, and economic conditions in the United States, Europe and Asia. Words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Unless the context otherwise requires, references in this Form 10-Q to "we," "us," or the "Company" refer to Castelle. Readers are cautioned that the forward-looking statements reflect management's analysis only as of the date hereof, and we assume no obligation to update these statements. Actual events or results may differ materially from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to the risks and uncertainties discussed herein, as well as other risks set forth under the caption "Risk Factors" below and in our Annual Report on Form 10-K for the year ended December 31, 2003.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that are subject to many risks and uncertainties that could cause actual results to differ significantly from expectations. For more information on forward-looking statements, refer to the "Special Note on Forward-Looking Statements" prior to this section. The following discussion should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and the Notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and our Form 10-K for the year ended December 31, 2003.

Critical Accounting Policies

Castelle's financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States of America. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, sales and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for us include revenue recognition; distributor programs and incentives; warranty; credit, collection and allowances for doubtful accounts; inventories and related allowance for obsolete and excess inventory; and income taxes, which are discussed in more detail under the caption "Critical Accounting Policies" in our 2003 Annual Report on Form 10-K.

Consolidated Statements of Operations - As a Percentage of Net Sales

	Three months ended		Six months e	
	June 30, 2004	June 30, 2003	June 30, 2004	Ju
Net sales				
Products	77%	82%	78%	
Services	23%	18%	22%	
Total net sales	100%	100%	100%	
Cost of sales	22%	23%	23%	
Gross profit	78%	77%	77%	

Operating expenses:				
Research and development	15%	17%	16%	
Sales and marketing	33%	30%	32%	
General and administrative	19%	20%	19%	
Total operating expenses	67%	67%	67%	
Income from operations	11%	10%	10%	
Interest income, net	*	*	*	
Other expense, net	*	(1%)	*	
Income before provision for income taxes	11%	9%	10%	
Provision for income taxes	5%	*	4%	
Net income	6%	9%	6%	

* Less than 1%

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Results of Operations

Net Sales

	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2
Net sales				
Products	$ 2,090	$ 2,050	$ 4,102	$ 4,151
Services	627	461	1,173	860
Total Net sales	$ 2,717	$ 2,511	$ 5,275	$ 5,011

	(Unaudited)			
	Three months ended		Six months ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net Sales				
United States	$ 2,305	$ 2,020	$ 4,435	$ 4,008
Europe	148	153	332	328

Pacific Rim	153	258	335	500
Rest of Americas, excluding United States	111	80	173	175
Total Net Sales	$ 2,717	$ 2,511	$ 5,275	$ 5,011

Net sales for the second quarter of 2004 increased 8% to $2.7 million from $2.5 million in the same period in 2003. Net sales for the first six months of 2004 increased 5% to $5.3 million from $5.0 million for the same period in 2003.

Product sales of $2.1 million for the second quarter of 2004 were relatively unchanged as compared to the same period in 2003. Product sales of $4.1 million for the six months of 2004 were also relatively unchanged as compared to the first six months of 2003.

Service revenues are comprised primarily of extended warranty and support programs aw well as 60-days of maintenance bundled with initial product sales. Revenue related to these arrangements is recognized ratably over the period of the arrangement. Service revenues in the second quarter of 2004 increased 36% to $627,000 from $461,000 in the same period in 2003. For the first six months of 2004, service revenues increased 37% to $1.2 million from $860,000 in the same period in 2003. The increase in service revenues was primarily due to increased sales of extended warranty contracts due to an increase in our installed customer base as well as the launch of our FaxPress Premier fax server products in the second half of 2003.

Domestic sales in the second quarter of 2004 were $2.3 million, as compared to $2.0 million for the same period in 2003, representing 85% and 81% of total net sales in the second quarter of 2004 and 2003, respectively. Domestic sales for the first six months of 2004 were $4.4 million, as compared to $4.0 million for the same period of 2003, which represents 84% and 80% of total net sales in 2004 and 2003, respectively. The increase in sales was mostly attributable to sales of the new FaxPress Premier fax server products.

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International sales (excluding sales to the rest of the Americas) for the second quarter of 2004 were $301,000 as compared to $411,000 in the second quarter of 2003. This represents 11% and 16% of net sales for 2004 and 2003, respectively. International sales were $667,000 for the first six months of 2004, as compared to $828,000 for the same period in 2003, which represents 13% and 17% of total net sales for 2004 and 2003, respectively. The decline in sales was mostly due to lower sales of our fax server products.

