

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 8745 / September 27, 2006

SECURITIES EXCHANGE ACT OF 1934
Release No. 54525 / September 27, 2006

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2485 / September 27, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12441

In the Matter of

LANTRONIX, INC.,

Respondent.

ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS, AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”), against Lantronix, Inc. (“Lantronix” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to

Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 (“Order”), as set forth below.

III.

On the basis of this Order and Respondent’s Offer, the Commission finds that:

Summary

This case involves a scheme by Lantronix, Inc., through its former chief financial officer/chief operating officer, to overstate its financial results for the second and third quarters of fiscal year 2001, its fiscal year 2001 and the first quarter of fiscal year 2002.¹ The CFO’s scheme to inflate the company’s revenues was effected primarily through artificially boosting sales by offering distributors special terms to induce them to purchase more product than they needed (a fraudulent practice known as “channel stuffing”). As a result of this scheme, Lantronix overstated its revenues for these periods by 2.24% to 21.42% and understated pre-tax losses by 12% to 98%.

Respondent

1. Lantronix, Inc. is a Delaware corporation headquartered in Irvine, California. Its common stock is registered with the Commission pursuant to Section 12(g) of the Exchange Act and trades on the Nasdaq Stock Market. Lantronix designs, develops, and markets network hardware and software solutions that enable network connectivity and system management for a broad range of devices and equipment. Its customers include original equipment manufacturers, value added resellers, system integrators, and distributors. In a July 2001 offering of its common stock, Lantronix received net proceeds of approximately \$48 million.

Background

2. Lantronix relied on sales to its distributors for the majority of its revenue. Lantronix artificially inflated reported revenue and earnings by deliberately sending excessive product to distributors and granting them expanded return rights and extended payment terms. In addition, as part of its channel stuffing scheme and to prevent imminent product returns, Lantronix loaned funds to a third party to purchase Lantronix product from one of its distributors. The third party later returned the product. Lantronix also engaged in other improper revenue recognition practices, including shipping product without a purchase order and recognizing revenue on a contingent sale.

Transactions With Full Stock Rotation or Return Rights

3. Full stock rotation rights exist when a distributor has the ability to exchange any portion of or its entire order for different product. Return rights exist when a company sells its

¹ Lantronix’s fiscal calendar commences July 1 and concludes on June 30.

product but gives the buyer the right to return product for credit that the buyer did not sell. Lantronix recognized revenue on certain transactions despite outstanding return rights and full stock rotation rights. Sales with return rights may be treated as revenue if there is a history of similar types of sales of similar products to provide a basis for estimating the amount of future returns and if income is reduced to reflect the estimated future returns through establishing a reserve for the returned product. See Statement of Financial Accounting Standards (“SFAS”) No. 48, Revenue Recognition When Right of Return Exists. Stock rotation rights constitute rights of return and, therefore, must meet all the requirements of SFAS 48 before a sale can be recognized as revenue. See In the Matter of Microtest, Inc., AAER No. 1397 (May 16, 2001). Lantronix had a returns reserve based on historical returns, but that reserve was not based on allowing distributors full return rights or full stock rotation rights. Lantronix did not have a history of giving full return rights or full stock rotation rights. As such, Lantronix did not have the historical data to estimate a proper returns reserve, and should not have recognized revenue from sales giving such rights to its distributors.

4. For example, in the negotiations for a March 2001 transaction with one of its largest distributors, located in Germany (the German distributor), which totaled approximately \$1.5 million, Lantronix offered the German distributor the ability to rotate any unsold inventory at the end of June 2001. The stock rotation terms associated with this order were not included on either the purchase order or the invoice. Instead, the terms were included in an email. Lantronix improperly recognized \$1,531,659 in revenue on this transaction for the quarter ended March 2001.

5. Similarly, Lantronix granted another foreign distributor full stock rotation rights for 90 days in connection with a \$421,900 sale in June 2001. Lantronix had not made a sale of this magnitude to this distributor in prior or subsequent periods. Lantronix was unable to locate a purchase order for this transaction, but the company noted the stock rotation terms for this transaction in an email. Lantronix improperly recognized \$421,900 in revenue on this transaction for the quarter ended June 2001. The distributor never paid for the product and ultimately returned it during Lantronix’s quarter ended December 2001.

