

SECURITIES AND EXCHANGE COMMISSION

FORM 10-K

Annual report pursuant to section 13 and 15(d)

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FILER

CASTELLE \CA

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

FORM 10-K

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

For the fiscal year ended December 31, 2006

- 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

(State or other jurisdiction of
incorporation or organization)

77-0164056

(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

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

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 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 Form 10-K or any amendment to this Form 10-K. ___

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

Large Accelerated Filer ___ Accelerated Filer ___ Non-Accelerated Filer

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

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

5

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 :

Product Model	Number of Channels	Email Integration	Network Topology	Network Environment	
				NetWare 3.x, 4.x, 5.x, 6.x (IPX,IP)	Windows NT/2000/XP/ 2003 /Vista

FaxPress 2500	1, 2	✓	Ethernet	✓	✓
FaxPress 5000	2, 4 or 8	✓	Ethernet	✓	✓
FaxPress Premier Analog	4, 8, 12, 16	✓	Ethernet	n/a	✓
FaxPress Enterprise Digital	8, 24, 48, 72	✓	Ethernet	n/a	✓
T1					
FaxPress Enterprise ISDN	4, 8, 12	✓	Ethernet	n/a	✓
FaxPress Enterprise Digital	10, 30, 60, 90	✓	Ethernet	n/a	✓
E1					

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.

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:

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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.

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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.

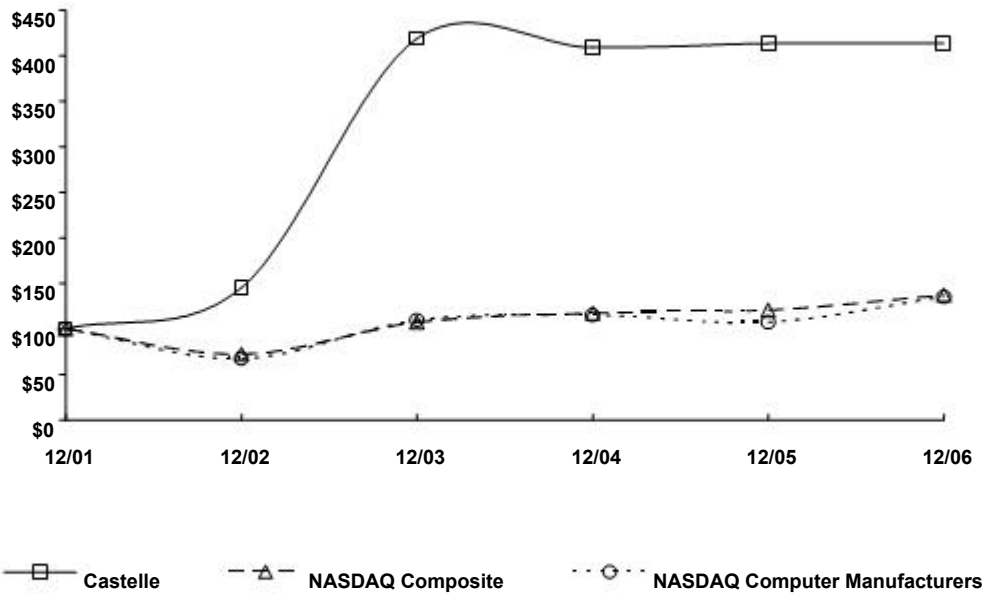
Performance Graph

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 Castle’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 Castle, The NASDAQ Composite Index
And The NASDAQ Computer Manufacturers Index



* \$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
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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

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	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 uncertainty 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

	<u>December 31, 2006</u>	<u>December 31, 2005</u>
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

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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
<hr/>	
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 Castle 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
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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

Incorporated by Reference

Exhibit Number	Exhibit Description	Incorporated by Reference			
		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	<u>Addendum dated December 3, 1991 to Distributor Agreement dated February 26, 1990, by and between the Registrant and Ingram Micro Inc.</u>					X
10.14	<u>Distributor Agreement dated September 29, 1997, by and between the Registrant and Tech Data Corporation</u>					X
10.15	<u>International Distributor Agreement dated May 31, 2001, by and between the Registrant and Macnica, Inc.</u>					X
10.16	<u>Amended and Restated International Distributor Agreement dated July 18, 2002, by and between the Registrant and AMS Limited.</u>					X
23.1	<u>Consent of Grant Thornton LLP, Independent Registered Public Accounting Firm</u>					X
31.1	<u>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</u>					X
31.2	<u>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</u>					X
32.1**	<u>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</u>					X
32.2**	<u>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</u>					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.