Sales to the rest of the Americas (excluding the United States) in the second quarter of 2004 were $111,000 as compared to $80,000 in the year-ago quarter, representing 4% and 3% of total net sales, respectively. The increase in sales was mostly due to sales of our fax server products. For the six months ended June 30, sales to the Rest of the Americas were 173,000 and 175,000 for 2004 and 2003, respectively. This represents 3% of net sales for both periods.

Cost of Sales; Gross Profit

Gross profit was $2.1 million, or 78% of net sales, for the second quarter of 2004, as compared to $1.9 million, or 77% of net sales, for the same period in 2003. Gross profit for the first six months of 2004 and 2003 was $4.0 million and $3.7 million, or 77% and 75% of net sales, respectively. Gross profit for the second quarter of 2004 included a benefit of $61,000, or 2% of net sales, due to adjustment of an estimated liability based on a settlement reached during the quarter.

We are unable to provide the cost of sales separately for products and services as our internal financial reporting systems do not track this information in the reported periods.

Research & Development

Research and development expenses for the second quarter of 2004 were $428,000, or 16% of net sales, as compared to $429,000 or 17% of net sales for the same period in 2003. For the first six months of 2004, research and development expenses were $842,000, as compared to $784,000 in the same period of 2003, or 16% of net sales for both periods. The increase of $58,000 was mostly attributable to higher compensation expenses relating to headcount additions.

Sales & Marketing

Sales and marketing expenses for the second quarter of 2004 were $892,000, or 33% of net sales, as compared to $760,000, or 30% of net sales, for the same period in 2003. Sales and marketing expenses were $1.7 million for the first six months of 2004, and $1.5 million for the same period of 2003, which represents 32% and 30%, respectively, of net sales for the period. The increases for both the quarter and the six-month period of $132,000 and $191,000, respectively, were primarily due to an increase in compensation expense related to headcount additions.

General & Administrative

General and administrative expenses were $508,000 for the second quarter of 2004, or 19% of net sales, as compared to $509,000, or 20% of net sales for the second quarter of 2003. For the first six months of 2004, general and administrative expenses were $973,000, or 18% of net sales, as compared to $966,000, or 19% of net sales for the first six months of 2003.

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Provision for Income Tax

Prior to the fourth quarter of 2003, we had not reported significant income tax expenses because we had utilized available net operating loss (NOL) and tax credit carry-forwards. These NOLs were fully reserved by a valuation allowance due to uncertainty surrounding the likelihood of their realization. Due to our continued profitability and a determination that it is more likely than not that certain future tax benefits will be realized, a portion of the deferred tax assets were recognized in the fourth quarter of 2003. Beginning in 2004, for purposes of financial reporting, we are providing for income taxes at an effective tax rate of 40%. As a result, $121,000 of income tax expense has been provided in the second quarter of 2004 as compared to $2,000 in the second quarter of 2003. For the first six months of 2004, we have provided $219,000 for income taxes, as compared to $4,000 in 2003. However, for income tax purposes, we had $12.9 million of NOLs available at the end of December 2003 to offset future taxable income, and we do not expect to utilize significant amounts of cash for income tax payments until these NOLs have been utilized.

Liquidity and Capital Resources

	June 30, 2004	December 31, 2003	June 30, 20
	(dollars in thousands)		
Cash and cash equivalents	$ 4,842	$ 4,614	$ 3,6
Working capital	$ 4,898	$ 4,180	$ 2,9
Working capital ratio	2.7	2.4	2

As of June 30, 2004, we had approximately $4.8 million of cash and cash equivalents, an increase of $228,000 from December 31, 2003. Our operating activities generated cash of $80,000 and $281,000 in the six month periods ended June 30, 2004 and June 30, 2003, respectively. Cash generated in the six month period ended June 30, 2004 was principally the result of net income in the amount of $318,000, depreciation and amortization, deferred taxes and an increase in accounts payable, offset in part by increases in inventories (primarily due to our FaxPress Premier fax servers), accounts receivable, prepaid expenses, and a decrease in accrued liabilities. Cash generated in the six month period ended June 30, 2003 was primarily the result of net income in the amount of $471,000, depreciation and amortization, a reduction in inventories and an increase in accrued liabilities, offset partially by increases in accounts receivables, and prepaid expenses, and decrease in accounts payable.

