CASTELLE \CA\
Form 10-K
March 30, 2007

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

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

o 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)

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act: **Common Stock, No Par Value**

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

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

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 ü No __

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):.

Large Accelerated Filer__ Accelerated Filer__ Non-Accelerated Filer ü

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

The approximate aggregate market value of the Registrant s common stock held by non-affiliates of the Registrant, based upon the last sale price of the common stock reported on the Nasdaq SmallCap Market on June 30, 2006 was $11,368,474.

The number of shares of Registrant s common stock outstanding at February 28, 2007 was 4,045,021.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this Form 10-K are incorporated by reference from certain portions of the Registrant s proxy statement relating to its 2007 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that are based on our current expectations about our company and our industry. All of our forward-looking statements involve risks and uncertainties. Our actual results could differ significantly from our expectations and from the results expressed in, or implied by, these forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in Item 1A of Part I of this Annual Report on Form 10-K. We urge you to consider these cautionary statements carefully in evaluating our forward-looking statements. Except as required by law, we undertake no obligation to publicly update any forward-looking statements to reflect subsequent events and circumstances.

PART I

ITEM 1. BUSINESS

The following summary should be read in conjunction with, and is qualified in its entirety by, the more detailed information and Consolidated Financial Statements and Notes thereto appearing elsewhere in this Annual Report on Form 10-K.

OVERVIEW

Castelle was incorporated in California in 1987, and its principal offices are located at 855 Jarvis Drive, Suite 100, Morgan Hill, California 95037. Unless the context otherwise requires, references in this Form 10-K to we, us, or the Company refer to Castelle. Our telephone number is (408) 852-8000. Castelle®, LANpress® and JetPress® are registered trademarks of the Company. FaxPress™, FaxPress Premier™, FaxPress Enterprise™, FaxPress Plus™ and InfoPress™ are trademarks of the Company. This Annual Report on Form 10-K includes trademarks and trade names of other companies. Our common stock is listed on the Nasdaq SmallCap Market under the symbol CSTL. We maintain a Website with the address www.castelle.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available free of charge through our website our Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q as soon as reasonably practicable after we electronically file such material with the Securities and Exchange Commission. In addition, we intend to disclose on our website any amendments to, or waivers of, our code of business conduct and ethics, that are required to be publicly disclosed pursuant to the rules of the Securities and Exchange Commission and the Nasdaq Stock Market.

We develop, manufacture, market and support office automation systems that allow organizations to implement faxing over local area networks (known as LANs) and the Internet. Our FaxPress fax servers provide a simple way to integrate fax with email, desktop and back-end applications. Our products are designed to be easy to use and maintain, and provide an economical way for companies to share resources over their networks.

Our products have historically centered on fax and print servers and related technologies. Beginning in 1997, our revenues declined as competition increased with respect to print server products, while at the same time the Internet and other networking technologies advanced. As a result, we experienced annual operating losses during 1997 through 1999. During the past ten years, management has redirected our efforts to focus on server appliances and on development efforts to integrate existing and future products with the Internet and emerging networking technologies. During 2004, we discontinued our LANpress print server and InfoPress product lines, but will continue to provide support to our customers during the warranty periods. Through the introduction of enhanced fax automation products that generate higher gross profits, restructuring actions and cost reductions, we were able to report operating profits in the fourth quarter of 1999 and in each of the four quarters of 2000. We incurred a loss in 2001 resulting from a decrease in demand for our products due in part to the general downturn of the economy. Our sales and profitability rebounded in 2002, and since then we have had five consecutive years of net profits.

Industry Background

In the mid-1980s, organizations began to interconnect personal computers into LANs in order to allow workgroups to share files, peripherals such as printers, and other specialized applications. As LANs have proliferated throughout organizations and client/server architectures have gained acceptance, they have become increasingly complex and the applications operating on computer networks have become more critical to the success of the business enterprise. The further proliferation of the Internet and Intranets and popularity of electronic communications expanded the role of LANs as a means to provide common access to the Internet, email and other office automation applications. Installation, maintenance and administration of LAN equipment required a staff of highly skilled professionals. The costs associated with LANs and related equipment, server-class hardware, specialized software, network integration, and support services are significant and typically affordable only by larger

organizations. Many businesses were not able to afford office automation applications beyond basic email, such as integrating fax technology into the network. This has created the opportunity for specialized networking equipment that would perform a single application very well, known in the industry as a server appliance. It is similar to using a toaster instead of an oven, as it does a specific job better and it costs less. A server appliance is an integrated hardware and software product designed to reduce the complexity and cost for a specific server-based application. Internet routers, email servers, remote access servers, communication servers, fax servers and print servers are examples of server appliances used by businesses today.

We are a pioneer in server appliances, establishing all-in-one network fax solutions for business and enterprise, with our easy to use fax server product family.

Fax Office Automation Products: Fax machines have become a basic method of doing business worldwide. Fax is ubiquitous in business; many homes even have fax machines. While computers have automated many business applications, faxing remains as a basic method of business communication. We believe fax is here to stay, just as the computer has not replaced paper. Fax servers integrate legacy fax business methods into the network to improve office productivity. Fax servers also provide the opportunity for new business applications to be developed to take advantage of the inherent strength and prevalence of fax machines. Virtually every business in the world has a fax machine that can be used to receive information. Sending purchase orders, invoices, order confirmations, etc. directly to a fax machine, as compared to using the mail, is a growing segment of the fax server market.

The increasing popularity of email and the Internet has provided a boost to electronic communications as many users and organizations become more comfortable and accustomed to their use. To further simplify and improve inter- and intra-organizational communications, corporate Management Information Services departments are looking for ways to integrate different types of messaging into a unified messaging environment. Fax remains one of the key business communication tools and is one of the essential components of the corporate messaging environment. In corporate communication infrastructures, fax is being integrated into email. To facilitate this capability companies install email-integrated fax server systems.

Fax servers allow users to send and receive faxes as easily as emails, using the same email application for both types of messages. A fax server can sort incoming faxes directly and deliver them electronically and confidentially to the electronic mailboxes of the intended recipients. A fax server can also be used as an independent network shared system in environments that require high volume incoming and outgoing faxes. Users are able to send and receive faxes directly from their computers or workstations, eliminating the need to print a document, take it to a stand-alone fax machine and wait for its transmission. Fax servers can help reduce fax transmission costs by sending non-urgent faxes at off-peak telephone rates and by utilizing fax over the Internet technology.

Many fax servers are implemented using complex software that requires the installation of a Windows or UNIX network operating system, a server-class computer, and specialized expensive fax modems. Our fax servers, FaxPress, FaxPress Premier and FaxPress Enterprise, are self-contained units with all the necessary hardware and software to integrate fax into network, desktop, email and back-end applications. As server appliances, they are designed to be easy to use and maintain and we believe that they are more economical than other solutions.

Server appliances, such as communications/messaging servers, have emerged and gained market acceptance due to their ability to significantly reduce complexity and cost associated with the installation and maintenance of networking systems. These appliances also make the complex functionality of Internet and Intranet communications available and affordable to smaller businesses. As professionals in enterprises and small organizations alike continue to recognize the benefits of server appliances, such as remote access, scanning, faxing, electronic mail and related functions, we believe that the demand for such network systems will increase.

Our Strategy

Our objective is to be a leading supplier of network server appliances worldwide for all-in-one network fax solutions for business and enterprise, offering organizations several network fax options: desktop faxing, production faxing, fax and email integration, workflow application integration, and tools for developing custom fax applications. Our fax servers, FaxPress, FaxPress Premier, FaxPress Enterprise, include the FaxPress or FaxPress Plus software suite that enables administrators and users to perform functions such as managing fax queues, creating

reports, and viewing fax archives. Our products are installed in many Fortune 1000 companies and small and medium sized businesses worldwide.

Focus on Server Appliances: We focus exclusively on providing innovative, reliable, easy-to-use network products. Since our inception, we have focused on developing networking products that tightly integrate proprietary hardware systems with standard computing platforms. As a result, we believe we have developed a high level of expertise in networking, software development, hardware design and telephony technology. We plan to capitalize on these attributes by continuing to focus on providing network enhancement products that enable users to communicate more effectively.

Focus on Application Solutions and Communications: We focus on developing application solutions for inter and intra-company communications. We believe that our focus on application servers rather than on infrastructure systems enables us to offer products that bring higher value services to customers and provide a higher margin to us.

Expand Product Line: We are leveraging our expertise in server appliances to offer new easy-to-use, cost-effective solutions. We continue to expand our fax server products and apply our proven technology to other areas.

Focus on E-commerce and Other High Volume Distribution Channels: We have established a two-tier domestic and international distribution network of leading national and regional network product distributors and resellers including Ingram Micro and Tech Data. Our products are well suited for sale by e-commerce vendors and we have been successful working with leading resellers such as CDW and Insight. We are focused on maintaining and strengthening our current distribution network in North America, Europe and the Pacific Rim.

Leverage Strategic Relationships: We augment our product offerings by establishing relationships with companies able to provide products in areas outside of our core technical competencies or in instances where internal development of such products is not cost-effective. We also establish relationships with numerous leaders in hardware and software technology to keep abreast of, and respond quickly to, technological changes that may affect the network enhancement market.

Products

We develop and market a range of fax servers that enhance network productivity, performance and functionality.

Fax Server Products: We have incorporated plug-and-play and ease of use with our FaxPress family of network fax servers. We position FaxPress, FaxPress Premier and FaxPress Enterprise as the easiest way to add faxing to a company s network and integrate fax with email. Our FaxPress family of products allow network users to send, receive, route, print, store, edit and retrieve fax transmissions from their own personal computers on a network. Our fax servers can be integrated into an email system creating a unified fax/email environment. The FaxPress family of products enables users to transmit documents directly to a fax device as easily as if they were printing to a local or network printer or sending an email message. The product also provides network administration features such as, monitoring, logging or configuring FaxPress, FaxPress Premier and FaxPress Enterprise users. Our fax server products are designed to comply with current regulatory standards in the United States, Europe and the Pacific Rim. During the past few years, fax products and related services represented almost 100% of our total net sales.

Key features of FaxPress, FaxPress Premier and FaxPress Enterprise products (configured with its current software versions) include:

Easy installation and maintenance: FaxPress, FaxPress Premier and FaxPress Enterprise are network fax servers that include all the necessary hardware and software. The hardware system is a box with an integrated 10/100 Base-T Ethernet interface and one to seventy-two fax channels. Our fax server products include all required server and client software.

Support for popular network operating environments: Our fax server products operate in any local area network based on Microsoft Windows 2000 and 2003; Windows XP, Vista, and Terminal Server; Novell NetWare; or Linux servers.

Ability to create a unified fax/email messaging environment: Our fax server products have the ability to integrate fax into a corporate email system, allowing users to send and receive faxes in the same manner as emails. Our products support Microsoft Exchange/Outlook, Lotus Notes, Novell GroupWise, Netscape and other SMTP compatible email systems. Our unique Outlook Direct interface offloads fax processing from the Microsoft Exchange Server while maintaining tight integration with the Outlook client.

Integration with many popular accounting and Customer Relationship Management applications: Our fax server products are available with the Reform-for-FaxPress software package from FabSoft that allows users to send faxes from many popular accounting, financial and payroll systems including Oracle, SAP, PeopleSoft, Great Plains, ACCPAC and Macola. Reform can support any application that supports form printing. Our products also integrate with GoldMine contact management software.

Ability to send faxes from many applications: Faxing from within any Windows applications such as Microsoft Office and Lotus Smart Suite.

Electronic delivery of faxes to desktops: Our fax server products support several methods to deliver incoming faxes direct to the email or fax inbox of the intended recipient. Such methods include Direct Inward Dialing, Dual Tone Multifrequency, T.30 sub-addressing, and line routing.

Internet faxing capabilities reduce transmission costs: Our fax server products enable users to connect several units via the Internet or the Intranet to form a private Fax-over-IP network that can significantly reduce the cost of fax transmissions.

Integration into custom applications: We provide a software development kit that allows programmers to integrate fax functions into their current applications or to create new customized applications that use the FaxPress, FaxPress Premier, or FaxPress Enterprise servers.

Software options: We offer a range of value-added software options that increase the functionality of our FaxPress, FaxPress Premier and FaxPress Enterprise systems and enable these servers to address specialized applications as mentioned above. Software upgrades and options are available to the installed base units at prices starting at $495.

We offer a family of FaxPress, FaxPress Premier and FaxPress Enterprise fax server systems ranging from entry-level products targeted for small businesses with fewer than 50 users to high-end fax solutions capable of supporting enterprise-wide installations. The suggested list prices for our server products range from $1,995 to $81,495. Server pricing is based on hardware model, with no per-user costs. The FaxPress 2500 and 5000 families come with the FaxPress 9.x network fax software that adds integration with popular email packages, and many advanced fax management and integration features. The FaxPress Premier and Enterprise families come with the FaxPress Plus 4.x network fax software.

In July 2006, we announced the release of our new FaxPress Enterprise Redundant Fax Server, the newest addition to our FaxPress Enterprise family of digital fax servers, providing an all-in-one redundant fax solution for T1, E1 or ISDN environments. Duplicated and backup hardware components provide increased reliability for business-critical faxing. In the event of a hardware failure, the backup components are designed to automatically take over allowing the fax server to continue to operate. The server-class hardware closely monitors the system and simultaneously sends notification to the administrator reporting the failed component. FaxPress Enterprise Redundant features include:

Dual hot swappable hard disk drives

RAID technology for disk mirroring

Dual hot swappable power supplies

Dual hot swappable cooling fans

Dual Gigabit Ethernet connectivity with client cross over support

Industrial grade hardware

Support for Digital T1, E1 and ISDN Environments in single or dual configurations for auto failover

In August 2006, we announced that we will enter into the fax-over-IP (FoIP) market with a new generation of network fax servers that support internet protocol (IP) faxing, which will be the fastest growing segment of the fax server market from 2004 to 2009, according to a report by independent research firm, Davidson Consulting. We expect to release our new generation of IP fax servers in 2007. As companies implement full IP telephony solutions or voice over IP (VoIP), the demand for IP fax solutions is also expected to increase. By utilizing the IP faxing T.38 protocol, users are able to send faxes in real time, receiving status and confirmation as the fax is sent over the VoIP network. The advantages of IP faxing include significant savings on long distance charges, accelerated document processing and centralized management for the network administrator.