/S/ ROBERT H. HAMBRECHT Director
Robert H. Hambrecht

March 30, 2007

/S/ ROBERT O. SMITH Director
Robert O. Smith

March 30, 2007

/S/ PETER R. TIERNEY Director
Peter R. Tierney

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

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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

Accumulated deficit

Total shareholders' equity

28,234

27,860

(19,139)

(19,808)

9,095

8,052

\$ 11,979

\$ 10,674

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

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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
Shares used in per share calculation - diluted	4,475	4,488	4,417

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

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

Common Stock		Accumulated Deficit	Total
Shares	Amount		

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
<hr/>				
Balances, December 31, 2004	3,799	27,668	(20,387)	7,281
<hr/>				
Issuance of common stock through exercise of stock options	187	192	-	192
Net income	-	-	579	579
<hr/>				
Balances, December 31, 2005	3,986	27,860	(19,808)	8,052
<hr/>				
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
<hr/>				
Balances, December 31, 2006	4,049	\$ 28,234	\$ (19,139)	\$ 9,095
<hr/>				

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

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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
	<hr/>	<hr/>	<hr/>
Net cash provided by operating activities	1,674	1,583	626
	<hr/>	<hr/>	<hr/>

Cash flows from investing activities:

Acquisition of property and equipment	(181)	(193)	(35)
Acquisition of licenses	–	(400)	–
	<hr/>	<hr/>	<hr/>
Net cash used in investing activities	(181)	(593)	(35)
	<hr/>	<hr/>	<hr/>

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
	<hr/>	<hr/>	<hr/>
Net cash provided by financing activities	0	177	394
	<hr/>	<hr/>	<hr/>

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
	<hr/>	<hr/>	<hr/>
Cash and cash equivalents, end of period	\$ 8,259	\$ 6,766	\$ 5,599
	<hr/>	<hr/>	<hr/>

Supplemental Information:

Cash paid during the period for:			
Interest	1	3	5

The accompanying notes are an integral part of these 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.

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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.

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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.

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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):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
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.

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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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Notes to Consolidated Financial Statements

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)
	<hr/>	<hr/>
Total accounts receivable, net	\$ 932	\$ 1,137
	<hr/>	<hr/>

Inventories:

	December 31,	
	2006	2005
Raw materials	\$ 669	\$ 745
Work in process	26	55
Finished goods	321	356
	<hr/>	<hr/>
Total inventories	\$ 1,016	\$ 1,156

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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

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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
	<hr/>
	\$ 501
	<hr/>

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	\$ 21	\$ 13

the beginning of the year			
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

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Notes to Consolidated Financial Statements

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

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Notes to Consolidated Financial Statements

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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Castelle
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
<hr/>						
Total Current		18		12		(69)
Deferred						
Federal		16		351		(849)
State		(5)		32		(149)
<hr/>						
Total Deferred		11		383		(998)
<hr/>						
Total provision (benefit) for income taxes	\$	29	\$	395	\$	(1,067)
<hr/>						

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Castelle
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):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
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)	-
	<hr/>	<hr/>	<hr/>
	\$ 29	\$ 395	\$ (1,067)
	<hr/>	<hr/>	<hr/>

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

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
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)
	<hr/>	<hr/>
Total net deferred tax assets	\$ 1,129	\$ 1,140
	<hr/>	<hr/>

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,

Castelle
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):

Customer	Year Ended December 31,					
	2006		2005		2004	
	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):

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

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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

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Castelle and Subsidiaries
Financial Data Schedule

<u>Exhibit</u> <u>Number</u>	<u>Description</u>
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

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Addendum Number 1 to Distribution Agreement Dated February 26, 1990 by and between Ingram Micro Inc. (successor to Ingram Micro D Inc.) and Castelle, Inc.