Our investing activities in the first six months of 2004 and 2003 were for purchases of capital assets to replace obsolete computer equipment.

We generated $163,000 from financing activities in the first six months of 2004 as compared to $21,000 in the same period of 2003 primarily from proceeds received from issuance of common stock, offset partially by repayment of debt.

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $2.3 million shares of our common stock and at a price not to exceed $1.20 per share, for cash in open market, negotiated or block transactions. The timing of these transactions has depended and will depend on market conditions, other corporate strategies and has been and will be at the discretion of our management. No time limit was set for the completion of this program. Since the beginning of this program, we have repurchased from open market and negotiated transactions a total of 1.7 million shares for $1.8 million, at an average per share price of $1.10. We have not repurchased any shares since the first quarter of 2003, but intend to continue to execute our buyback program as we deem appropriate.

We have extended our lease for our corporate headquarters in Morgan Hill, California. The modified lease on the Morgan Hill facility has a term of five years, commencing on June 1, 2004 and expiring in May 31, 2009, with one conditional three-year renewal option, which if exercised, would extend the lease to May 2012 commencing with rent at 95% of fair market value. As of June 30, 2004, future minimum payments under the lease were $1.0 million.

In December 2000, as a source of capital asset financing, we entered into a loan and security agreement with a finance company for an amount of

$75,000. This loan bears interest at 12.8% and is repayable by December 2006. As of June 30, 2004, the aggregate value of future minimum payments was $41,000.

The following represents combined aggregate maturities for all our financing and commitments as of June 30, 2004:

	Payments Due by Period				
Contractual Obligations	Total	1 Year	2 - 3 Years	4 - 5 Years	M
Capital (Finance) Lease Obligations	$ 41	$ 18	$ 23	-	
Operating Lease Obligations	$1,036	$ 207	$ 415	$ 414	
Total contractual cash obligations	$1,077	$ 225	$ 438	$ 414	

As of June 30, 2004, we had a $3.0 million collateralized revolving line of credit with a bank which was to expire in March 2005, pursuant to which we could borrow 100% against pledges of cash at the bank's prime rate. As of June 30, 2004, we had not drawn on this facility. On August 2, 2004, we secured from the same bank a new revolving line of credit to replace the previous credit facility. The new revolving line of credit provides for borrowings of up to $4.0 million and has a one year term. Borrowings under this line of credit agreement are collateralized by all of our assets and bear interest at the bank's prime rate plus 0.50%. Under the new facility we are required to maintain certain minimum cash and investment balances with the bank and meet certain other financial covenants. As of August 2, 2004, we have not drawn down on the line of credit and were in compliance with the terms of the agreement.

We believe that our existing cash balances and anticipated cash flows from operations will be sufficient to meet our anticipated capital requirements for the next 12 months. If we have a need for additional capital resources, we may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products, if any, and changes in technology in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in our inability to achieve our long-term business objectives. To the extent that additional capital is raised through the sale of additional equity or convertible debt securities, the issuance of such securities would result in additional dilution to our shareholders.

In addition, because we are dependent on a small number of distributors for a significant portion of the sales of our products, the loss of any of our major distributors or their inability to satisfy their payment obligations to us could have a significant adverse effect on our business, operating results and financial condition.

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We believe that, for the periods presented, inflation has not had a material effect on our operations.

Recent Accounting Pronouncements:

In December 2003, the FASB issued a revised FASB interpretation No. 46, "Consolidation for Variable Interest Entities, an interpretation of ARB No. 51" ("FIN 46R"). The FASB published the revision to clarify and amend some of the original provisions of FIN 46, which was issued in January 2003, and to exempt certain entities from its requirements. A Variable Interest Entity ("VIE") refers to an entity subject to consolidation according to the provisions of the Interpretation. FIN 46R applies to entities whose equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support provided by any parties, including equity holders, or where the equity investors (if any) do not have a controlling financial interest. FIN 46R provides that if an entity is the primary beneficiary of a VIE, the assets, liabilities, and results of operations of the VIE should be consolidated in the entity's financial statements. In addition, FIN 46R requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE provide additional disclosures. The provisions of FIN 46R are effective for our fiscal 2004 first quarter. The adoption of FIN 46R did not have a material impact on our financial position or results of operations.

RISK FACTORS

Shareholders or investors considering the purchase of shares of our common stock should carefully consider the following risk factors, in addition to other information in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2003. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations

Our revenue and operating results have fluctuated in the past and are likely to fluctuate significantly in the future, particularly on a quarterly basis.