The following table summarizes our FaxPress, FaxPress Premier and FaxPress Enterprise system products :

				Network Environment	
Product Model	**Number of Channels**	**Email Integration**	**Network Topology**	**NetWare 3.x, 4.x, 5.x, 6.x (IPX,IP)**	**Windows NT/2000/XP/2003 /Vista**
FaxPress 2500	1, 2	ü	Ethernet	ü	ü
FaxPress 5000	2, 4 or 8	ü	Ethernet	ü	ü
FaxPress Premier Analog	4, 8, 12, 16	ü	Ethernet	n/a	ü
FaxPress Enterprise Digital T1	8, 24, 48, 72	ü	Ethernet	n/a	ü
FaxPress Enterprise ISDN	4, 8, 12	ü	Ethernet	n/a	ü
FaxPress Enterprise Digital E1	10, 30, 60, 90	ü	Ethernet	n/a	ü

Research and Product Development

We have invested substantially in research and product development since inception. We believe our future performance will depend in large part on our ability to enhance our current products, to expand our product offerings, to maintain technological competitiveness, and to meet an expanding range of customer requirements. We spent $1.8 million, $1.7 million and $1.7 million in research and product development activities in 2006, 2005 and 2004, respectively.

We continue to invest in enhancing our server appliance product lines by developing new versions of client and server software and server hardware. The product feature set is driven by the increasing complexity of user needs. The changing corporate communications/messaging environment and increasing demand for easy-to-use networking systems define these needs. The development efforts are focused on enhancing functionality of existing

products and developing other systems to expand our product offerings. Our development efforts are focusing on high value applications, while relying on our partners to provide basic functionality for some of our product lines.

In January 2007, we released version 9.0 of our FaxPress software, following the release of FaxPress Plus software version 4.0 in 2005. Our current version of the FaxPress Plus software is 4.1.1. The new releases of FaxPress 9.0 and FaxPress Plus 4.1.1 Network Fax Software offer a new level of email integration, expanded operating environments and fax automation. It integrates with popular multi-functional peripherals from such suppliers as Xerox, HP, Canon eCopy, Ricoh GlobalScan, EFI and Sharp OSA. It includes improved integration with Microsoft Exchange, enhanced Windows XP/2003/Vista and Citrix MetaFrame XP support, improved Microsoft Office support, production faxing and fax automation made easy. In 2006, we released our new FaxPress Enterprise Redundant Fax Server, which provides full hardware redundancy for fax applications.

The current FaxPress, FaxPress Premier and FaxPress Enterprise fax server product lines are continuously being enhanced to offer greater integration into corporate networking environments. In addition, we expect to release a new generation of network fax servers that support IP faxing by early 2007.

Sales, Marketing and Distribution

Our products are installed in many Fortune 1000 firms and small and medium sized businesses worldwide. We sell our products through multiple channels, determined by the product, market and customer need. We have an established two-tier domestic and international distribution network of leading national and regional network product distributors and resellers. Software enhancements and options that complement the FaxPress products are primarily marketed directly by us to registered end users. The direct sales group works closely with distributors and value-added resellers (VARs) in qualifying sales opportunities for the fax server products. Demand for our products is created through a variety of marketing programs. These programs are targeted toward end-users to stimulate demand for the products and toward distributors, resellers, VARs and e-commerce vendors to promote the product in the sales channel. These programs include targeted and active participation in industry networking and communication trade shows, as well as advertising in associated publications. We increase awareness of our products by Internet marketing via targeted e-advertising, publishing and sponsoring email newsletters, enhancing our Web presence, print advertising, conducting direct mail campaigns, offering seminars, trade shows and conferences, and other forms of public relations efforts. Our Web site has been updated and designed to assist customers in obtaining information about our products and contacting our sales personnel.

Our products are well suited for sale by e-commerce vendors, and we have experienced success working with leading resellers such as CDW and Insight.

In 2006, Ingram Micro and Tech Data, our domestic distributors, individually accounted for more than 10% of our sales and collectively represented approximately 47% of our net sales. In 2005 and 2004, the same distributors together accounted for approximately 43% and 44%, respectively, of our net sales. Total sales to customers located in the Pacific Rim, Europe and rest of Americas comprised approximately 14%, 20%, and 18% of our net sales in 2006, 2005 and 2004, respectively.

Customer Service and Support

We provide customers with support services, which are available to assist customers with installation, use and operation issues in an effort to ensure smooth and reliable operation of our products. Our network engineers, located at corporate headquarters, provide technical support via telephone, fax and email during normal business days from 6:00 a.m. to 5:00 p.m. (Pacific Time). Support is provided under warranty terms as well as through extended warranty agreements sold directly to the customer by us. We also provide other customer support through our Web site. We have an automated call management distribution system that provides improved levels of support to help resolve customer issues.

Manufacturing

Our current in-house manufacturing operations consist primarily of material planning, final testing, quality control and service repair. Most of our products are manufactured by third-party manufacturers that provide customized, integrated manufacturing services, including procurement, manufacturing, printed circuit board assembly and final testing. These arrangements enable us to shift certain costs to such providers, thereby allowing us to focus resources on our product development efforts. The failure of such manufacturers to meet their contractual commitments to us could cause delays in product shipments, thereby potentially adversely affecting our business, operating results and financial condition.

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 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 and integrated circuits and modem boards from Dialogic Corporation, 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 making of our FaxPress Products. However, we purchased several years worth of supplies of these end-of-life components in an effort to guarantee an uninterrupted supply of FaxPress Products to our customers while we continue to develop new replacement products.

Competition

The network enhancement products and computer software markets are highly competitive, and we believe that such 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.

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. In addition, certain competing methods of communications such as the Internet or electronic mail could adversely affect the market for fax products.

Proprietary Rights

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. Additionally, we generally enter into confidentiality agreements with those employees, distributors, customers and suppliers who have access to sensitive information and limit access to and distribution of our software documentation and other proprietary information. Because of the rapid pace of technological change in the LAN product industry, we believe that patent protection for our products is less significant to our success than the knowledge, ability and experience of our employees, the frequent introduction and market acceptance of new products and product enhancements, and the timeliness and quality of our support services. We may not be able to obtain the necessary intellectual property rights and other parties may contest our intellectual property rights.

Government Regulation

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, particularly in foreign countries, could have a material, adverse effect on our business, operating results and financial condition. Additionally, our products must comply with a variety of equipment, interface and installation standards promulgated by communications regulatory authorities in different countries.

Employees

As of March 11, 2007, we employed a total of 40 full-time equivalent personnel, 8 in operations, 10 in sales and marketing, 7 in engineering, 8 in customer service and 7 in finance and administration. We have not experienced a work stoppage, no employees are represented by a labor organization and we consider our employee relations to be good.

Executive Officers

The names and ages of our executive officers as of February 28, 2007 are set forth below:

Name	Age	Position
Scott C. McDonald	53	President, Chief Executive Officer
Eric Chen	54	Senior Vice President, Engineering and Business Development
Paul Cheng	58	Vice President, Finance and Administration, Chief Financial Officer and Secretary
Richard Fernandez	47	Vice President, Operations
Edward J. Heinze	61	Vice President, Worldwide Sales
Michael Petrovich	45	Vice President, North America Sales

Scott C. McDonald

Mr. McDonald has served as our President and Chief Executive Officer since April 2002 and has served as a director since April 1999. From May 2001 to the first quarter of 2002, Mr. McDonald served on the board of directors for Octant Technologies and Digital Power Corporation and provided consulting services. Mr. McDonald served as the Chief Financial and Administrative Officer at Conxion Corporation, a network and Internet services company, from December 1999 to April 2001. From 1997 to 1999, Mr. McDonald served on the board of directors for CIDCO, Inc, Octant Technologies Inc. and Digital Power Corporation; in addition to providing consulting services to CIDCO, Inc. Mr. McDonald currently serves on the board of directors of privately held Octant Technologies, Inc. Mr. McDonald holds a BS in Accounting from the University of Akron and an MBA from Golden Gate University.

Eric Chen

Mr. Chen has served as our Senior Vice President, Engineering and Business Development since May 2002. From May 2000 to May 2002, Mr. Chen served as our Vice President, Engineering. Upon joining us in 1989, Mr. Chen initially worked on software development projects including developing the first FaxPress e-mail gateways, porting FaxPress to non-Novell platforms, and the first menu-driven installation and configuration programs for both FaxPress and LANpress. Successive to that, Mr. Chen served as the Director of Print Server Product Marketing and Business Unit and has managed the engineering development and manufacturing business relationships with our partners. Before joining our company, Mr. Chen was with 3COM, a network solutions provider. Mr. Chen has a BS in Engineering from Taiwan and an MS in Computer Science from the University of Massachusetts.

Paul Cheng

Mr. Cheng has served as our Vice President, Finance and Administration since April 2000. In March 2001, Mr. Cheng was also appointed as Chief Financial Officer and Secretary. Mr. Cheng brings more than 20 years of financial experience from a career that was launched in Hong Kong where he was the Plant Controller of Fairchild Semiconductor Hong Kong Ltd. Before joining our company, he served as the Vice President of Finance and Administration at Eclipse International, Inc., a systems development company, from April 1997 to March 2000. In addition, he has held various executive positions including Vice President of Finance at Quintus Corporation, a developer of customer relations management software from 1993 to 1995 and Corporate Controller at Power Integration, Inc., a semiconductor manufacturer from 1995 to 1997. Mr. Cheng is a member of the Chartered Certified Accountants and holds a BS in Accounting from Hong Kong.

Richard Fernandez

Mr. Fernandez has served as our Vice President of Operations since December 2002. From June 2002 to December 2002, Mr. Fernandez served as our Director of Operations. Mr. Fernandez has more than 22 years of manufacturing and materials planning experience prior to joining the Company. Prior to joining our company, Mr. Fernandez managed the acquisition of servers and storage devices for Conxion Corporation from June 2000 to May 2002. Prior to joining Conxion, Mr. Fernandez was Director of Operations with CIDCO, Inc. since March 1994. In addition, Mr. Fernandez has held various management positions with Computer Products Inc., MAD Intelligent Systems and Sperry Univac.

Edward J. Heinze

Mr. Heinze has served as our Senior Vice President, Sales since July 2006. From January 2000 to July 2006, Mr. Heinze served as our Vice President, Sales, U.S. From 1994 to January 2000, Mr. Heinze served in several capacities including Product Manager of the Fax Product Line, and Regional Sales Manager. Before joining our company, Mr. Heinze served in several capacities at Visual/White Pine Software, a software developer, including Vice President of Sales. Prior to his tenure at White Pine, he was Chief Operations Officer for XMARK, a computer systems manufacturer, and Vice President of Sales and Marketing at EIT, Millicom, Olympia, and Ontel. He holds a BS degree from Waynesburg College.

Michael Petrovich

Mr. Petrovich has served as our Vice President, North American Sales since July 2006. From October 2000 to July 2006, Mr. Petrovich served as our Vice President, Sales, International and has been with us since 1992. Prior to joining us, Mr. Petrovich was the marketing communications manager for Novell s National Reseller Organization, a software company. In this role Mr. Petrovich focused on business strategies and development of Novell s direct reseller sales channel. Before joining Novell, Mr. Petrovich held sales and marketing positions at Excelan, a LAN manufacturer, and International Microcircuits Incorporated, a semiconductor company. Mr. Petrovich holds a BA in Behavioral Sciences from San Jose State University.

ITEM 1A. 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 Annual Report on Form 10-K. 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 and acceptance 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 service revenue,
- the commencement or conclusion of significant development contracts;
- the timing of significant marketing and sales promotions ; and
- changes in income tax provisions or benefits

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 may not be able to sustain profitability.

Though we have been profitable in recent years, we have experienced significant operating losses in the past and, as of December 31, 2006, had an accumulated deficit of $19.1 million. Our development and marketing of current and new products will continue to require substantial expenditures. We incurred $591,000 of losses as recently as 2001 due to a slowdown in demand for our products due in part to industry-wide adverse economic conditions. We were able to recover and since then we have five consecutive years of net profits. There can be no assurance that growth in net sales will be achieved or profitability sustained in future years.

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

We derived all of our revenue from the sale of fax server products and related services in 2006. We expect that our current products and related services 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 emergence of 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 which

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. Both direct and indirect competition could adversely affect our business and operating results through pricing pressure, loss of market share and other factors. 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 we. 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. 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 14%, 20% and 18% of our net sales in 2006, 2005 and 2004, respectively. We sell our products in approximately 40 foreign countries through approximately 50 international distributors. 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, which could adversely affect our revenue and net income. On the other hand, if we have over purchased the end-of-life components, resulting in excessive inventory after we have developed replacement products, we may be exposed to inventory write-offs. 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.

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 further. In the event we are unable to satisfy regulatory requirements relating to internal controls, or if these internal controls over financial reporting are not effective, our business could suffer.

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 to incur significant costs in connection with compliance with Section 404 of that law regarding internal controls over financial reporting. 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.

We have identified and may from time to time identify a number of deficiencies in our disclosure controls and procedures. In connection with the audit of the consolidated financial statements for the year ended December

31, 2006, our independent registered public accounting firm, Grant Thornton LLP, determined that we had internal control deficiencies that constituted significant deficiencies . Furthermore, we cannot assure you that we will be able to implement enhancements on a timely basis in order to prevent a failure of our internal controls or enable us to furnish future unqualified certifications. A significant deficiency in internal control over financial reporting could materially impact our reported financial results and the market price of our stock could significantly decline. Additionally, adverse publicity related to the disclosure of a material weakness or significant deficiency in internal controls over financial reporting could have a negative impact on our reputation, business and stock price. Any internal control or procedure, no matter how well designed and operated, can provide only reasonable assurance of achieving desired control objectives.