The above-referenced agreement is hereby amended as follows:

1. Section 2.1 line 2, delete "in the continental United States, Canada, South America and Caribbean countries" and insert "worldwide"

Agreed this 3rd day of December, 1991.

Ingram Micro Inc.
2801 South Yale Street
Santa Ana, CA 92704-5850

Castelle, Inc.
3255-3 Scott Blvd.
Santa Clara, CA 95054

/s/ Sanat K. Dutta

/s/ Patrick Linehan

Name: Sanat K. Dutta

Name: Patrick Linehan

Title: Senior Vice President, Operations

Title: President & CEO

EXHIBIT 10.13

CERTIFICATION OF DISCOUNT LEVEL

Castelle agrees to provide product for GSA resale at the Castelle standard discount plus five points. Castelle will consider a greater discount for small and large bid pricing, based on the number of units and delivery schedule. Additionally, discounts such as co-op, reseller or distributor spiffs, as well as promotional considerations, will not be applicable. Castelle will honor purchase orders for ship and debit or purchase at government discount rates. In either case, the distributor agrees to provide the following:

The reseller purchase order with reference to the government agency.

The distributor purchase order with reference to the reseller and the government agency.

A copy of the distributor invoice referencing the Castelle product serial number.

In the case of a ship and debit purchase order, Castelle reserves the right to determine the eligibility for the discount and will reimburse the distributor upon review of the supporting documentation to Castelle's

satisfaction. Netting the additional discount against the distribution accounts receivable will not be permissible on any situation without prior approval by Castelle.

Approved:

/s/ D. Patrick Linehan

Patrick Linehan

President

DISTRIBUTION AGREEMENT

THIS AGREEMENT, dated as of the 29th day of September, 1997, is between TECH DATA PRODUCT MANAGEMENT, INC., a Florida corporation (“Tech Data”), with its principal corporate address at 5350 Tech Data Drive, Clearwater, Florida 34620 and CASTELLE, INC., a California corporation (“Castelle” or “Vendor”), with its principal corporate address at: 3255-3 Scott Boulevard, Santa Clara, California 95054.

RECITALS

A. Tech Data desires to purchase certain Products from Castelle from time to time and Castelle desires to sell certain Products to Tech Data in accordance with the terms and conditions set forth in this Agreement.

B. Castelle desires to appoint Tech Data as its non-exclusive distributor to market Products within the Territory (as hereinafter defined) and Tech Data accepts such appointment on the terms set forth in this Agreement.

NOW, THEREFORE, in consideration of the Recitals, the mutual covenants contained in this Agreement and other good and valuable consideration, Tech Data and Castelle hereby agree as follows:

ARTICLE 1.

DEFINITIONS. APPOINTMENT AND TERM OF AGREEMENT

1.1 Definitions. The following definitions shall apply to this Agreement.

(a) “Customers” of Tech Data shall include dealers, resellers, value added resellers, mail order resellers and other entities that acquire the Products from Tech Data.

(b) “DOA” shall mean Product, or any portion thereof, which fails to operate properly on initial “burn in”, boot, or use, as applicable.

(c) “Documentation” shall mean user manuals, training materials, Product descriptions and specifications, brochures, technical manuals, license agreements, supporting materials and other printed information relating to the Products, whether distributed in print, electronic, or video format.

(d) “Effective Date” shall mean the date on which this Agreement is signed and dated by a duly authorized representative of Tech Data.

Exhibit 10.14

(e) “End Users” shall mean the final retail purchasers or licensees who have acquired Products for their own use and not for resale, remarketing or redistribution.

(f) "Non-Saleable Products" shall mean any Product that has been returned to Tech Data by its Customers that has had the outside shrink wrapping or other packaging seal broken; any components of the original package are missing, damaged or modified; or is otherwise not fit for resale.

(g) "Products" shall mean, individually or collectively as appropriate, hardware, licensed software, Documentation, supplies, accessories, and other commodities related to any of the foregoing produced by Castelle, as more particularly described in Schedule 1.1(g) attached hereto.