Our operating results may vary significantly from quarter to quarter due to many factors, some of which are outside our control. For example, the following conditions could all affect our results:

- changes in our product sales and customer mix;
- constraints in our manufacturing and assembling operations;
- shortages or increases in the prices of raw materials and components;
- changes in pricing policy by us or our competitors;
- a slowdown in the growth of the networking market;
- seasonality;
- timing of expenditures; and
- economic conditions in the United States, Europe and Asia.

Our sales often reflect orders shipped in the same quarter in which they are received. In addition, significant portions of our expenses are relatively fixed in nature, and planned expenditures are based primarily on sales forecasts. Therefore, if we inaccurately forecast demand for our products, the impact on net income may be magnified by our inability to adjust spending quickly enough to compensate for the net sales shortfall.

Other factors contributing to fluctuations in our quarterly operating results include:

- changes in the demand for our products;
- customer order deferrals in anticipation of new versions of our products;
- the introduction of new products and product enhancements by us or our competitors;
- the effects of filling the distribution channels following introductions of new products and product enhancements;
- potential delays in the availability of announced or anticipated products;
- the mix of product and revenue derived from the sale of extended warranty contracts;
- the commencement or conclusion of significant development contracts;
- changes in foreign currency exchange rates; and
- the timing of significant marketing and sales promotions.

Based on the foregoing, we believe that quarterly operating results are likely to vary significantly in the future and that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be viewed as indications of future performance.

We have a history of losses and a large accumulated deficit.

We have experienced significant operating losses and, as of June 30, 2004, had an accumulated deficit of $22.2 million. Our development and marketing of current and new products will continue to require substantial expenditures. We incurred $591,000 of losses in 2001 attributable to a slowdown in demand for our products due in part to industry-wide adverse economic factors. We have been profitable since the third quarter of 2001, with total net income of $659,000 in 2002 and $1.6 million in 2003, and $318,000 for the first six months in 2004. There can be no assurance that growth in net sales will be achieved or profitability sustained in future years.

Substantially all of our revenue comes from the sale of fax server products, and a decline in demand for those products would harm our business, operating results and financial condition.

We derive substantially all of our revenue from the sale of fax and print server products, with fax server products accounting for 97% of total sales in 2003 and almost all sales in the first six months of 2004. We expect that our current products will continue to account for most of our sales in the near future. A decline in demand for our fax server products as a result of competition, technological change, shortages of components or other factors, or a delay in the development and market acceptance of new features and products, would have a material adverse effect on our business, operating results and financial condition.

We sell our products through a limited number of distributors, and any deterioration in our relationship with those distributors would harm our business, operating results and financial condition.

We sell our products primarily through a two-tier domestic and international distribution network. Our distributors sell our products to VARs, e-commerce vendors and other resellers. The distribution of personal computers and networking products has been characterized by rapid change, including consolidations due to the financial difficulties of distributors and the emergence of alternative distribution channels. An increasing number of companies are competing for access to these channels. Our distributors typically represent other products that are complementary to, or compete with, our products. Our distributors are not contractually committed to future purchases of our products and could discontinue carrying our products at any time for any reason. In addition, because we are dependent on a small number of distributors for a significant portion of the sales of our products, the loss of any of our major distributors or their inability to satisfy their payment obligations to us could have a significant adverse effect on our business, operating results and financial condition. We have a stock rotation policy with certain of our distributors that allows them to return marketable inventory against offsetting orders. If we reduce our prices, we credit certain distributors for the difference between the purchase price of products remaining in their inventory and our reduced price for these products. In addition, inventory levels of our products held by distributors could become excessive due to industry conditions or the actions of competitors, resulting in product returns and inventory write-downs.

The market for our products is affected by rapidly changing technology and if we fail to predict and respond to customers' changing needs, our business, operating results and financial condition may suffer.

The market for our products is affected by rapidly changing networking technology, evolving industry standards and the Internet and other new communication technologies. We believe that our future success will depend upon our ability to enhance our existing products and to identify, develop, manufacture and introduce new products that:

- conform to or support emerging network telecommunications standards;
- are compatible with a growing array of computer and peripheral devices;
- support popular computer and network operating systems and applications;
- meet a wide range of evolving user needs; and
- achieve market acceptance.