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 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 of 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.

From time to time, 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 will 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.

If a third party asserts that we are infringing proprietary technology rights, whether successful or not, it could subject us to costly and time-consuming litigation or expensive licenses, which could harm our business.

Our success depends on our ability to operate without infringing the patents and proprietary rights of third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies.

Third parties have in the past sent us letters and other communications regarding their intellectual property, and in the future, we may receive claims that our products infringe or violate their intellectual property rights. Any claims or litigation could cause us to incur significant expenses and, if successfully asserted against us, could require that we pay substantial damages and prevent us from selling our products. Even if we were to prevail, any litigation regarding our intellectual property could be costly and time-consuming and divert the attention of our management and key personnel from our business operations. We may also be obligated to indemnify our customers or business partners in connection with any such litigation, which could further exhaust our resources. Furthermore, as a result of an intellectual property challenge, we may be required to enter into royalty, license or other agreements. We may not be able to obtain these agreements at all or on terms acceptable to us.

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.

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.

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.

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

At February 28, 2007, our officers, directors and principal shareholders beneficially owned approximately 51% of the outstanding shares of common stock. Accordingly, together they have 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.

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.

Our reported financial results may be adversely affected by changes in accounting principles generally accepted in the United States.

Generally accepted accounting principles in the United States are subject to interpretation by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the Securities Exchange Commission (SEC), and various bodies formed to promulgate and interpret appropriate accounting principles. A change in these principles or interpretations could have a significant effect on our reported financial results, and could affect the reporting of transactions completed before the announcement of a change.

For example, as of January 1, 2006 we were required to adopt the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share Based Payment, causing us to expense employee stock options. This change decreased our diluted net income per share by $0.17 for the full year 2006. This impact may change based upon additional stock option grants, if any, methodology refinement or other factors.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (as amended) an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of analyzing the impact of FIN 48, which is required to be adopted by the first quarter of fiscal 2007. The adoption of FIN 48 may have an adverse impact on our reported financial results.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

Our headquarters, including our executive offices and corporate administration, development, manufacturing, marketing, sales and technical services/support facilities, are located in Morgan Hill, California in approximately 16,600 square-feet of leased office space. We occupy this facility under a lease, the term of which expires on May 31, 2009 with one conditional three-year option, which if exercised, would extend the lease to May 31, 2012. We believe our existing facilities will be adequate to meet our requirements for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

From time to time and in the ordinary course of business, we are involved in various legal proceedings and third party assertions of patent or trademark infringement claims against us in the form of letters and other forms of communication. 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.

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

Not applicable.

PART II

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

Our common stock (Nasdaq symbol CSTL) began trading on the Nasdaq National Market on December 20, 1995 and was transferred to the Nasdaq SmallCap Market as of April 1999. The following table shows the closing high and low sale prices per share of our common stock as reported on the Nasdaq SmallCap Market. Such quotations do not include retail markups, markdowns or commissions.

2005	HIGH	LOW
First Quarter	$3.90	$2.57
Second Quarter	$5.04	$2.73
Third Quarter	$4.50	$3.16
Fourth Quarter	$3.78	$2.93

2006	HIGH	LOW
First Quarter	$3.48	$2.92
Second Quarter	$3.65	$2.70
Third Quarter	$3.15	$2.26
Fourth Quarter	$4.18	$2.55

The market price of our common stock has been volatile. See Risk Factors Our stock price has been volatile, and is likely to continue to be volatile in the future.

As of March 9, 2007 there were 765 holders of record of our common stock. On March 9, 2007 the last sale price reported on the Nasdaq SmallCap Market for our common stock was $3.10 per share.

Dividend Policy

We have not paid cash dividends on our common stock. The Board of Directors periodically reviews the dividend policy and currently intends to retain any and all earnings for use in our business and we do not anticipate paying cash dividends in the foreseeable future. Our credit line provides that we shall not pay any dividend without the Bank s prior consent.

Performance Graph

This performance graph shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act) or otherwise subject to the liabilities under that Section and shall not be deemed to be incorporated by reference into any filing of Castelle s under the Securities Act of 1933, as amended or the Exchange Act.

The following graph shows a comparison of cumulative total returns for the Company, the NASDAQ Stock Market (United States Companies) and the NASDAQ Computer Manufacturers Index for the last five fiscal years ended on December 31, 2006. The graph assumes that $100 was invested on December 31, 2001 in the common stock of the Company, the Nasdaq Market Index and the NASDAQ Computer Manufacturers Index and assumes that all dividends have been reinvested. The stock price performance on the following graph is not necessarily indicative of future stock price performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Castelle, The NASDAQ Composite Index

And The NASDAQ Computer Manufacturers Index

$0

$50

$100

$150

$200

$250

$300

$350

$400

$450

12/01

12/02

12/03

12/04

12/05

12/06

Castelle

NASDAQ Composite

NASDAQ Computer Manufacturers

* $100 invested on 12/31/01 in stock or index-including reinvestment of dividends.

Fiscal year ending December 31.

Equity Compensation Plan Information

The following table sets forth a summary of our equity compensation plans as of December 31, 2006. Details of the plans are discussed in Note 6 to the Consolidated Financial Statements.

	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans
1988 Equity compensation plan approved by security holders	7,000	$ 2.37	-0-
1998 (1988) Equity compensation plan (As Amended) approved by security holders	595,866	$ 0.95	-0-
2002 Equity compensation plan approved by security holders	436,281	$ 3.05	214,996
Equity compensation plans not approved by security holders	-0-	n/a	-0-
Total	1,039,147	$ 1.83	214,996

Stock Buyback Program

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $750,000 of our common stock 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 our discretion. No time limit was set for the completion of this program. The Company has not repurchased any of its common stock since then under this program. This stock buyback program does not obligate us to acquire any specific number of shares and may be suspended or discontinued at any time. We made the following repurchases pursuant to this stock buyback program:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
2002	19,500	$ 1.03	19,500	$ 730,000
2003	46,500	1.04	46,500	680,000
Total	66,000	$ 1.04	66,000	$ 680,000

In the third quarter of 2006, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $1 million of our common stock for cash in open market, negotiated or block transactions. The timing and exact number of shares purchased will be at our discretion and will depend on market conditions. We do not intend to repurchase any shares from our management team or other insiders. This stock buyback program does not obligate us to acquire any specific number of shares and may be suspended or discontinued at any time. During the fourth quarter of 2006, we made the following repurchases pursuant to this stock buyback program:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
2006	22,466	$ 2.81	22,466	$ 936,000
Total	22,466	$ 2.81	22,466	$ 936,000

ITEM 6. SELECTED FINANCIAL DATA

The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related Notes thereto included elsewhere in this Annual Report on Form 10-K.

The selected consolidated financial data set forth below are derived from our consolidated financial statements. The consolidated statements of earnings data for the years ended December 31, 2004, 2005 and 2006 and the consolidated balance sheet data as of December 31, 2005 and 2006 are derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The consolidated statements of earnings data for the years ended December 31, 2002 and 2003 and the consolidated balance sheet data as of December 2002, 2003 and 2004 are derived from our audited consolidated financial statements not included in this Annual Report on Form 10-K.

	Years ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share amounts)				
CONSOLIDATED STATEMENT OF EARNINGS DATA:					
Net Sales	$ 10,590	$ 10,832	$ 10,457	$ 10,180	$ 9,720
Gross Profit	$ 6,634	$ 7,103	$ 7,075	$ 6,969	$ 6,180
Gross Profit as a % of Net Sales	63%	66%	68%	68%	64%
Net income	$ 669(1)	$ 579(2)	$ 2,119(3)	$ 1,606(4)	635
Net income as a % of Net Sales	6%(1)	5%(2)	20%(3)	16%(4)	7%
Net income per share diluted	$ 0.15(1)	$ 0.13(2)	$ 0.48(3)	$ 0.38(4)	$ 0.14

	Years ended December 31,									
	2006		2005		2003		2003		2002	
	(in thousands, except per share amounts)									
CONSOLIDATED BALANCE SHEET DATA:										
Cash and Cash Equivalents	$	8,259	$	6,766	$	5,599	$	4,614	$	3,460(5)
Working Capital	$	7,746	$	6,784	$	5,750	$	4,156	$	2,437
Total Assets	$	11,979	$	10,674	$	10,147	$	7,803	$	5,635
Long-term Liabilities	$		$		$	14	$	29	$	44
Shareholders Equity	$	9,095	$	8,052	$	7,281	$	4,752	$	2,926(5)

(1) In 2006, we recorded a tax provision of $29,000, or $0.01 per diluted share, resulting from federal and state provision and a decrease in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods. 2006 federal and state tax liability was almost entirely offset by the utilization of existing net operating losses, and therefore, we do not expect to utilize significant amounts of cash for income tax payments until our $11 million of available net operating loss carryforwards as of December 31, 2006 have been utilized.

(1) In 2005, we recorded a tax provision of $395,000, or $0.09 per diluted share, resulting from federal and state provision and an increase in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods. 2005 federal and state tax liability was almost entirely offset by the utilization of existing net operating losses.

(3) In 2004, we recorded a non-cash tax benefit of $1.1 million, or $0.24 per diluted share. This was a result of releasing a portion of our tax valuation allowance due to our continued profitability and a determination that it is more likely than not that certain future tax benefits will be realized.

(4) In the fourth quarter of 2003, we recorded a non-cash tax benefit of $526,000, or $0.12 per diluted share, resulting from the release of a portion of our tax valuation allowance. 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 carryforwards. These NOLs were fully reserved by a valuation allowance due to uncertainly surrounding the likelihood of their realization. Due to our continued profitability over the past ten quarters and a determination that it was 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

(5) In 2002, cash and cash equivalents and shareholders equity reflect the use of $2 million of cash for the repurchase of 1.62 million shares of our common stock and the associated expenses.

Unaudited Quarterly Results of Operations

The following table sets forth certain consolidated quarterly financial data for the eight quarters ended December 31, 2006. This information is unaudited, but in our opinion, has been prepared on the same basis as the audited consolidated financial statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the unaudited interim results. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

Selected Consolidated Quarterly Data (unaudited)

	Year 2006, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
Net sales	$ 2,989	$ 2,412	$ 2,618	$ 2,571
Gross profit	1,922	1,493	1,604	1,615
Operating income/(loss)	147	(96)	163	205
Net income/(loss)	206	(34)	237	260[(1)]
Net income/(loss) per share, basic	0.05	(0.01)	0.06	0.07[(1)]
Net income/(loss) per share, diluted	0.05	(0.01)	0.05	0.06[(1)]

[(1)] In 2006, we recorded a tax provision of $29,000, or $0.01 per diluted share, resulting from federal and state provision and a decrease in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods. 2006 federal and state tax liability was almost entirely offset by the utilization of existing net operating losses, and therefore, we do not expect to utilize significant amounts of cash for income tax payments until our $11 million of available net operating loss carryforwards as of December 31, 2006 have been utilized.

	Year 2005, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
Net sales	$ 2,594	$ 2,846	$ 2,701	$ 2,691
Gross profit	1,782	1,914	1,679	1,728
Operating income	110	296	222	241
Net income	135	316	248	(120)[(1)]
Net income per share, basic	0.04	0.08	0.06	(0.03)[(1)]
Net income per share, diluted	0.03	0.07	0.05	(0.03)[(1)]

[(1)] Includes a tax provision of $395,000, or $0.09 per diluted share, resulting from the federal and state provision and an increase in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods..

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

(All tabular amounts in thousands except per share amounts and as noted)

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 at the front of this Annual Report on Form 10-K.

Our products have historically centered on fax and print servers and related technologies. Starting in 1997, our revenues began to decline as competition increased, with respect to print server products, while at the same time the Internet and other networking technologies advanced. As a result, we experienced annual operating losses beginning in 1997 through 1999. We redirected our efforts to focus on server appliances and on development efforts to integrate existing and future products with the Internet and emerging networking technologies. We introduced our products, the FaxPress 5000 in February 1999, FaxPress 2500 in November 1999, FaxPress SBE in February 2000, the FaxPress 7500 in September 2000 and the FaxPress Premier Analog and FaxPress Enterprise Digital in September 2003. In July 2006, we announced our new FaxPress

Redundant Fax Server. In addition, in August 2006, we announced that we will enter into the FoIP market with a new generation of network fax servers that support IP faxing. We expect to release our new generation of IP fax servers in 2007. Today, our analog fax servers can provide up to 16 fax channels, the digital servers up to 72 T1 fax channels, the ISDN servers up to 12 fax channels and the E1 servers up to 90 fax channels. Our current FaxPress and FaxPress Plus software versions are 9.0 and 4.1, respectively, to support our hardware.

Improved cash management and operating results resulted in positive operating cash flows in 2006, 2005 and 2004. Cash balances increased to $8.3 million at December 31, 2006 from $6.8 million and $5.6 million at December 31, 2005 and December 31, 2004, respectively.

From time to time, component manufacturers announce the end of life of certain of their products and at the same time introduce replacement components which are usually more efficient or cost effective. We were informed by several of our component suppliers that new components are available to replace certain of their end-of-life components currently used in our FaxPress products. We purchased several years supply of these end-of-life components in an effort to guarantee a smooth supply of our FaxPress Products to our customers. We believe this will give us ample time to develop new replacement products. We believe that most of these end-of-life components will be utilized within approximately the next two years resulting in insignificant amounts of excessive inventory or none at all. We believe that Castelle s liquidity continues to be strong despite these purchases, as our cash balances increased during the periods when the parts were purchased. Even though we believe we have secured enough components for the next two years, there is no assurance that we will be able to secure additional components in the future, or be able to redesign new products in a timely manner. These end-of-life products represented $281,000 of the ending inventory balance at December 31, 2006 as compared to $390,000 at December 31, 2005.