(h) "Return Credit" shall mean a credit to Tech Data in an amount equal to the price paid by Tech Data for Products less any price protection credits but not including any early payment or prepayment discounts.

(i) "Services" means any warranty, maintenance, advertising, marketing or technical support and any other services performed or to be performed by Castelle.

(j) "Territory" shall mean worldwide.

1.2 Term of Agreement. The term of this Agreement shall commence on the Effective Date and, unless terminated by either party as set forth in this Agreement, shall remain in full force and effect for a term of one (1) year, and will be automatically renewed for successive one (1) year terms unless prior written notification of termination is delivered by one of the parties in accordance with the notice provision of this Agreement.

1.3 Appointment as Distributor. Castelle hereby grants to Tech Data the non-exclusive right to distribute Products within the Territory during the term of this Agreement. This Agreement does not grant Castelle or Tech Data an exclusive right to purchase or sell Products and shall not prevent either party from developing or acquiring other vendors or customers or competing Products. Tech Data will use commercially reasonable efforts to promote sales of the Products. Castelle agrees that Tech Data may obtain Products in accordance with this Agreement for the benefit of its parent, affiliates and subsidiaries of Tech Data. Said parent, affiliates and subsidiaries of Tech Data shall be entitled to order Products directly from Castelle pursuant to this Agreement.

Exhibit 10.14

ARTICLE II. PURCHASE ORDERS

2.1 Issuance and Acceptance of Purchase Order.

(a) This Agreement shall not obligate Tech Data to purchase any Products or Services except as specifically set forth in a written purchase order.

(b) Tech Data may issue to Castelle one or more purchase orders identifying the Products Tech Data desires to purchase from Castelle. Notwithstanding any preprinted terms or conditions on Tech Data's purchase orders, the terms and conditions of this Agreement shall apply to and govern all purchase orders accepted or shipped by Castelle hereunder, except that purchase orders may include other terms and conditions which are consistent with the terms and conditions of this Agreement, or which are mutually agreed to in writing by Tech Data and Castelle. Purchase orders will be placed by Tech Data by fax or electronically transferred.

(c) A purchase order shall be deemed accepted by Castelle unless Castelle notifies Tech Data in writing within five (5) days of the date of the purchase order that Castelle does not accept the purchase order.

- 2.2 Purchase Order Alterations or Cancellations. Prior to shipment of Products, Castelle shall accept alterations or cancellation to a purchase order in order to: (i) change a location for delivery, (ii) modify the quantity or type of Products to be delivered or (iii) correct typographical or clerical errors. Customized products are not included.
- 2.3 Evaluation or Demonstration Purchase Orders. Castelle shall provide to Tech Data a reasonable number of demonstration or evaluation Products as mutually agreed.
- 2.4 Product Shortages. If for any reason Castelle's production is not on schedule, Castelle may allocate available inventory to Tech Data and make shipments based upon a fair and reasonable percentage allocation among Castelle's customers. Such allocations shall not impact the calculation of performance rebates.
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Exhibit 10.14

ARTICLE III. DELIVERY AND ACCEPTANCE OF PRODUCTS

- 3.1 Acceptance of Products. Tech Data shall, after a reasonable time to inspect each shipment, accept Product (the "Acceptance Date") if the Products and all necessary documentation delivered to Tech Data are in accordance with the purchase order. Any Products not ordered or not otherwise in accordance with the purchase order (e.g. mis-shipments, overshipments) may be returned to Castelle at Castelle's expense (including without limitation costs of shipment or storage). Castelle shall refund to Tech Data within ten (10) business days following notice thereof, all monies paid in respect to such rejected Products. Tech Data shall not be required to accept partial shipment unless Tech Data agrees prior to shipment.
- 3.2 Title and Risk of Loss. FOB Castelle's manufacturing plant (Santa Clara, CA). Title and risk of loss or damage to Products shall pass to Tech Data at the time the Products are delivered to the common carrier.
- 3.3 Transportation of Products. Castelle shall deliver the Products clearly marked on the Product package with serial number, Product description and machine readable bar code (employing UPC or other industry standard bar code) to Tech Data at the location shown and on the delivery date set forth in the applicable purchase order or as otherwise agreed upon by the parties. Charges for transportation of the Products shall be paid by Castelle. Castelle shall use only those common carriers preapproved by Tech Data or listed in Tech Data's published routing instructions, unless prior written approval of Tech Data is received.