There can be no assurance that we will be successful in these efforts.

We have incurred, and expect to continue to incur, substantial expenses associated with the introduction and promotion of new products. There can be no assurance that the expenses incurred will not exceed research and development cost estimates or that new products will achieve market acceptance and generate sales sufficient to offset development costs. In order to develop new products successfully, we are dependent upon timely access to information about new technological developments and standards. There can be no assurance that we will have such access or will be able to develop new products successfully and respond effectively to technological change or new product announcements by others.

Complex products such as those offered by us may contain undetected or unresolved hardware defects or software errors when they are first introduced or as new versions are released. Changes in our or our suppliers' manufacturing processes or the inadvertent use of defective components could adversely affect our ability to achieve acceptable manufacturing yields and product reliability. We have in the past discovered hardware defects and software errors in certain of our new products and enhancements after their introduction. Replacement of discontinued components used in our products could lead to further defects and errors. There can be no assurance that despite testing by us and by third-party test sites, errors and defects will not be found in future releases of our products, which would result in adverse product reviews and negatively affect market acceptance of these products.

The introduction of new or enhanced products requires us to manage the transition from the older products to the new or enhanced products or versions, both internally and for customers. We must manage new product introductions so as to minimize disruption in customer ordering patterns, avoid excessive levels of older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demands. We have from time to time experienced delays in the shipment of new products. There can be no assurance that we will successfully manage future product transitions.

Our success depends upon the continued contributions of our key management, marketing, product development and operational personnel.

Our success will depend, to a large extent, upon our ability to retain and continue to attract highly skilled personnel in management, marketing, product development and operations. Competition for employees in the computer and electronics industries is intense, and there can be no assurance that we will be able to attract and retain enough qualified employees. Volatility or lack of positive performance in our stock price may also adversely affect our ability to retain and continue to attract key employees, many of whom have been granted stock options. Our inability to retain and attract key employees could have a material adverse effect on our product development, business, operating results and financial condition. We do not carry key person life insurance with respect to any of our personnel.

The markets for our products are highly competitive and may become more competitive in the future.

The network enhancement products and computer software markets are highly competitive, and we believe that competition will intensify in the future. The competition is characterized by rapid change and improvements in technology along with constant pressure to reduce the prices of products. We currently compete principally in the market for network fax servers, network print servers and fax-on-demand software. Both direct and indirect competition could adversely affect our business and operating results through pricing pressure, loss of market share and other factors. In particular, we expect that, over time, average selling prices for our print server products will continue to decline, as the market for these products becomes increasingly competitive. Any material reduction in the average selling prices of our products would adversely affect gross margins. There can be no assurance we will be able to maintain the current average selling prices of our products or the related gross margins.

The principal competitive factors affecting the market for our products include:

- product functionality;
- performance;
- quality;
- reliability;
- ease of use;
- quality of customer training and support;
- name recognition;
- price; and
- compatibility and conformance with industry standards and changing operating system environments.

Several of our existing and potential competitors have substantially greater financial, engineering, manufacturing and marketing resources than us. We also experience competition from a number of other software, hardware and service companies. In addition to our current competitors, we may face substantial competition from new entrants into the network enhancement market, including established and emerging computer, computer peripheral, communications and software companies. In the fax server market we compete with companies such as Captaris Inc., Omtool, Ltd. and Esker Software. There can be no assurance that competitors will not introduce products incorporating technology more advanced than the technology used by us in our products. In addition, certain competing methods of communications such as the Internet or electronic mail could adversely affect the market for fax products. Certain of our existing and potential competitors in the print server market are manufacturers of printers and other peripherals, and these competitors may develop closed systems accessible only through their own proprietary servers. There can be no assurance that we will be able to compete successfully or that competition will not have a material adverse effect on our business, operating results and financial condition.

We depend on sales in foreign markets, and political or economic changes in these markets could affect our business, operating results and financial condition.