6. Also in June 2001, the German distributor issued two purchase orders to Lantronix that totaled approximately \$2.3 million. These orders included about \$1.6 million of Lantronix product (over \$900,000 of which was new product) and approximately \$700,000 of Lightwave product. Lantronix had no previous sales history for either the new Lantronix product or the Lightwave product. The German distributor required return rights with this order because it largely involved new products for the German distributor. Lantronix agreed to \$1.1 to \$1.5 million of return rights. The terms of this transaction, as evidenced in an email, also included full stock rotation rights. Due to the return and rotation rights, and Lantronix brokering a deal to avoid a return of product (discussed in paragraphs 8 and 9 below), Lantronix improperly recognized \$2,157,234 of revenue on this transaction for the quarter ended June 2001.

7. In late September 2001, Lantronix sold \$496,927 of product to a components distributor. Lantronix granted this distributor the right to return any unsold product for 79 days as

well as 60-day payment terms. Lantronix improperly recognized \$496,927 in revenue on this transaction for the quarter ended September 2001.

Lantronix Loans Funds to Prevent a Return By the German Distributor

8. During the quarter ended September 2001, the German distributor intended -- and had authorization from Lantronix -- to return to Lantronix about \$1.1 million of product that Lantronix previously had shipped to the German distributor and had recognized as revenue. In order to reduce this return, Lantronix negotiated a deal whereby the German distributor would ship \$498,240 of product from its March and June orders to a Texas-based company.² The Texas-based company would then pay the German distributor for the product. The terms stated on the purchase order between the German distributor and the Texas-based company included, among other things, full rotation rights.

9. The Texas-based company wanted the Lantronix product for a future sale to a customer in the Philippines. In December 2001, the German distributor attempted to collect from the Texas-based company for this transaction. Because the Philippines deal had not yet come through and the Texas-based company did not have the money to pay the German distributor for the product, Lantronix lent money to the Texas-based company to pay the German distributor. In December 2001, Lantronix wired \$475,000 to the Texas-based company. Lantronix also issued a check in December 2001 to the Texas-based company for \$50,000. After Lantronix issued the funds to the Texas-based company, the Texas-based company paid the German distributor. In conjunction with this loan, the Texas-based company's owner signed two promissory notes totaling \$525,000. This transaction was improper because Lantronix essentially paid for its own sales when it sent funds to the Texas-based company to pay the German distributor. Further, by fronting money to the Texas-based company, Lantronix was able to avoid the return of its product and a corresponding reduction in revenue.

The German Distributor Overshipments and Out-of-Quarter Transaction

10. In addition to the revenue recognition problems involving the German distributor discussed above, Lantronix also improperly recognized revenue in the quarters ended December 2000 and March 2001, totaling approximately \$536,530, on shipments of product to the German distributor. These sales were improperly recorded as revenue because the German distributor placed the purchase order after quarter-end or did not order the product.

11. On or about December 31, 2000, Lantronix shipped \$272,605 of product to the German distributor without having received a purchase order from the German distributor. On January 4, 2001, the German distributor issued a purchase order for the exact amount of the shipment. Lantronix improperly recorded revenue from this transaction in the December quarter

² The purchase order was actually placed in the name of another company under the same ownership as the Texas-based company in 2001. For all practical purposes, this transaction was between the Texas-based company, the German distributor, and Lantronix.

even though the German distributor did not actually issue the purchase order until January 4, 2001, four days into the next quarter.

12. In addition to, and as part of, the approximately \$1.5 million March 2001 transaction with the German distributor discussed above wherein Lantronix granted full stock rotation rights to the German distributor, Lantronix shipped an additional \$263,925 of unordered product to the German distributor. Lantronix improperly recognized revenue on this transaction.

13. Lantronix's revenue recognition on these overshipments to the German distributor was not in conformity with generally accepted accounting principles ("GAAP"). Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises" (CON 5), ¶ 83(a) provides that "revenues . . . generally are not recognized until realized. Revenues . . . are realized when products . . . are exchanged for cash or claims to cash." Lantronix should not have recognized revenue on these overshipments to the German distributor because Lantronix had no claims to cash. Lantronix had no reasonable expectation that the German distributor would pay on an invoice for product that it had not ordered.