Critical Accounting Policies

We have identified the policies below as critical to our business operations and to the understanding of our results of operations. We have defined a critical accounting policy as one that is both important to the portrayal of our financial condition and results of operations and requires our management to make difficult, subjective or complex judgments. For a detailed discussion on the application of these and other accounting policies, see Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report on Form 10-K, beginning on page F-7. Note that preparation of this Annual Report on Form 10-K 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 our financial statements, and reported amounts of revenue and expenses during the reporting period. Estimates about future events and their effects cannot be made with certainty. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments. These estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as our operating environment changes.

Revenue recognition

We recognize revenue based on the provisions of Staff Accounting Bulletin No. 104 *Revenue Recognition*, AICPA Statement of Position No. 97-2 (SOP 97-2) *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions*, and Statement of Financial Accounting Standards (SFAS) No. 48 *Revenue Recognition When Right of Return Exits*.

We use the residual method to recognize revenue when an agreement includes one or more elements to be delivered at a future date. If there is an undelivered element under the arrangement, we defer revenue based on vendor-specific objective evidence of the fair value of the undelivered element, as determined by the price charged when the element is sold separately. If vendor-specific objective evidence of fair value does not exist for all undelivered elements, we defer all revenue until sufficient evidence exists or all elements have been delivered.

Product revenue is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the fee is fixed or determinable; collection is probable; and returns can be reasonably estimated. If an acceptance period or other contingency exists, revenue is recognized upon satisfaction of the contingency, customer acceptance or expiration of the acceptance period. Shipment generally occurs and title and risk of loss is transferred when the product is delivered to a common carrier.

The Company accrues a liability for any sales taxes and value-added taxes collected on behalf of various taxing authorities. This liability is relieved when any taxes collected are remitted to the taxing authority. Revenue excludes sales taxes and any value-added taxes.

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.

Pursuant to our agreements with distributors, we also protect our distributors exposure related to the impact of price reductions. Future price adjustments are estimated and accrued at the time of sale as a reduction in revenue.

We generally provide our distributors the opportunity to earn volume incentive rebates based on sales volume achieved during the fiscal quarter. These incentive rebates are accrued in the quarter incurred and recorded as a reduction in revenue.

We also provide co-op and market development funds to our distributors. These incentives are accrued at the time revenue is recognized and recorded as a reduction in revenue.

We offer a standard trade-in discount to all of our end-user customers under which the customer, upon trade-in of any previously purchased product, is entitled to a discount from our published price list on any product included in our current product offerings. We require our customers to physically return the previously purchased products to qualify for the trade-in discount. We account for the trade-in discount as a reduction of revenue at the time the product is traded in and a new product is purchased.

Payment terms to our distributors and customers are generally 30 days, cash in advance, or by credit card.

We evaluate product sales through our distribution channels and the related reserve requirement to establish an estimate for our sales returns reserve by reviewing detailed point-of-sales and on-hand inventory reports provided to us by our channel partners. Based on a combination of historical return experience, the sales activities to end-user customers by our channel partners and the level of inventories on hand at the channel partners, we determine our returns reserve at the end of each financial period, and increase or reduce the reserve balance accordingly.

We provide standard support to our customers for an initial period of 60 days, which includes advance swap of the defective hardware and software, bug fixes, software upgrades and technical support. In addition to standard support, we also offer our customers the option to purchase extended support at the time of product purchase or anytime thereafter. Extended support covers hardware and software for a period of one year. We have established vendor-specific objective evidence with respect to the fair value of the standard support contracts based on standalone sales and renewals of our one-year extended support contracts. The fair value of our 60 day support contracts included with product sales is determined by pro-rating the related one-year extended support contracts. We recognize revenue from extended support contracts ratably over the period of the contract.

We do not sell software, which is incorporated into our hardware, separately, other than for our customers to purchase as an upgrade to their existing products when we announce a major release of the software.

Product Warranty

Hardware is warranted for one year from the date of sale and is repaired free-of-charge. Provisions for estimated warranty costs are recorded at the time products are shipped as a charge to cost of sales. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should product failure rates, material usage or service delivery cost differ from our estimates, revision to the estimated warranty liability would be required, which could affect the amount of gross profit reported.

Distributor Programs and Incentives

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. We also protect our distributors exposure related to the impact of price reductions. We generally provide our distributors the opportunity to earn volume incentive rebates based upon the amount of sales volume achieved during the fiscal quarter. We also provide co-op and market development funds to our distributors.

If market conditions were to change, we may take actions to increase distributor incentive offerings possibly resulting in an incremental reduction of revenues at the time the incentive is offered. Moreover, if the actual incentive offerings are different from our estimates, or if the actual incentive claims are significantly higher than our historical experience, then revisions to the estimated incentive programs may be required resulting in additional reductions to revenue.

We record estimated reductions to revenues for these distributor programs and incentive offerings including special pricing agreements, promotions and other volume-based incentives.

Credit, collection and allowance for doubtful accounts

We perform ongoing customer credit evaluations based on a number of factors, including past transaction history with the customer and the credit-worthiness of the customer. When credit criteria are not met, we require cash-on-delivery or payment by credit card before products are shipped. On a quarterly basis, we specifically analyze accounts receivable, historical bad debts, customer concentration, and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Such losses have generally been within our expectations. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Two customers accounted for 58% and 59% of accounts receivable at December 31, 2006 and 2005, respectively.

Inventories and related write-downs for excess and obsolete inventory

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market. We record write downs for excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based on assumptions about future product life-cycles, product demand and market conditions. If actual product life cycles, product demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

In light of the approximately two years worth of end-of-life components we had purchased to ensure a smooth supply of our FaxPress Products to our customers, our management periodically reviews the usage, supply and inventory levels of these parts to determine whether additional purchases or excessive inventory provisions are necessary. At December 31, 2006, we have approximately $281,000 worth of end-of-life components on hand, as compared to $390,000 at December 31, 2005 and we believe that most of these components will be utilized in the following two years resulting in insignificant amounts of excessive inventory, or none at all.

Income taxes

We account for income taxes in accordance with the liability method. Under the liability method, deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The provision for income taxes is comprised of the current tax liability and the change in deferred tax assets and liabilities. We assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance against these tax assets. Significant management judgment is required in determining the amount of any valuation allowance recorded against our deferred tax assets. The establishment or reversal of any valuation allowance is based in large part on projected future taxable income.

Consolidated Results of Operations

Comparison of Years Ended December 31, 2006 and 2005

Net Sales

	Year Ended December 31,		
	2006	**2005**	**2004**
Net Sales:			
Products	$ 7,253	$ 7,891	$ 8,011
Services	3,337	2,941	2,446
Total net sales	$ 10,590	$ 10,832	$ 10,457

Net sales decreased 2% to $10.6 million in 2006 from $10.8 million in 2005. The decrease of $242,000 was primarily from a decrease in product sales of $638,000, offset by an increase in sales derived from services of $396,000.

Products sales of $7.3 million in 2006, which represented 68% of total sales in 2006, declined by 8% as compared to $7.9 million in 2005, which represented 73% of total sales in 2005. The lower product sales in 2006 were due largely to the continuing phase-out of our legacy products as a result of our decision in 2004 to divest our legacy products as part of our overall strategy to transition to our new generation of network fax servers, FaxPress Premier and FaxPress Enterprise. This decline in sales of our legacy products, which declined primarily to the international channels, was partially offset by the continuing increase in sales of our new generation FaxPress Premier and Enterprise network fax servers. We anticipate sales of our FaxPress Premier and Enterprise fax servers to continue to grow as we continue to expand our fax server product family.

Service revenues are comprised of extended warranty and support programs as well as 60-days of maintenance included with initial product sales. Revenue related to these arrangements is recognized ratably over the period of the arrangement. Service revenues, which represented 31% of total sales in 2006, increased 13% to $3.3 million in 2006 from $2.9 million in 2005, which represented 27% of total sales in 2005. The increase in service revenues was primarily due to increased sales of extended warranty contracts mostly due to an increase in our installed customer base and higher average prices of extended warranty contracts on FaxPress Premier and Enterprise fax server products relative to our legacy products. We anticipate service revenues to increase as more FaxPress Premier fax servers are sold.

Sales by geographic area (unaudited)

	Year Ended December 31,		
	2006	**2005**	**2004**
Net Sales:			
United States	$ 9,064	$ 8,722	$ 8,574
Europe	543	722	785
Pacific Rim	659	872	804
Rest of Americas, excluding United States	324	516	294
Total net sales	$ 10,590	$ 10,832	$ 10,457

Sales in the United States were $9.1 million in 2006 as compared to $8.7 million in 2005, representing 86% and 80%, respectively, of total net sales. The increase in domestic sales was mostly attributable to the increase in service revenues referred to above and the continuing shift in our sales mix to the FaxPress Premier and Enterprise fax server products, which carry higher selling prices.

International sales (excluding sales to the rest of the Americas) were $1.2 million in 2006 and $1.6 million in 2005, representing 11% and 15% of total net sales, respectively. The decrease in international sales

was largely due to the continuing phase-out of our legacy products as a result of our decision in 2004 to divest our legacy products as part of our overall strategy to transition to our new generation of network fax servers, FaxPress Premier and Enterprise. During 2006, our primary Pacific Rim integrator took longer than anticipated lead time to evaluate our FaxPress Premier fax servers, resulting in a delay in orders for our fax server products. The evaluation process has now been satisfactorily completed and we anticipate orders for these servers to increase in 2007. Most of our international sales are denominated in U.S. dollars and thus, could be adversely affected by changes in demand resulting from fluctuations in currency exchange rates.

Sales to the rest of the Americas, excluding the United States, were $324,000 in 2006, as compared to $516,000 in 2005, representing 3% and 5% of total net sales in 2006 and 2005, respectively. Sales in 2005 included a $203,000 shipment of FaxPress Premier fax server products to a certain customer in Latin America.

In 2006 and 2005, our top two customers Ingram Micro and Tech Data together accounted for approximately 47% and 43% of our net sales, respectively.

Cost of Sales; Gross profit

	Year Ended December 31		
	2006	**2005**	**2004**
Cost of sales:			
Products	$ 2,931	$ 2,694	$ 2,556
Services	1,025	1,035	826
Total cost of sales	$ 3,956	$ 3,729	$ 3,382
Gross profit	$ 6,634	$ 7,103	$ 7,075
Gross profit as % of sales	63%	66%	68%

Gross profit is equal to net sales less cost of sales. Cost of sales includes cost of materials, including components, manuals, diskettes, packaging materials and shipping. Cost of sales also includes compensation costs and overhead related to our manufacturing operations and technical services, inventory obsolescence and warranty expenses. Gross profit from service revenues in fiscal 2006 increased to $2.3 million, as compared to $1.9 million in 2005, due primarily to an increase in the proportion of FaxPress Premier and Enterprise fax server products sold in 2006 relative to 2005, which have higher average prices on extended support agreements. The higher gross profit from service revenues was offset by lower gross profit from product sales of $4.3 million in 2006 as compared to $5.2 million in 2005 due chiefly to lower product sales and product mix. FaxPress Premier and Enterprise fax server products yield a lower gross profit percentage as compared to FaxPress fax server products. We believe the gross margin percentage achieved in 2006 to be more indicative of future periods than the gross margin percentage achieved during prior years.

Periodically, we review obsolete and unmarketable products in our inventory and make appropriate allowances for excess and obsolete inventory. Products that are determined to be obsolete and unmarketable are physically scrapped when it is determined that such inventories are no longer usable or salable. In 2006, we identified $70,000 of unmarketable products, which were scrapped and included in cost of sales, as compared to $108,000 worth of unmarketable products scrapped and included in cost of sales in 2005.

Research and Development

	Year Ended December 31		
	2006	2005	2004
Research and development expenses	$ 1,782	$ 1,683	$ 1,722
Research and development expenses as % of sales	17%	16%	17%

Research and development expenses represent costs associated with the development of new products and consist primarily of employee-related expenses, including beginning in 2006, share-based compensation costs, material costs and allocated facility costs. The higher research and development expenses in 2006 were mostly due to $122,000 in share-based compensation expense incurred as a result of the adoption of SFAS 123R. Research and development spending has supported both existing products and the development of new server appliances. We remain committed to the development of highly competitive new products and services through the efficient utilization of our engineering resources.

Sales and Marketing

	Year Ended December 31		
	2006	2005	2004
Sales and marketing expenses	$ 2,502	$ 2,506	$ 2,486
Sales and marketing expenses as % of sales	24%	23%	24%

Sales and marketing expenses consist primarily of employee-related expenses, commissions to sales representatives, product promotion expenses, and allocated facilities expenses, including expenses associated with our regional sales and support offices. Sales and marketing expenses are anticipated to continue to remain relatively stable.

General and Administrative

	Year Ended December 31		
	2006	2005	2004
General and administrative expenses	$ 1,931	$ 2,045	$ 1,801
General and administrative expenses as % of sales	18%	19%	17%

General and administrative expenses consist primarily of employee-related expenses, including beginning in 2006, share-based compensation costs, for administration, finance, human resources and general management, as well as consulting, outside services, legal and accounting expenses, and allocated facilities expenses. Share-based compensation costs charged to general and administrative expense were $141,000 during 2006. The decrease in 2006, as compared to 2005, is mainly attributable to accounting fees incurred in the first half of fiscal 2005 related to the restatement of our historical financial statements included in our December 31, 2004 Annual Report on Form 10-K and our response to a series of comment letters issued by the Division of Corporation Finance of the Securities and Exchange Commission during the first quarter of fiscal 2005. General and administrative expenses related to the management assessment portion of Sarbanes-Oxley related internal control compliance are expected to increase in fiscal 2007.

Interest and Other Income (Expenses)

Interest and other income (expense) consists primarily of interest income earned from our invested cash balances, interest expense on capital leases, bank service fees, and miscellaneous income and expenses. The $174,000 increase in interest and other income (expense) in 2006 as compared to 2005 is primarily due to the interest earned on higher invested cash balances.