Sales to customers located outside the United States accounted for approximately 19%, 21% and 25% of our net sales in 2003, 2002 and 2001, respectively. We sell our products in approximately 44 foreign countries through approximately 89 distributors. Our principal Japanese distributor accounted for approximately 38%, 27% and 40% of our international sales in 2003, 2002 and 2001, respectively, and 7%, 6% and 10% of our total net sales in 2003, 2002 and 2001, respectively. We expect that international sales will continue to represent a significant portion of

our product revenues and that we will be subject to the normal risks of international sales, such as export laws, currency fluctuations, longer payment cycles, greater difficulties in accounts receivable collections and the requirement of complying with a wide variety of foreign laws. There can be no assurance that we will not experience difficulties resulting from changes in foreign laws relating to the export of our products in the future. In addition, because we primarily invoice foreign sales in U.S. dollars, fluctuations in exchange rates could affect demand for our products by causing prices to be out of line with products priced in the local currency. Additionally, any such difficulties would have a material adverse effect on our international sales and a resulting material adverse effect on our business, operating results and financial condition. We may experience fluctuations in European sales on a quarterly basis because European sales may be weaker during the third quarter than the second quarter due to extended holiday shutdowns in July and August. There can be no assurance that we will be able to maintain the level of international sales in the future. Any fluctuations in international sales will significantly affect our operating results and financial condition.

The introduction of new products may reduce the demand for our existing products and increase returns of existing products.

From time to time, we may announce new products, product versions, capabilities or technologies that have the potential to replace or shorten the life cycles of existing products. The release of a new product or product version may result in the write-down of products in inventory if this inventory becomes obsolete. We have in the past experienced increased returns of a particular product version following the announcement of a planned release of a new version of that product. There can be no assurance that product returns will not exceed our allowance for these returns in the future and will not have a material adverse effect on our business, operating results and financial condition.

If we fail to obtain components of our products from third-party suppliers and subcontractors, our business could suffer.

Our products require components procured from third-party suppliers. Some of these components are available only from a single source or from limited sources. In addition, we subcontract a substantial portion of our manufacturing to third parties, and there can be no assurance that these subcontractors will be able to support our manufacturing requirements. We purchase components on a purchase order basis, and generally have no long-term contracts for these components. If we are unable to obtain a sufficient supply of high-quality components from our current sources, we could experience delays or reductions in product shipments. From time to time, component manufacturers announce the end of life of certain of their products and may or may not have replacement products. If we are unable to secure enough inventories of the end-of-life components or their replacements, we might not be able to deliver our products to our customers and could adversely affect our revenue and net income. Furthermore, a significant increase in the price of one or more of these components or our inability to lower component or sub-assembly prices in response to competitive price reductions could adversely affect our gross margin.

We depend on proprietary technology, and inability to develop and protect this technology or license it from third parties could adversely affect our business, operating results and financial condition.

Our success depends to a certain extent upon our technological expertise and proprietary software technology. We rely upon a combination of contractual rights and copyright, trademark and trade secret laws to establish and protect our technologies. Despite the precautions taken by us, it may be

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possible for unauthorized third parties to copy our products or to reverse engineer or obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries either do not protect our proprietary rights or offer only limited protection. Given the rapid evolution of technology and uncertainties in intellectual property law in the United States and internationally, there can be no assurance that our current or future products will not be subject to third-party claims of infringement. Any litigation to determine the validity of any third-party claims could result in significant expense and divert the efforts our technical and management personnel, whether or not any litigation is determined in favor of us. In the event of an adverse result in litigation, we could be required to expend significant resources to develop non-infringing technology or to obtain licenses to the technology that is the subject of the litigation. There can be no assurance that we would be successful in this development or that any such licenses would be available on commercially reasonable terms. We also rely on technology licensed from third parties. There can be no assurance that these licenses will continue to be available upon reasonable terms, if at all. Any impairment or termination of our relationship with third-party licensors could have a material adverse effect on our business, operating results and financial condition. There can be no assurance that our precautions will be adequate to deter misappropriation or infringement of our proprietary technologies.

We have received, and may receive in the future, communications asserting that our products infringe the proprietary rights of third parties or seeking indemnification against the alleged infringement. There can be no assurance that third parties will not assert infringement claims against us with respect to current or future products or that any assertion may not require us to enter into royalty arrangements or result in costly litigation. Any claims, with or without merit, can be time consuming and expensive to defend. There can be no assurance that any intellectual property litigation will not have a material adverse effect on our business, operating results and financial condition.

Our common stock is listed on the Nasdaq SmallCap Market, and we have had difficulty satisfying the listing criteria to avoid the delisting of our common stock.