Contingent Order

14. Lantronix also improperly recognized \$343,520 in revenue on a June 30, 2001 contingent transaction. Lantronix sales personnel were attempting to close a sale with a customer, but the customer was unwilling to place an order with Lantronix because it did not yet have an order from its end-user. Lantronix suggested that another one of Lantronix's distributors agree to take the product; hold it for the customer until it could authorize a purchase order; and then the distributor would ship the product to the customer. Although the invoices to the distributor stated a 60-day payment term, an October 23, 2001 email confirms the contingent nature of this transaction. The email indicates that the distributor was not required to pay Lantronix until it had "receive[d] ...the money." The distributor eventually paid Lantronix \$62,500 for this transaction in the quarters ended December 2001 and March 2002 and returned the remainder of the product in the quarter ended March 2002.

15. Lantronix did not recognize revenue on this transaction in conformity with GAAP. Sales made contingent upon the resale of the product to an end-user cannot be recognized as revenue under GAAP. FAS 48, ¶ 6.b. Statement of Accounting Concepts No. 5, ¶ 83(a). See also SEC v. Scientific Software Intercomp, Inc., AAER No. 956 (Sept. 11, 1997); In the Matter of William D. Kyle, AAER No. 941 (July 28, 1997).

Reported Financial Results and Subsequent Restatement

16. Lantronix filed periodic reports with the Commission for the quarters ended December 2000 and March 2001, fiscal year ended June 2001, and the quarter ended September 2001 that misstated and misrepresented its financial condition and results of operations and omitted material information. These misstatements were material. As a result of the fraud, Lantronix overstated its revenues for these periods by 2.24% to 21.42% and understated pre-tax losses by

12% to 98%. Lantronix also reported these inflated revenue numbers for the December 2000 and March 2001 quarters in its Form S-1 in connection with its offering in July 2001.

17. On June 25, 2002, Lantronix restated its periodic reports, which included fiscal year ended June 2001 and the quarter ended September 2001.

Legal Analysis

18. As a result of the conduct described above, Lantronix violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, which prohibit making untrue statements of material fact or omitting to state material facts in the offer or sale, or in connection with the purchase or sale, of securities. As described above, Lantronix violated these provisions by filing a registration statement and periodic reports that misstated and misrepresented its financial condition and results of operations by overstating revenue and understating pre-tax losses.

19. Further, as a result of the conduct described above, Lantronix violated Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder, which require issuers of securities registered pursuant to Section 12 of the Exchange Act to file accurate annual and quarterly reports. These reports must contain any material information necessary to make the required statements made in the reports not misleading. As previously discussed, Lantronix filed periodic reports with the Commission that misstated its financial results and omitted material information.

20. Further, as a result of the conduct described above, Lantronix violated Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies registered under Section 12 of the Exchange Act to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions of the issuer. During its fiscal years 2001 and 2002, Lantronix's books and records were inaccurate as demonstrated by Lantronix's restatements.

21. In addition, as a result of the conduct described above, Lantronix violated Section 13(b)(2)(B) of the Exchange Act, which requires reporting companies to devise and maintain a system of internal accounting controls sufficient to reasonably assure that transactions are recorded and financial statements are prepared in conformity with GAAP. During its fiscal years 2001 and 2002, Lantronix had insufficient internal controls to assure that it accounted properly for its revenue.

Undertakings

Respondent has undertaken to:

22. Cooperate fully with the Commission and its staff in connection with this action and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party. In particular, Respondent agrees to:
(i) take all possible steps to make its officers, directors, employees, agents and other

representatives available to be interviewed, by the Commission's staff, at such times as the Commission's staff reasonably may direct; (ii) take all possible steps to make its officers, directors, employees, agents and other representatives available to appear and testify in such investigations, depositions, hearings, or trials as the Commission's staff reasonably may direct; (iii) accept service and promptly respond to notices or subpoenas issued by the Commission for documents or testimony at depositions, hearings, or trials, or in connection with any related investigation by Commission staff; (iv) appoint Respondent's attorney in this matter as agent to receive service of such notices and subpoenas; (v) with respect to such notices and subpoenas, waives the territorial limits on service contained in Rule 45 of the Federal Rules of Civil Procedure and any applicable local rules, provided that the party requesting the testimony reimburses Respondent's travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (vi) consent to personal jurisdiction over Respondent in any United States District Court for purposes of enforcing any such subpoena.

In determining to accept the Offer, the Commission has considered these undertakings, as well as remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff.

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Lantronix's Offer.

Accordingly, it is hereby ORDERED that:

Respondent Lantronix cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, and 13a-13 thereunder.

By the Commission.

Nancy M. Morris
Secretary