Provision for Income Tax

In fiscal 2004, we recorded a tax benefit of $1.1 million as a result of releasing portions of our tax valuation allowance. During fiscal 2005, we recorded a tax provision of $395,000 as a result of increasing our tax valuation allowance. Consequently, as of December 31, 2005, we had recorded a total of $1.1 million of deferred tax assets. During 2006, we again reviewed the need for a valuation allowance against our deferred tax assets. As a result of this review, we determined that, based on 2006 financial results and projected future taxable income, a slight decrease in the valuation allowance was necessary. We recorded a tax provision in 2006 of $29,000 resulting from federal and state provision offset by the aforementioned decrease in the valuation allowance. Due to our determination that it is more likely than not that certain future tax benefits will be realized, a total of $1.1 million of our deferred tax assets have been recognized and are included on our consolidated balance sheet as of December 31, 2006. As of December 31, 2006, we had approximately $11.4 million of net operating loss (NOL) carryforwards available to offset future federal taxable income. In addition, at December 31, 2006, we had federal and California credit carryforwards of approximately $1.3 million and $855,000, respectively. We do not expect to utilize significant amounts of cash for income tax payments until the NOLs have been utilized.

Comparison of Years Ended December 31, 2005 and 2004

Net Sales

	Year Ended December 31		
	2005	2004	2003
Net Sales:			
Products	$ 7,891	$ 8,011	$ 8,337
Services	2,941	2,446	1,843
Total net sales	$ 10,832	$ 10,457	$ 10,180

Net sales increased 4% to $10.8 million in 2005 from $10.5 million in 2004. The increase of $375,000 was primarily from increased sales derived from services of $495,000, offset by a reduction in products sales of $120,000.

Products sales of $7.9 million in 2005, which represented 73% of total sales in 2005, declined by 1% as compared to $8.0 million in 2004, which represented 77% of total sales in 2004. The lower product sales in 2005 were due largely to our decision in 2004 to divest our legacy products as part of our overall strategy to transition to our new generation of network fax servers, FaxPress Premier.

Service revenues are comprised of extended warranty and support programs as well as 60-days of maintenance included with initial product sales. Revenue related to these arrangements is recognized ratably over the period of the arrangement. Service revenues, which represented 27% of total sales in 2005, increased 20% to $2.9 million in 2005 from $2.4 million in 2004, which represented 23% of total sales in 2004. The increase in service revenues was primarily due to increased sales of extended warranty contracts due to an increase in our installed customer base from additional sales of our FaxPress fax servers augmented by the introduction of our FaxPress Premier fax server products in the second half of 2003.

Sales by geographic area (unaudited)

	Year Ended December 31,		
	2005	2004	2003
Net Sales:			
United States	$ 8,722	$ 8,574	$ 8,222
Europe	722	785	704
Pacific Rim	872	804	883
Rest of Americas, excluding United States	516	294	371
Total net sales	$ 10,832	$ 10,457	$ 10,180

Sales in the United States were $8.7 million in 2005 as compared to $8.6 million in 2004, representing 80% and 82%, respectively, of total net sales. The increase in sales was mostly attributable to the increase in service revenues and the FaxPress Premier fax server products, which carry higher selling prices.

International sales (excluding sales to the rest of the Americas) were $1.6 million in 2005 and 2004, representing 15% of total net sales in each year. Most of our international sales are denominated in U.S. dollars and thus, could be adversely affected by changes in demand resulting from fluctuations in currency exchange rates.

Sales to the rest of the Americas, excluding the United States, were $516,000 in 2005, as compared to $294,000 in 2004, representing 5% and 3% of total net sales in 2005 and 2004, respectively. The increase in sales was mostly due to higher sales of the FaxPress Premier fax server products to Latin America.

In 2005, Ingram Micro and Tech Data, our top two customers together accounted for approximately 43% of our net sales. In 2004, the same two distributors accounted for 44% of our net sales.

Cost of Sales; Gross profit

	Year Ended December 31		
	2005	2004	2003
Cost of sales:			
Products	$ 2,694	$ 2,556	$ 2,485
Services	1,035	826	726
Total cost of sales	$ 3,729	$ 3,382	$ 3,211
Gross profit	$ 7,103	$ 7,075	$ 6,969
Gross profit as % of sales	66%	68%	68%

Gross profit is equal to net sales less cost of sales. Cost of sales includes cost of materials, including components, manuals, diskettes, packaging materials and shipping. Cost of sales also includes compensation costs and overhead related to our manufacturing operations and technical services, inventory obsolescence and warranty expenses. Gross profit from service revenues in fiscal 2005 increased to $1.9 million, as compared to $1.6 million in 2004, due primarily to more extended support agreements sold along with higher sales of our FaxPress Premier fax servers in fiscal 2005 as compared to 2004. The higher gross profit from service revenues was partially offset by lower gross profit from product sales of $5.2 million in 2005 as compared to $5.5 million in 2004 due chiefly to product mix. Gross profit in 2004 also included a one-time pre-tax benefit of $126,000 from an adjustment of certain accruals related to a sales development program.

Periodically we review obsolete and unmarketable products in our inventory and make appropriate allowances for excess and obsolete inventory. Products that are determined to be obsolete and unmarketable are physically scrapped when it is determined that such inventories are no longer usable or salable. In 2005, we identified $108,000 of unmarketable products, which were scrapped and included in

cost of sales, as compared to $35,000 worth of unmarketable products scrapped and included in cost of sales in 2004.

Research and Development

	Year Ended December 31		
	2005	2004	2003
Research and development expenses	$ 1,683	$ 1,722	$ 1,590
Research and development expenses as % of sales	16%	17%	15%

Research and development expenses represent costs associated with the development of new products and consist primarily of employee-related expenses, material costs and allocated facility costs. The lower research and development expenses in 2005 were mostly due to a reduction in outside consulting expenses of $91,000 as a result of the completion of certain projects to enhance our current product features, partially offset by $47,000 in higher employee-related expenses.

Sales and Marketing

	Year Ended December 31		
	2005	2004	2003
Sales and marketing expenses	$ 2,506	$ 2,486	$ 2,398
Sales and marketing expenses as % of sales	23%	24%	24%

Sales and marketing expenses consist primarily of employee-related expenses, commissions to sales representatives, product promotion expenses, and allocated facilities expenses, including expenses associated with our regional sales and support offices.

General and Administrative

	Year Ended December 31		
	2005	2004	2003
General and administrative expenses	$ 2,045	$ 1,801	$ 1,902
General and administrative expenses as % of sales	19%	17%	18%

General and administrative expenses consist primarily of employee-related expenses for administration, finance, human resources and general management, as well as consulting, outside services, legal and accounting expenses, and allocated facilities expenses. The increase of $245,000 in 2005, as compared to 2004, is mainly attributable to increases in accounting fees incurred in the first half of fiscal 2005 related to the restatement of our historical financial statements included in our December 31, 2004 Annual Report on Form 10-K and our response to a series of comment letters issued by the Division of Corporation Finance of the Securities and Exchange Commission during the first quarter of fiscal 2005.

Interest and Other Income (Expenses)

Interest and other income (expense) consists primarily of interest income earned from our invested cash balances, interest expense on capital leases, bank service fees, and miscellaneous income and expenses. The $119,000 increase in interest and other income (expense) in 2005 as compared to 2004 is primarily due to the interest earned on higher invested cash balances.

Provision for Income Tax

In fiscal 2004 and 2003, we recorded tax benefits of $1.1 million and $526,000, respectively, as a result of releasing portions of our tax valuation allowance. Consequently, as of December 31, 2004, we had recorded a total of $1.5 million of deferred tax assets. During 2005, we again reviewed the need for a valuation allowance against our deferred tax assets. As a result of this review, we determined that, based on 2005 financial results and projected future taxable income, an increase in the valuation allowance was necessary. We recorded a tax provision in 2005 of $395,000 resulting from federal and state provision and an increase in the valuation allowance.

LIQUIDITY AND CAPITAL RESOURCES

	December 31, 2006		December 31, 2005	
Cash and cash equivalents	$	8,259	$	6,766
Working capital	$	7,746	$	6,784
Working capital ratio		3.7		3.6

Since our initial public offering of common stock in December 1995, our principal source of funding has been cash from our operations, with some funding from capital equipment lease lines. As of December 31, 2006, we had $8.3 million of cash and cash equivalents, an increase of $1.5 million from December 31, 2005. The increase in cash and cash equivalents was primarily attributable to cash provided by operating activities of $1.7 million, partially offset by purchases of $181,000 of computer equipment. As of December 31, 2006, we had no bank debt.

Our operating activities generated cash of $1.7 million in 2006, primarily due to operating income, improved cash collections from outstanding accounts receivable of $205,000 and reduction of inventories of $140,000.

In 2006, our net cash from financing activities, which was primarily from proceeds from issuance of common stock of $78,000, was totally offset by cash used in the repurchase of common stock of $64,000 and repayment of notes payable of $13,000. We acquired additional equipment and licenses of $181,000, $593,000 and $35,000 in 2006, 2005 and 2004, respectively. In 2005, net cash provided by financing activities was $177,000 primarily from proceeds from issuance of common stock.

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $750,000 of our common stock 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 our discretion. No time limit was set for the completion of this program. Under this program, we repurchased from open market and negotiated transactions a total of approximately 66,000 shares for approximately $68,000, at an average per share price of $1.04. The Company has not repurchased any of its common stock since then under this program.

In the third quarter of 2006, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $1 million worth of shares of our common stock for cash in open market, negotiated or block transactions. The timing of such 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. At the time of approval by our Board of Directors, we had approximately 4 million shares of common stock outstanding. As of March 21, 2007, we have repurchased from open market transactions a total of 30,000 shares for $88,000, at an average per share price of $2.90. We intend to continue to execute our buyback program as our management deems advisable.

We renewed our line of credit with Silicon Valley Bank in July 2006, which now matures on July 30, 2007. The revolving line of credit provides for borrowings of up to $6.0 million. 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%. We are required to maintain certain minimum cash and investment balances with the bank and to meet certain other financial covenants. This credit line provides that we shall not pay any dividend without the Bank s prior consent.

As of December 31, 2006, we have not drawn down on the line of credit and were in compliance with debt covenants and all other terms of the agreement.

We lease our headquarters in Morgan Hill, California. We 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. As of December 31, 2006, future minimum payments under the lease were $501,000.

The following represents combined aggregate maturities for all our financing and commitments as of December 31, 2006:

	Payments Due by Period				
Contractual Obligations	**Total**	**Less Than 1 Year**	**1 - 3 Years**	**3 - 5 Years**	**More than 5 Years**
Operating Lease Obligations	$ 501	$ 207	$ 294		
Total contractual cash obligations	$ 501	$ 207	$ 294		

We believe that our existing cash balances, anticipated cash flows from operations and available lines of credit will be sufficient to meet our anticipated capital requirements for the foreseeable future. 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 of our dependency 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.

OFF BALANCE SHEET TRANSACTIONS

As of December 31, 2006, we did not have any off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (as amended) an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of analyzing the impact of FIN 48, which is required to be adopted by the first quarter of fiscal 2007.

In June 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20, Accounting Changes , and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements . SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the

period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS No. 154 did not have an effect on the Company s financial condition, or results of operations.

In September 2006, the FASB issued SFAS No. 157, Accounting for Fair Value Measurements . SFAS No. 157 defines fair value, and establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure about fair value measurements. SFAS No. 157 is effective for the Company for financial statements issued subsequent to November 15, 2007. The Company does not expect the new standard to have any material impact on the financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities Including an amendment of FASB Statement No. 115 , which permits entities to measure eligible items at fair value. For items where the fair value election is made, we will be required to report unrealized gains or losses in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. At this time, the Company is assessing the impact the adoption of SFAS 159 will have on our financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, (SAB No. 108). SAB No. 108 provides guidance regarding the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of materiality assessments. The method established by SAB No. 108 requires each of the Company s financial statements and the related financial statement disclosures to be considered when quantifying and assessing the materiality of the misstatement. SAB No. 108 is effective for fiscal years ending after November 15, 2006 and applies to the Company s financial statements for the fiscal year ended December 31, 2006. The adoption of SAB No. 108 did not have a material effect on the Company s financial condition and results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We had no holdings of derivative financial or commodity instruments at December 31, 2006. 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, certain spending is transacted in Pounds Sterling. These amounts are not currently material to our financial statements. Therefore we believe that changes in foreign currency exchange rates currently do not materially affect our overall financial position, results of operations or cash flows. The fair value of our money market accounts and related income would not be significantly impacted by increases or decreases in interest rates due mainly to the highly liquid nature of these investments. However, sharp declines in interest rates could seriously harm interest earnings.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and supplementary data required by this Item are set forth at the pages indicated in Item 15 of this report.

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

Not applicable.

ITEM 9A. 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 Annual Report on Form 10-K, concluded that our disclosure controls and procedures were effective for this purpose.

Changes in Internal Control Over Financial Reporting

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 period covered by this Annual Report on Form 10-K that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls

In designing and evaluating our disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and our management necessarily applied its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item 10 is incorporated herein by reference from our definitive Proxy Statement (the Proxy Statement), related to our 2007 Annual Meeting of Shareholders to be filed by us with the Securities and Exchange Commission (SEC) no later than April 30, 2007 or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item 11 is incorporated herein by reference from the Proxy Statement or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item 12 is incorporated herein by reference from the Proxy Statement or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

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

In October 2002, we engaged W.R. Hambrecht + Co. (WRH + Co.), an investment bank, to manage our stock buyback program as approved by the Board of Directors. Mr. Robert Hambrecht, a member of our Board of Directors, is also a director of WRH + Co. Through December 31, 2006, WRH + Co. had received an insignificant amount of compensation under this and subsequent arrangements.