Our common stock has been listed on the Nasdaq SmallCap Market since April 1999. In order to maintain our listing on the Nasdaq SmallCap Market, we must maintain total assets, capital and public float at specified levels, and our common stock generally must maintain a minimum bid price of $1.00 per share. If we fail to maintain the standards necessary to be quoted on the Nasdaq SmallCap Market, our common stock could become subject to delisting. There can be no assurance that we will be able to maintain the $1.00 minimum bid price per share of our common stock and thus maintain our listing on the Nasdaq SmallCap Market. We have traded below $1.00 as recently as December 2002.

If our common stock is delisted, trading in our common stock could be conducted on the OTC Bulletin Board or in the over-the-counter market in what is commonly referred to as the "pink sheets." If this occurs, a shareholder will find it more difficult to dispose of our common stock or to obtain accurate quotations as to the price of our common stock. Lack of any active trading market would have an adverse effect on a shareholder's ability to liquidate an investment in our common stock easily and quickly at a reasonable price. It might also contribute to volatility in the market price of our common stock and could adversely affect our ability to raise additional equity or debt financing on acceptable terms or at all. Failure to obtain desired financing on acceptable terms could adversely affect our business, financial condition and results of operations.

Our stock price has been volatile, and is likely to continue to be volatile in the future.

The price of our common stock has fluctuated widely in the past. Sales of substantial amounts of our common stock, or the perception that sales could occur, could adversely affect prevailing market prices for our common stock. Our management believes past fluctuations may have been caused by the factors identified above, and that these factors may continue to affect the market price of our common stock. Additionally, stock markets have experienced extreme price volatility in recent years. This volatility has had a substantial effect on the market price of the common stock of us and other high technology companies, often for reasons unrelated to operating performance. We anticipate that prices for our common stock may continue to be volatile. Future stock price volatility may result in the initiation of securities litigation against us, which may divert substantial management and financial resources and have an adverse effect on our business, operating results and financial condition.

We may require additional capital in the future, and may be unable to obtain this capital at all or on commercially reasonable terms.

The development and marketing of products requires significant amounts of capital. If we need additional capital resources, we may be required to sell additional equity or debt securities, secure additional lines of credit or obtain other third party financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products and changes in technology in the networking industry. There can be no assurance that additional financing will be available on satisfactory terms when needed, if at all. Failure to raise such additional financing, if needed, may result in our inability to achieve our long-term business objectives. The issuance of equity or convertible debt securities to raise additional capital would result in additional dilution to our shareholders.

Government regulation could increase our costs of doing business and adversely affect our gross margin.

Certain aspects of the networking industry in which we compete are regulated both in the United States and in foreign countries. Imposition of public carrier tariffs, taxation of telecommunications services and the necessity of incurring substantial costs and expenditure of managerial resources to obtain regulatory approvals, or the inability to obtain regulatory approvals within a reasonable period of time, could have a material, adverse effect on our business, operating results and financial condition. This is particularly true in foreign countries where telecommunications standards differ from those in the United States. Our products must comply with a variety of equipment, interface and installation standards promulgated by communications regulatory authorities in different countries. Changes in government policies, regulations and interface standards could require the redesign of products and result in product shipment delays which could have a material, adverse impact on our business, operating results and financial condition.

Recent FASB Exposure Draft on Share-Based Payments may have a significant effect on our Results of Operations, if adopted.

During March 2004, the FASB issued a proposed Statement, "Share-Based Payment, and amendment of FASB Statements No. 123 and 95". The proposed Statement addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for equity instruments of the company that are based on the fair values of the company's equity instruments or that may be settled by the issuance of such equity instruments. The proposed statement eliminates the treatment for share-based transactions using APB

Opinion No. 25, "Accounting for Stock Issued to Employees," and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expenses in our statement of income. The proposed standard would require the modified prospective method be used, which would require that the fair value of new awards granted from the beginning of the year of adoption plus unvested awards at the date of adoption be expensed over the vesting term. In addition, the proposed statement encourages companies to use the "binomial" approach to value stock options, as opposed to the Black-Scholes option pricing model that is currently being used for the fair value of our options.

The effective date the proposed standard is recommending is for fiscal years beginning after December 15, 2004. Should the proposed statement be finalized, it will have a significant impact on our consolidated statement of operations as we will be required to expense the fair value of our stock options rather than disclosing the impact on our consolidated net income within our footnotes (See Note 4 of the notes to the condensed consolidated financial statements).

The costs of compliance with recent developments in corporate governance regulation may affect our business, operating results and financial condition in ways that presently cannot be predicted.