Other information required by this Item 13 is incorporated herein by reference from the Proxy Statement or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item 14 is incorporated herein by reference from the Proxy Statement or will be provided in an amendment to this Form 10-K to be filed with the SEC no later than April 30, 2007.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1) Financial Statements

	Page in Form 10-K
Report of Independent Registered Public Accounting Firm	F-1
Consolidated Balance Sheets as of December 31, 2006 and 2005	F-2
Consolidated Statements of Earnings for the years ended December 31, 2006, 2005 and 2004	F-3
Consolidated Statements of Shareholders Equity for the years ended December 31, 2006, 2005 and 2004	F-4
Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004	F-5
Notes to Consolidated Financial Statements	F-6

2) Financial Statement Schedules

The following financial statement schedule of Castelle for the years ended December 31, 2006, 2005 and 2004 is filed as part of this Form 10-K and should be read in conjunction with the Company s Financial Statements.

	Page in Form 10-K
Schedule II Valuation and Qualifying Accounts	F-23

Schedules not listed above have been omitted because they are not applicable or are not required or because the required information is included in the Financial Statements or Notes thereto.

3) Exhibits

See Item 15(b) below.

(b) Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Date of First Filing	Exhibit Number	
3.1	Registrant s Amended and Restated Articles of Incorporation.	SB-2/A	33-99628-LA-	12/8/1995	3.3	
3.2	Registrant s Amended and Restated Bylaws	8-K	000-22020	8/8/2006	3.01	
4.1	Specimen Stock Certificate representing shares of Registrant s Common Stock.	SB-2/A	33-99628-LA-	12/14/1995	4.1	
10.1*	1995 Non-Employee Directors Stock Option Plan, as amended, and form of Director Stock Option Agreement	SB-2/A	111-22020	12/14/1995	10.2	
10.2	Distribution Agreement dated February 26, 1990, by and between the Registrant and Ingram Micro D Inc.	SB-2/A	33-99628-LA-	12/8/1995	10.8	
10.3*	1988 Equity Incentive Plan, as amended, and form of option agreement	S-8	333-75247	3/29/1999	99.1	
10.4	International Distributor Agreement dated April 24, 2001 by and between the Registrant and AMS Limited.	10-K	000-22020	3/29/2002	10.11	
10.5	Commercial Tenant Lease Agreement dated August 16, 2000 by and among the Registrant and Kyung S. Lee and Ieesun Kim Lee.	10-K	000-22020	3/29/2002	10.12	
10.6	First Amendment to Lease Agreement dated June 1, 2004 by and among the Registrant and by and between Kyung S. Lee and Ieesun Kim Lee.	10-Q	000-22020	8/11/2004	10.1	
10.7*	Summary of Severance Agreements with Named Executive Officers.	10-K	000-22020	4/15/2005	10.11	
10.8	Employment agreement dated April 22, 2002 by and between the Registrant and Scott McDonald.	10-K	000-22020	3/28/2003	10.16	
10.9	Form of Executive Severance and Transition Benefits Agreement dated April 22, 2002 by and between the Registrant and Scott McDonald.	10-K	000-22020	3/28/2003	10.16	
10.10*	2002 Equity Incentive Plan.	10-K	000-22020	3/28/2003	10.16	
10.11	Loan and Security Agreement dated August 2, 2004 by and between the Registrant and Silicon Valley Bank.	10-Q	000-22020	8/11/2004	10.2	
10.12	Loan Modification Agreement dated July 18, 2006 by and between the Registrant and Silicon Valley Bank.	10-Q	000-22020	11/13/2006	10.1	
10.13	Addendum dated December 3, 1991 to Distributor Agreement dated February 26, 1990, by and between the Registrant and Ingram Micro Inc.					X
10.14	Distributor Agreement dated September 29, 1997, by and between the Registrant and Tech Data Corporation					X
10.15	International Distributor Agreement dated May 31, 2001, by and between the Registrant and Macnica, Inc.					X
10.16	Amended and Restated International Distributor Agreement dated July 18, 2002, by and between the					X

		Incorporated by Reference	
	Registrant and AMS Limited.		
23.1	Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm		X
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		X
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		X
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 of Castelle		X
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		X

* Indicates management contracts or compensatory plans or arrangements filed pursuant to Item 601(b)(10) of Regulation S-K

** 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.

(c) Financial Statement Schedules

See Item 15(a)(2) above.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, as amended, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized on the thirtieth day of March 2007.

By: /S/ SCOTT C. MCDONALD

Scott C. McDonald
President and Chief Executive Officer

KNOW BY ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Scott C. McDonald, as his true and lawful attorney-in-fact and agent, with full power of substitution for him, and in his name in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite and necessary to be done therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, and any of them, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Name	Title	Date
/S/ SCOTT C. MCDONALD Scott C. McDonald	President, Chief Executive Officer (principal executive officer) and Director	March 30, 2007
/S/ PAUL CHENG Paul Cheng	Vice President, Finance and Administration, Chief Financial Officer (principal accounting officer) and Secretary	March 30, 2007
/S/ DONALD L. RICH Donald L. Rich	Chairman of the Board	March 30, 2007
/S/ ROBERT H. HAMBRECHT Robert H. Hambrecht	Director	March 30, 2007
/S/ ROBERT O. SMITH Robert O. Smith	Director	March 30, 2007
/S/ PETER R. TIERNEY Peter R. Tierney	Director	March 30, 2007

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Castelle

We have audited the accompanying consolidated balance sheets of Castelle and its subsidiary (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of earnings, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Castelle and its subsidiary as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The Schedule II is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule, for each of the three years in the period ended December 31, 2006, has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements taken as a whole.

As discussed in Note 2 to the consolidated financial statements, Castelle adopted Financial Accounting Standards Board Statement No. 123(R), *Share-Based Payment* on a modified prospective basis as of January 1, 2006.

Grant Thornton LLP
San Francisco, California
March 27, 2007

Castelle
Consolidated Balance Sheets
(in thousands)

	December 31,	
	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ 8,259	$ 6,766
Accounts receivable, net	932	1,137
Inventories	1,016	1,156
Prepaid expenses and other current assets	238	135
Deferred taxes	185	212
Total current assets	10,630	9,406
Property and equipment, net	280	200
Other assets	125	140
Deferred taxes	944	928
Total assets	$ 11,979	$ 10,674
Liabilities and Shareholders Equity		
Current liabilities:		
Current portion of long-term debt	$	$ 14
Accounts payable	349	286
Accrued liabilities	825	824
Deferred revenue	1,710	1,498
Total current liabilities	2,884	2,622
Commitments and contingencies *(Note 4)*		
Shareholders equity:		
Preferred stock, no par value:		
Authorized: 2,000 shares in 2006 and 2005		
Issued and outstanding: none in 2006 and 2005		
Common stock, no par value:		
Authorized: 25,000 shares		
Issued and outstanding: 4,049 shares at December 31, 2006 and 3,986 shares at December 31, 2005	28,234	27,860
Accumulated deficit	(19,139)	(19,808)
Total shareholders equity	9,095	8,052
Total liabilities and shareholders equity	$ 11,979	$ 10,674

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Earnings
(in thousands, except per share data)

	Year Ended December 31		
	2006	**2005**	**2004**
Net sales:			
Products	$ 7,253	$ 7,891	$ 8,011
Services	3,337	2,941	2,446
Total net sales	10,590	10,832	10,457
Cost of sales:			
Products	2,931	2,694	2,556
Services	1,025	1,035	826
Total cost of sales	3,956	3,729	3,382
Gross profit	6,634	7,103	7,075
Operating expenses:			
Research and development	1,782	1,683	1,722
Sales and marketing	2,502	2,506	2,486
General and administrative	1,931	2,045	1,801
	6,215	6,234	6,009
Operating income	419	869	1,066
Interest income, net	331	163	36
Other expense, net	(52)	(58)	(50)
Income before provision for (benefit from) income taxes	698	974	1,052
Provision for (benefit from) income taxes	29	395	(1,067)
Net income	$ 669	$ 579	$ 2,119
Net income per common share basic	$ 0.17	$ 0.15	$ 0.59
Net income per common share diluted	$ 0.15	$ 0.13	$ 0.48
Shares used in per share calculation basic	4,023	3,904	3,616

	Year Ended December 31		
Shares used in per share calculation diluted	4,475	4,488	4,417

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Shareholders Equity
Years Ended December 31, 2006, 2005 and 2004
(in thousands)

	Common Stock			
	Shares	**Amount**	**Accumulated Deficit**	**Total**
Balances, December 31, 2003	3,425	$ 27,258	$ (22,506)	$ 4,752
Issuance of common stock through exercise of stock options	374	410		410
Net income			2,119	2,119
Balances, December 31, 2004	3,799	27,668	(20,387)	7,281
Issuance of common stock through exercise of stock options	187	192		192
Net income			579	579
Balances, December 31, 2005	3,986	27,860	(19,808)	8,052
Issuance of common stock through exercise of stock options	85	78		78
Repurchase and cancellation of common stock	(22)	(64)		(64)
Share based compensation		360		360
Net income			669	669
Balances, December 31, 2006	4,049	$ 28,234	$ (19,139)	$ 9,095

The accompanying notes are an integral part of these financial statements.

Castelle
Consolidated Statements of Cash Flows
Years Ended December 31, 2006, 2005 and 2004
(in thousands)

	Year Ended December 31,		
	2006	**2005**	**2004**
Cash flows from operating activities:			
Net income	$ 669	$ 579	$ 2,119
Adjustments to reconcile net income to net cash provided by operating activities:			
Share based compensation	360		
Depreciation and amortization	115	202	206
Allowance for sales returns and stock rotation	(52)	507	886
Deferred taxes	11	383	(997)
Loss on disposal of fixed assets			2
Changes in assets and liabilities:			
Accounts receivable, net	258	(787)	(870)
Inventories	140	629	(608)
Prepaid expenses and other current assets	(103)	299	57
Accounts payable	63	(225)	197
Accrued liabilities	1	(249)	(663)
Deferred revenue	212	245	297
Net cash provided by operating activities	1,674	1,583	626
Cash flows from investing activities:			
Acquisition of property and equipment	(181)	(193)	(35)
Acquisition of licenses		(400)	
Net cash used in investing activities	(181)	(593)	(35)
Cash flows from financing activities:			
Repayment of notes payable	(14)	(15)	(16)
Repurchase of common stock	(64)		
Proceeds from issuance of common stock	78	192	410
Net cash provided by financing activities	0	177	394
Net increase in cash and cash equivalents	1,493	1,167	985
Cash and cash equivalents, beginning of period	6,766	5,599	4,614
Cash and cash equivalents, end of period	$ 8,259	$ 6,766	$ 5,599

Supplemental Information:

	Year Ended December 31,		
Cash paid during the period for:			
Interest	1	3	5

The accompanying notes are an integral part of these financial statements.

Castelle
Notes to Consolidated Financial Statements

1. Business and Organization of the Company

Castelle develops, manufactures, markets and supports office automation systems that offer organizations several network fax options: desktop faxing, production faxing, fax and email integration, workflow application integration, and tools for developing custom fax applications. Castelle s FaxPress, FaxPress Premier and FaxPress Enterprise network fax servers include the FaxPress or FaxPress Plus software suite that enables administrators and users to perform functions such as managing fax queues creating reports, and viewing fax archives.

The Company distributes its products primarily through a two-tier domestic and international distribution network, with its distributors selling Castelle s products to value-added resellers, system integrators, e-commerce retailers and other resellers in the United States, Europe and the Pacific Rim. The Company also has relationships with selected original equipment manufacturers and sells software enhancements and upgrades directly to end-users.

The Company believes that its existing cash balances and anticipated cash flows from operations will be sufficient to meet its anticipated capital requirements for the next 12 months. If the Company has a need for additional capital resources, it 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 the Company s 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 the Company not being able to achieve its long-term business objectives.

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

2. Summary of Significant Accounting Policies

Use of estimates in preparation of financial statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the 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.

Principles of consolidation

The consolidated financial statements include the accounts of Castelle and its wholly owned subsidiary in the United Kingdom. All intercompany balances and transactions have been eliminated.

Financial instruments

Cash equivalents consist of highly liquid investments with original or remaining maturities of three months or less when purchased.

Castelle
Notes to Consolidated Financial Statements

Carrying amounts of financial instruments consisting of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities included in the Company s financial statements approximate fair value due to their short-term maturities.

Concentrations of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of trade receivables and cash equivalents. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers financial condition. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other available information. The determination of past due status is based on contractual terms. Two customers (both distributors) accounted for 58% and 59% of accounts receivable at December 31, 2006 and 2005, respectively. These same two customers also accounted for 47%, 43% and 44% of the Company s total sales in 2006, 2005 and 2004, respectively. Although the Company does not require collateral on accounts receivable arising from sales to large, well-established companies, it does require prepayments on certain sales to foreign and smaller companies.

With respect to cash equivalents, the Company has cash investment policies that limit the amount of credit exposure to any one issuer and restrict placement of these investments to issuers evaluated as creditworthy.

Inventories and related allowances for excess and obsolete inventory

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market. We record allowances for excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based on assumptions about future product life-cycles, product demand and market conditions. If actual product life cycles, product demand and market conditions are less favorable than those projected by management, additional inventory write-downs may be required. At the point of the loss recognition, a new, lower-cost basis for that inventory is established, and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

We have purchased approximately two years worth of end-of-life components to ensure a smooth supply of our FaxPress Products to our customers. Accordingly, our management reviews periodically the usage, supply and inventory levels of these parts to determine whether additional purchases or excessive inventory provisions are necessary. We had approximately $281,000 and $390,000 worth of end-of-life components on hand at December 31, 2006 and 2005, respectively. We believe that most of these components will be utilized in the following two years, resulting in insignificant amounts of excessive inventory, or none at all.

Property and equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is provided using the straight-line method over the estimated useful lives of the respective assets, generally three to seven years. Amortization of leasehold improvements is provided on a straight-line basis over the life of the related asset or the lease term, if shorter. Gains and losses upon asset disposal are recognized in the year of disposition. Expenditures for replacements and betterments are capitalized, while expenditures for maintenance and repairs are charged against earnings as incurred.

Accounting for long-lived assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability is measured by comparison of the carrying amount to undiscounted future net cash flows the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value.