Beginning with the enactment of the Sarbanes-Oxley Act of 2002, a significant number of new corporate governance requirements have been adopted or proposed through legislation and regulation by the Securities and Exchange Commission and Nasdaq National Stock Market. We may not be successful in complying with these requirements at all times in the future. Additionally, we expect these developments to increase our legal compliance and accounting costs, and to make some activities more difficult, such as stockholder approval of new stock option plans. We expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain qualified members of our Board of Directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur as a result, or the effect that these increased costs may have on our operating results.

Recent terrorist activity in the United States and the military action to counter terrorism could adversely impact our business.

Terrorist acts or acts of war (wherever located around the world) could significantly impact our revenue, costs and expenses, and financial condition. The terrorist attacks that took place in the United States on September 11, 2001 have created many economic and political uncertainties, some of which may materially harm our business, operating results and financial condition. The long-term effects on our business of the September 11, 2001 attacks and the ensuing war on terror are unknown. The potential for future terrorist attacks, the national and international responses to terrorist attacks or perceived threats to national security, and other actual or potential conflicts, acts of war or hostility, including the United States' activities in Iraq, have created many economic and political uncertainties that could adversely affect our business, operating results and financial condition in ways that cannot presently be predicted.

Provisions in our charter documents might deter a company from acquiring us, which could inhibit your ability to receive an acquisition premium for your shares.

Our Board of Directors has authority to issue shares of preferred stock and to fix the rights, including voting rights, of these shares without any further vote or action by the shareholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the

rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock, while providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock, thereby delaying, deferring or preventing a change in control. Furthermore, such preferred stock may have other rights, including economic rights, senior to the common stock, and as a result, the issuance thereof could have a material adverse effect on the market.

Voting control by officers, directors and affiliates may delay, defer or prevent a change of control.

At July 28, 2004, our officers and directors and their affiliates beneficially owned approximately 26% of the outstanding shares of common stock. Accordingly, together they had the ability to significantly influence the election of our directors and other corporate actions requiring shareholder approval. Such concentration of ownership may have the effect of delaying, deferring or preventing a change in control.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We had no holdings of derivative financial or commodity instruments at June 30, 2004. However, we are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. While much of our revenue is transacted in U.S. dollars, some revenues and capital spending are transacted in Pounds Sterling. These amounts are not currently material to our financial statements. Therefore, we believe that foreign currency exchange rates should not materially affect our overall financial position, results of operations or cash flows. The fair value of our money market accounts or related income would not be significantly impacted by increases or decreases in interest rates due mainly to the highly liquid nature of this investment. However, sharp declines in interest rates could seriously harm interest earnings.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to maintain "disclosure controls and procedures," which are defined to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Our Chief Executive Officer and our Chief Financial Officer, based on their evaluation of our disclosure controls and procedures as of the end of the period covered by this report, concluded that our disclosure controls and procedures were effective for this purpose.

Regulations under the Securities Exchange Act of 1934 require public companies, including our company, to evaluate any change in our "internal control over financial reporting," which is defined as a process to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. In connection with their evaluation of our disclosure controls and procedures as of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer did not identify any change in our internal control over financial reporting during the three-month period ended June 30, 2004 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

Additional Exhibit

In accordance with SEC Release No. 33-8212, Exhibits 32.1 and 32.2 are to be treated as "accompanying" this report rather than "filed" as part of the report.

10.1 Amended commercial lease agreement dated June 1, 2004 by and between Registrant and Kyung S. Lee and Ieesun Kim Lee.

10.2 Loan and Security Agreement with Silicon Valley Bank.

31.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, executed by Scott C. McDonald, Chief Executive Officer and President of Castelle.

31.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, executed by Paul Cheng, Chief Financial Officer of Castelle.

32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Scott C. McDonald, Chief Executive Officer and President of Castelle.

32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, executed by Paul Cheng, Chief Financial Officer of Castelle.

(b) Reports on Form 8-K

Castelle filed a Form 8-K on April 22, 2004. Furnished under Item 7, "Financial Statements and Exhibits", Castelle filed a press release regarding its financial results for the quarter ended March 31, 2004.

SIGNATURES

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

CASTELLE

By: /s/ Scott C. McDonald Date: August 11, 2004
Scott C. McDonald
Chief Executive Officer and President
(Principal Executive Officer)

By: /s/ Paul Cheng Date: August 11, 2004
Paul Cheng
Vice President of Finance and Administration
Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)