Castelle
Notes to Consolidated Financial Statements

Revenue recognition

We recognize revenue based on the provisions of Staff Accounting Bulletin No. 104 *Revenue Recognition*, AICPA Statement of Position No. 97-2 (SOP 97-2) *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Transactions*, and Statement of Financial Accounting Standards (SFAS) No. 48 *Revenue Recognition When Right of Return Exits*.

The Company uses the residual method to recognize revenue when an agreement includes one or more elements to be delivered at a future date. If there is an undelivered element under the arrangement, the Company defers revenue based on vendor-specific objective evidence of the fair value of the undelivered element, as determined by the price charged when the element is sold separately. If vendor-specific objective evidence of fair value does not exist for all undelivered elements, the Company defers all revenue until sufficient evidence exists or all elements have been delivered.

Product revenue is recognized when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the fee is fixed or determinable; collection is probable; and returns can be reasonably estimated. If an acceptance period or other contingency exists, revenue is recognized upon satisfaction of the contingency, customer acceptance or expiration of the acceptance period. Shipment generally occurs and title and risk of loss is transferred when the product is delivered to a common carrier.

The Company accrues a liability for any sales taxes and value-added taxes collected on behalf of various taxing authorities. This liability is relieved when any taxes collected are remitted to the taxing authority. Revenue excludes sales taxes and any value-added taxes.

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.

Pursuant to our agreements with distributors, we also protect our distributors exposure related to the impact of price reductions. Future price adjustments are estimated and accrued at the time of sale as a reduction in revenue.

We generally provide our distributors the opportunity to earn volume incentive rebates based on sales volume achieved during the fiscal quarter. These incentive rebates are accrued in the quarter incurred and recorded as a reduction in revenue.

We also provide co-op and market development funds to our distributors. These incentives are accrued at the time revenue is recognized and recorded as a reduction in revenue.

We offer a standard trade-in discount to all of our end-user customers under which the customer, upon trade-in of any previously purchased product, is entitled to a discount from our published price list on any product included in our current product offerings. We require our customers to physically return the previously purchased products to qualify for the trade-in discount. We account for the trade-in discount as a reduction of revenue at the time the product is traded in and a new product is purchased.

Payment terms to our distributors and customers are generally thirty days, cash in advance, or by credit card.

We evaluate product sales through our distribution channels and the related reserve requirement to establish an estimate for our sales returns reserve by reviewing detailed point-of-sales and on-hand

inventory reports provided to us by our channel partners. Based on a combination of historical return experience, the sales activities to end-user customers by our channel partners and the level of inventories on hand at the channel partners, we determine our returns reserve at the end of each financial period, and increase or reduce the reserve balance accordingly.

We provide standard support to our customers for an initial period of sixty days, which includes advance swap of the defective hardware and software, bug fixes, software upgrades and technical support. In addition to standard support, we also offer our customers the option to purchase extended support at the time of product purchase or anytime thereafter. Extended support covers hardware and software for a period of one year. We have established vendor-specific objective evidence with respect to the fair value of the standard support contracts based on standalone sales and renewals of our one-year extended support contracts. The fair value of our sixty day support contracts included with product sales is determined by pro-rating the related one-year extended support contracts. We recognize revenue from extended support contracts ratably over the period of the contract.

Hardware is warranted for one year from the date of sale and is repaired free-of-charge. Provisions for estimated warranty costs are recorded at the time products are shipped as a charge to cost of sales. While we engage in extensive product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure.

We do not sell software, which is incorporated into our hardware, separately, other than for our customers to purchase as an upgrade to their existing products when we announce a major release of the software.

Shipping and handling

Costs related to shipping and handling are included in cost of sales for all periods presented.

Advertising costs

Advertising costs, included in sales and marketing expenses, are expensed as incurred and were $284,000, $250,000 and $219,000 in 2006, 2005 and 2004, respectively.

Research and development expenses

Costs related to the conceptual formulation and design of both hardware and software products are expensed as research and development while costs incurred subsequent to establishing technological feasibility of software products are capitalized until general release of the product. Generally, technological feasibility is established upon completion of a working model. No significant costs subsequent to such point have been incurred, and all such costs have been expensed to date.

Income taxes

The Company accounts for income taxes in accordance with the liability method. Under the liability method, deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The provision for income taxes is comprised of the current tax liability and the change in deferred tax assets and liabilities. The Company establishes a valuation allowance to the extent that all or some portion of the deferred tax assets more likely than not will not be recoverable against future taxable income.

Foreign currency translation

The functional currency of the Company s foreign subsidiary is the U.S. dollar. Accordingly, all monetary assets and liabilities are translated into U.S. dollars at the current exchange rates as of the applicable balance sheet date while

non-monetary items are translated at historical rates. Revenues and expenses are translated at the average exchange rates prevailing during the period, and gains and losses from such translations have not been material. Cumulative gains and losses from the translation of the foreign subsidiaries financial statements have not been material to date. Foreign exchange gains and losses resulting from foreign currency transactions were not material in any of the periods presented.

Castelle
Notes to Consolidated Financial Statements

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 that period. Diluted net income per share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential shares consist of incremental common shares issuable upon exercise of stock options.

Basic and diluted net income per share are calculated as follows (in thousands except per share amounts):

	2006	2005	2004
Basic:			
Weighted average shares	4,023	3,904	3,616
Net income	$ 669	$ 579	$ 2,119
Net income per share	$ 0.17	$ 0.15	$ 0.59
Diluted:			
Weighted average shares	4,023	3,904	3,616
Common equivalent shares from stock options	452	585	801
Shares used in per share calculation	4,475	4,488	4,417
Net income	$ 669	$ 579	$ 2,119
Net income per share	$ 0.15	$ 0.13	$ 0.48

The calculation of diluted shares outstanding excludes 392,000, 132,000, and 123,000 shares of common stock issuable upon the exercise of outstanding stock options for the years ended December 31, 2006, 2005, and 2004 respectively, as their effect was antidilutive in the period.

Share-Based Compensation

The Company grants stock options to employees, non-employee directors and consultants under its 2002 Equity Incentive Plan (the 2002 Plan). Prior to January 1, 2006, the Company accounted for these share-based awards under the intrinsic value method of Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees (APB No. 25). This method under APB No. 25 resulted in no expense being recorded for stock option grants. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standard No. 123 (Revised 2004) Share-Based Payment , (SFAS No. 123R), which replaces SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No 123) and supersedes APB No. 25. SFAS No. 123R requires that compensation cost relating to share-based payment transactions be recognized in the Company s financial statements. That cost is measured based upon the fair value of the option issued. SFAS No. 123R applies to all of the Company s outstanding unvested share-based payment awards as of January 1, 2006 and all prospective awards using the modified prospective transition method without

restatement of prior periods. Accordingly, the Company s share-based compensation cost is measured at the grant date, based on the fair value of the award, and is either recognized as an expense over the requisite service period using the graded, or accelerated, attribution method, or capitalized as inventory.

Castelle
Notes to Consolidated Financial Statements

Share-Based Compensation Expense: Total compensation costs recognized in the Company s financial statements for the year ended December 31, 2006 was comprised as follows (in thousands):

		Year ended December 31, 2006
Share-based compensation expense by caption:		
Cost of products	$	13
Cost of services		34
Research and development		122
Sales and marketing		35
General and administrative		141
Total share-based compensation:	$	345

Share-based compensation expense of $16,000 was capitalized and included in inventory on the Company s consolidated balance sheet as of December 31, 2006. No tax benefits were recorded with respect to share-based compensation expense recorded during the year ended December 31, 2006.

For the year ended December 31, 2006, the Company recorded $345,000 of expense associated with share-based payments which would not have been recorded prior to the adoption of SFAS No. 123R. As a result of the adoption of SFAS No. 123R, income from continuing operations was reduced by $345,000 for the year ended December 31, 2006. Basic net income per share for the year ended December 31, 2006 was $0.08 lower as a result of the adoption of SFAS No. 123R. Diluted net income per share for the year ended December 31, 2006 was $0.08 lower as a result of the adoption of SFAS No. 123R.

FAS 123R requires the cash flows resulting from the tax benefits related to tax deductions in excess of the compensation costs recognized (excess tax benefits) to be classified as financing cash flows. However, due to the Company s existing net operating loss carryforwards and the valuation allowance established to reduce the deferred tax assets there were no excess tax benefits. Therefore, there was no impact on cash flows as a result of the adoption of SFAS No. 123R... The Company s share-based compensation cost is recognized as an expense over the requisite service period using the graded, or accelerated, attribution method, or capitalized as inventory.

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Notes to Consolidated Financial Statements

Through 2005, the Company accounted for its stock option plans using the intrinsic value method. Had the fair value method prescribed by SFAS 123 been used to account for share-based compensation for the years ended December 31, 2005 and December 31, 2004 net income and net income per share would have been reduced to the following pro forma amounts (in thousands, except per share amounts):

	Year ended December 31, 2005	Year ended December 31, 2004
Net income as reported	$ 579	$ 2,119
Fair value of stock-based compensation	(310)	(520)
Net income pro forma	$ 269	$ 1,599
Net income per share basic as reported	$ 0.15	$ 0.59
Net income per share diluted as reported	$ 0.13	$ 0.48
Net income per share basic pro forma	$ 0.07	$ 0.44
Net income per share diluted pro forma	$ 0.06	$ 0.36

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, and therefore, no separate statement of comprehensive income has been presented.

Segment information

The Company uses one measurement of profitability of its business for internal purposes and has determined that it operates in one business segment: server appliances. The Company s sales by geographic area are included in Note 9.

Recent accounting pronouncements

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (as amended) an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes, and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are in the process of analyzing the impact of FIN 48, which is required to be adopted by the first quarter of fiscal 2007.

In June 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS No. 154), a replacement of APB Opinion No. 20, Accounting Changes , and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements . SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the

period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS No. 154 did not have an effect on the Company s financial condition, or results of operations.

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In September 2006, the FASB issued SFAS No. 157, Accounting for Fair Value Measurements . SFAS No. 157 defines fair value, and establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosure about fair value measurements. SFAS No. 157 is effective for the Company for financial statements issued subsequent to November 15, 2007. The Company does not expect the new standard to have any material impact on the financial position and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities Including an amendment of FASB Statement No. 115 , which permits entities to measure eligible items at fair value. For items where the fair value election is made, we will be required to report unrealized gains or losses in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. At this time, the Company is assessing the impact the adoption of SFAS 159 will have on our financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, (SAB No. 108). SAB No. 108 provides guidance regarding the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of materiality assessments. The method established by SAB No. 108 requires each of the Company s financial statements and the related financial statement disclosures to be considered when quantifying and assessing the materiality of the misstatement. SAB No. 108 is effective for fiscal years ending after November 15, 2006 and applies to the Company s financial statements for the fiscal year ended December 31, 2006. The adoption of SAB No. 108 did not have a material effect on the Company s financial condition and results of operations.

3. Balance Sheet Detail (in thousands)

Accounts Receivable, net:

	December 31,	
	2006	2005
Accounts receivable	$ 1,222	$ 1,484
Less: allowance for sales returns	(265)	(317)
Less: allowance for doubtful accounts	(25)	(30)
Total accounts receivable, net	$ 932	$ 1,137

Inventories:

	December 31,	
	2006	2005
Raw materials	$ 669	$ 745
Work in process	26	55
Finished goods	321	356

	December 31,	
Total inventories	$ 1,016	$ 1,156

Castelle
Notes to Consolidated Financial Statements

Property and equipment:

	December 31,	
	2006	2005
Production, test and demonstration equipment	$ 480	$ 439
Computer equipment	1,407	1,275
Office equipment	125	120
Leasehold improvements	477	474
	2,489	2,308
Less accumulated depreciation and amortization	(2,209)	(2,108)
Total property and equipment	$ 280	$ 200

The Company recorded depreciation and amortization related to property and equipment of $115,000, $202,000 and $206,000 in 2006, 2005 and 2004, respectively.

As of both December 31, 2006 and 2005, the Company had $75,000 of equipment under capital leases. Accumulated amortization associated with these capital leases was $75,000 at both December 31, 2006 and 2005.

Accrued liabilities:

	December 31,	
	2006	2005
Accrued compensation	$ 422	$ 471
Accrued sales and marketing	175	118
Accrued professional fees	50	44
Advances from customers	58	75
Other accruals	120	116
Total accrued liabilities	$ 825	$ 824

Castelle
Notes to Consolidated Financial Statements

4. Commitments and Contingencies

Lease Commitments

The Company has entered into a noncancelable operating lease for its corporate headquarters that expires in 2009 and is responsible for certain maintenance costs, taxes and insurance under the lease. The lease on the Company s headquarters facility was extended 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. Future minimum payments under the noncancelable operating lease are as follows (in thousands):

Year Ending December 31,		
2007	$	207
2008		207
2009		87
	$	501

Rent expense, including the facility lease and equipment rental, was $222,000, $220,000 and $162,000 for 2006, 2005 and 2004, respectively.

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 Earnings as a Cost of Sales. If actual warranty costs are different from our estimated costs, or if the warranty claims were to be significantly higher than our historical experience, then revisions to the estimated warranty liability may be required and the warranty expense could change from current levels. A reconciliation of the changes in our warranty liability during the periods presented is as follows (in thousands):

	December 31,	
	2006	2005
Warranty accrual at the beginning of the year	$ 21	$ 13
Accruals for warranties issued during the year	3	10
Settlements made in kind during the year	(8)	(2)
Warranty accrual at the end of the year	$ 16	$ 21

As permitted under California law, the Company has agreements whereby the Company indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at the Company s 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, the Company has a director and officer insurance policy that limits the Company s exposure and enables the Company to recover a portion of any future amounts paid. As a result of the Company s insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal.

The Company enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally the Company s

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 the Company s products. The term of these indemnification agreements is generally perpetual following execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements.

5. Bank Borrowings

The Company renewed its line of credit with Silicon Valley Bank in July 2006, which now matures on July 30, 2007. The revolving line of credit provides for borrowings of up to $6.0 million. Borrowings under this line of credit agreement are collateralized by all of the Company s assets and bear interest at the bank s prime rate plus 0.50%. The Company is required to maintain certain minimum cash and investment balances with the bank and to meet certain other financial covenants. As of December 31, 2006, the Company had not drawn down on the line of credit and was in compliance with debt covenants and all other terms of the agreement.

6. Common Stock

Dividend Policy

We have not paid cash dividends on our common stock. The Board of Directors periodically reviews the dividend policy and currently intends to retain any and all earnings for use in our business and we do not anticipate paying cash dividends in the foreseeable future. Our credit line provides that we shall not pay any dividend without the Bank s prior consent.

Stock Repurchase Program

In the fourth quarter of 2002, our Board of Directors authorized us, from time to time, to repurchase at market prices, up to $2.25 million of our common stock 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 our discretion. No time limit was set for the completion of this program. Under this program, we repurchased from open market and negotiated transactions a total of approximately 1.67 million shares for approximately $1.8 million, at an average per share price of $1.10. The Company has not repurchased any of its common stock since then under this program.

In the third quarter of 2006, our Board of Directors authorized management, from time to time, to repurchase at market prices, up to $1 million worth of shares of the Company s common stock for cash in open market, negotiated or block transactions. The timing of such transactions has depended and will depend on market conditions, other corporate strategies and has been and will be at the discretion of management. No time limit was set for the completion of this program. At the time of approval by our Board of Directors, we had approximately 4 million shares of common stock outstanding. As of December 31, 2006, we had repurchased from open market transactions a total of 22,000 shares for $64,000, at an average per share price of $2.81. We intend to continue to execute our buyback program as our management deems advisable.

2002 Equity Incentive Plan

In December 2002, the shareholders of the Company approved the adoption of the 2002 Equity Incentive Plan (2002 Plan). A total of 850,000 shares of common stock have been reserved for issuance under the 2002 Plan. The 2002 Plan provides for awards to employees, directors, consultants and independent advisors. The adoption of the 2002 Plan was necessitated by the use or expiration of all but an insignificant amount of authorized shares under the prior option plans, (the 1995 Non-employee Directors Stock Option Plan (Directors Plan) and the 1988 Incentive Stock Plan (1988 Plan)). Under the 2002 Plan, the Board of Directors may grant either the right to purchase shares or options to purchase

shares of the Company s common stock at prices not less than the fair market value at the date of grant for incentive stock options and 85% of the fair market value at the date of grant for non-qualified options and purchase rights. Options granted under the 2002 Plan as well as those granted under the prior option plans generally become exercisable, and the Company s right to repurchase shares issued and sold pursuant to stock purchase rights generally lapses, at a rate of one-quarter of the shares under option or purchased under stock purchase rights at the end of the first year and thereafter ratably over the next three years. Awards under the 2002 Plan and the prior option plans generally expire seven years from the date of grant. No additional option grants will be made under any prior option plan.

The fair value of each of the Company s option awards is estimated on the date of grant using the Black-Scholes-Merton option-pricing model. Expected stock price volatility is based on historical volatility of the Company s common stock over the estimated expected life of the options. The expected term of options granted is based on historical experience, expected exercise behavior, and the terms and conditions of the options. Separate groups of option awardees that have similar historical exercise behavior are considered separately for valuation purposes. The ranges of the assumptions given below that were used to value option grants result from certain groups of option awardees exhibiting different behavior. As a result, the Company established two different groups of option awardees: directors and employees. The risk-free interest rates are based on the U.S. Treasury yield curve in effect at the time of grant.

As of December 31, 2006, the Company had 850,000 shares of common stock reserved for issuance under the 2002 Plan, of which 633,000 shares were subject to outstanding options and 215,000 shares were available for future grants of stock awards. There were 603,000 shares subject to options outstanding under prior plans.

Options granted under the 2002 Plan as well as those granted under the prior option plans generally become exercisable, and the Company s right to repurchase shares issued and sold pursuant to stock purchase rights under these plans generally lapses, at a rate of one-quarter of the shares subject to the options or purchased under stock purchase rights at the end of the first year and thereafter ratably over the next three years. Awards under the 2002 Plan and the prior option plans generally expire seven years from the date of grant.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton model with the following weighted-average assumptions for options granted during the years ended December 31:

Employees	2006	2005	2004
Risk-free interest rate	5.0%	4.4%	4.7%
Expected term	3.0 years	4.5 years	4.7 years
Expected dividends			
Volatility	49%	110%	192%

Directors	2006	2005	2004
Risk-free interest rate	5.1%	4.5%	3.8%
Expected term	5.0 years	3.2 years	4.7 years
Expected dividends			
Volatility	59%	184%	192%

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Notes to Consolidated Financial Statements

A summary of option activity during the year ended December 31, 2006 is presented below:

Options	Shares (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at Dec. 31, 2005	1,301	$ 1.94		
Granted	32	$ 3.10		
Exercised	(85)	$ 0.92		
Forfeited or expired	(12)	$ 3.25		
Outstanding at December 31, 2006	1,236	$ 2.03	3.6	$ 2,509
Exercisable at December 31, 2006	1,039	$ 1.83	3.2	$ 1,903

The weighted-average grant-date fair value of options granted during 2006, 2005, and 2004 was $1.52, $2.33 and $3.34 per share, respectively. The total intrinsic value of all options (which is the amount by which the stock price exceeded the exercise price of the options at the date of exercise) exercised was $171,000, $433,000 and $791,000 in 2006, 2005, and 2004, respectively.

As of December 31, 2006, there was $151,000 of total unrecognized compensation cost related to unvested stock options that is expected to be recognized over a weighted-average remaining vesting period of 0.9 years.

7. Income Taxes

The provision (benefit) for income taxes is as follows (amounts in thousands).

	Year Ended December 31, 2006	2005	2004
Current			
Federal	$ 9	$ 5	$ (70)
State	9	7	1
Total Current	18	12	(69)
Deferred			
Federal	16	351	(849)
State	(5)	32	(149)
Total Deferred	11	383	(998)
Total provision (benefit) for income taxes	$ 29	$ 395	$ (1,067)

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Notes to Consolidated Financial Statements

The Company s tax provision (benefit) differs from the provision computed using statutory income tax rates as follows (in thousands):

	2006	2005	2004
Federal tax provision at statutory rate	$ 233	$ 328	$ 353
Permanent difference due to non-deductible expenses	133	10	10
State tax provision, net of federal benefit	5	5	39
Utilization of net operating loss carryovers			(33)
Change in deferred tax asset/valuation allowance	(342)	221	(1,436)
General business credits		(169)	
	$ 29	$ 395	$ (1,067)

The components of the net deferred tax assets are as follows (in thousands):

	December 31,	
	2006	2005
Inventory allowances and adjustments	$ 18	$ 20
Accounts receivable allowances	10	12
Other liabilities and allowances	297	310
Net operating loss carryforwards	3,867	4,274
Tax credit carryforwards	1,905	1,801
Depreciation and amortization	449	515
Valuation allowance	(5,417)	(5,792)
Total net deferred tax assets	$ 1,129	$ 1,140

Significant management judgment is required in determining the provision for income taxes, and in particular, any valuation allowance recorded against the Company s deferred tax assets. During 2006, the Company recorded a tax provision of $29,000, while in 2005 it recorded a tax provision of $395,000. The Company annually reviews the future realization of its deferred tax assets based on the current year s results and future taxable income. Based on this analysis it determines the appropriate valuation allowance against the deferred tax asset. The tax provision in 2006 reflects a decrease in the valuation allowance because the Company determined that it was more likely than not that certain future tax benefits would be realized as a result of projected future income. At December 31, 2005, as a result of this review, it was determined that an increase in the valuation allowance was necessary.

A portion of deferred tax assets relating to net operating losses pertains to net operating loss carryforwards resulting from tax deductions upon the exercise or disposition of employee stock options of approximately $1.3 million. When, and if, recognized, the tax benefit of these loss carryforwards will be accounted for as a credit to additional paid-in capital rather than a reduction to income tax expense.

At December 31, 2006, the Company had net operating loss carryforwards of approximately $11.4 million and $97,000 available to offset future federal and California taxable income, respectively. These loss carryforwards will expire in

varying amounts beginning in 2008. In addition, at December 31, 2006, the Company had federal and California credit carryforwards of approximately $1.3 million and $855,000,

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Notes to Consolidated Financial Statements

respectively. The federal credits expire in varying amounts beginning in 2007. The California credits have no expiration.

For federal and state income tax purposes, the amount of benefit from the Company s net operating loss and credit carryforwards may be limited if the Company incurs a cumulative ownership change of more than 50%, as defined, over a three year period.

The Company s profit before provision for income taxes for all periods presented was derived substantially from domestic operations.

8. Retirement Plan

The Company has a voluntary 401(k) plan covering substantially all employees. The plan provides for employer contributions at the discretion of the Board of Directors. In 2006, 2005 and 2004, the Company made no contributions to the plan.

9. Major Customers and Geographic Information

Revenues by geographic area are determined by the location of the customer and are summarized as follows (in thousands):

	Year Ended December 31,		
	2006	2005	2004
United States	$ 9,064	$ 8,722	$ 8,574
Europe	543	722	785
Pacific Rim	659	872	804
Rest of Americas, excluding United States	324	516	294
Total revenues	$ 10,590	$ 10,832	$ 10,457

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

	Year Ended December 31,					
	2006		2005		2004	
Customer	Amount	Percentage	Amount	Percentage	Amount	Percentage
A	$ 3,033	29%	$ 2,735	25%	$ 2,186	21%
B	$ 1,940	18%	$ 1,994	18%	$ 2,451	23%

Customers that individually accounted for greater than 10% of accounts receivable are as follows (in thousands):

	Year Ended December 31,			
	2006		2005	
Customer	Amount	Percentage	Amount	Percentage

	Year Ended December 31,					
A	$	349	28%	$	325	22%
B	$	374	30%	$	540	37%

10. Litigation

From time to time and in the ordinary course of business, the Company is involved in various legal proceedings and third party assertions of patent or trademark infringement claims against the Company in the form of letters and other forms of communication. The Company is not currently involved in any litigation which, in management s opinion, would have a material adverse effect on its 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 the Company s business in the future.

11. Subsequent Events

As of March 21, 2007, the Company had repurchased 8,000 shares of common stock in open market transactions subsequent to December 31, 2006. These shares were repurchased for approximately $25,000 or $3.17 per share. The shares are, or will be, retired.

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Supplemental Financial Information

Supplemental Data (unaudited)

The information set forth below is not necessarily indicative of results of future operations, and should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related Notes thereto included elsewhere in this Annual Report on Form 10-K.

Quarterly Results of Operations (unaudited)

The following table sets forth certain consolidated quarterly financial data for the eight quarters ended December 31, 2006. This information is unaudited, but in our opinion, has been prepared on the same basis as the audited consolidated financial statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the unaudited interim results. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

	Year 2006, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
Net sales	$ 2,989	$ 2,412	$ 2,618	$ 2,571
Gross profit	1,922	1,493	1,604	1,615
Operating income/(loss)	147	(96)	163	205
Net income/(loss)	206	(34)	237	260(1)
Net income/(loss) per share, basic	0.05	(0.01)	0.06	0.07(1)
Net income/(loss) per share, diluted	0.05	(0.01)	0.05	0.06(1)

(1) In 2006, we recorded a tax provision of $29,000, or $0.01 per diluted share, resulting from federal and state provision and a decrease in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods. 2006 federal and state tax liability was almost entirely offset by the utilization of existing net operating losses, and therefore, we do not expect to utilize significant amounts of cash for income tax payments until our $11 million of available net operating loss carryforwards as of December 31, 2006 have been utilized.

	Year 2005, Quarter Ended			
	Mar 31	Jun 30	Sep 30	Dec 31
	(in thousands, except per share data)			
Net sales	$ 2,594	$ 2,846	$ 2,701	$ 2,691
Gross profit	1,782	1,914	1,679	1,728
Operating income	110	296	222	241
Net income/(loss)	135	316	248	(120)[1]
Net income/(loss) per share, basic	0.04	0.08	0.06	(0.03)[1]
Net income/(loss) per share, diluted	0.03	0.07	0.05	(0.03)[1]

(1) In 2005, we recorded a tax provision of $395,000, or $0.09 per diluted share, resulting from federal and state provision and an increase in valuation allowance to reflect management s best estimate of deferred tax assets expected to be utilized in future periods.

Castelle **Schedule II**
Valuation and Qualifying Accounts
(in thousands)

	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductions	Balance at End of Period
Year Ended December 31, 2004:				
Deducted from asset accounts:				
Allowance for doubtful accounts	$ 39	$ (1)	$ (8)	$ 30
Allowance for sales returns and stock rotation	$ 442	$ 886	$ (920)	$ 408
Valuation allowance for deferred tax asset	$ 6,688	$	$ (1,109)	$ 5,579
Year Ended December 31, 2005:				
Deducted from asset accounts:				
Allowance for doubtful accounts	$ 30	$ 2	$ (2)	$ 30
Allowance for sales returns and stock rotation	$ 408	$ 507	$ (598)	$ 317
Valuation allowance for deferred tax asset	$ 5,579	$ 383	$ (170)	$ 5,792
Year Ended December 31, 2006:				
Deducted from asset accounts:				
Allowance for doubtful accounts	$ 30	$	$ (5)	$ 25
Allowance for sales returns and stock rotation	$ 317	$	$ (52)	$ 265
Valuation allowance for deferred tax asset	$ 5,792	$	$ (375)	$ 5,417

Castelle and Subsidiaries
Financial Data Schedule

Exhibit Number	Description
23.1	Consent of Independent Registered Public Accounting Firm Grant Thornton LLP
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Chief Executive Officer
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 Chief Financial Officer
32.1	Certification Pursuant to 8 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Chief Executive Officer
32.2	Certification Pursuant to 8 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Chief Financial Officer