ARTICLE IV. RETURNS

- 4.1 Inventory Adjustment. At the beginning of each calendar quarter during the term of this Agreement Distributor may return Products to Castelle, freight prepaid, for Return Credit against future orders provided Tech Data meets the following criteria: (i) the total value of the returned products shall not exceed twenty five percent (25%) of the net Product purchased by Tech Data during the immediate prior calendar quarter; (ii) all returned product must be in their unopened, original packaging, be in new condition; be on Castelle's currently available Product Price List and not have been abused or damaged;

(iii) Tech Data shall not return any Products for the same identical product model; (iv) at the time of the return, Tech Data must place an irrevocable Purchase Order with Castelle having a net value of not less than the value of the returned product; (v) any products that have been customized cannot be returned to Castelle; (vi) Product not normally offered to distribution which is purchased by the Distributor under special conditions cannot be returned to Castelle.

The request for rotation, when granted, is valid for sixty (60) days from the date of grant. All Product must be received at Castelle dock within this time frame to be accepted, otherwise Castelle reserves the right to cancel the request.

Exhibit 10.14

- 4.2 Defective Products/Dead on Arrival (DOA). Tech Data shall have the right to return to Castelle for Return Credit any DOA Product that is returned to Tech Data within ninety (90) days after the initial delivery date to the End User and any Product that fails to perform in accordance with Castelle's Product warranty. Castelle shall bear all costs of shipping and risk of loss of DOA and in-warranty Products to Castelle's location and back to Tech Data. Tech Data is required to request a Return Material Authorization from Castelle, within sixty (60) days of receipt of product. The Authorization is valid for sixty (60) days from the date of issue and all Products must be received at Castelle's dock within this time frame to be accepted, otherwise Castelle reserves the right to cancel the request.
- 4.3 Obsolete or Outdated Product. Tech Data shall have the right to return for Return Credit, without limitation as to the dollar amount, all Products that become obsolete or Castelle discontinues or are removed from Castelle's current price list; provided Tech Data returns such Products within sixty (60) days after Tech Data receives written notice from Castelle that such Products are obsolete, superseded by a newer version, discontinued or are removed from Castelle's price list.
- 4.4 Miscellaneous Returns.
- (a) Bad Box. Tech Data shall have the right to return to Castelle for Return Credit Products which have boxes that are or become damaged.
- (b) Non-Saleable. Tech Data shall have the right to return to Castelle for Return Credit Non-Saleable Products.
- 4.5 Condition Precedent to Returns. As a condition precedent to returning Products, Tech Data shall request and Castelle shall issue a Return Material Authorization Number (RMA) in accordance with and subject to Section 8.9 of this Agreement.

ARTICLE V. PAYMENT TO VENDOR

- 5.1 Charges, Prices and Fees for Products. Charges, prices, quantities and discounts, if any, for Products shall be determined as set forth in Schedule 1.1 (g), or as otherwise mutually agreed upon by the parties in

writing, and may be confirmed at the time of order. In no event shall charges exceed Castelle' s then-current established charges. Tech Data shall not be bound by any of Castelle' s suggested prices.

Exhibit 10.14

- 5.2 Payment. Except as otherwise set forth in this Agreement, any undisputed sum due to Castelle pursuant to this Agreement shall be payable as follows: 2%-15, net thirty (30) days after the invoice receipt. Castelle shall invoice Tech Data no earlier than the applicable shipping date for the Products covered by such invoice. Products which are shipped from outside the United States, shall not be invoiced to Tech Data prior to the Products being placed on a common carrier within the United States for final delivery to Tech Data. The due date for payment shall be extended during any time the parties have a bona fide dispute concerning such payment.
- 5.3 Invoices. A "correct" invoice shall contain (i) Castelle' s name and invoice date, (ii) a reference to the purchase order or other authorizing document, (iii) separate descriptions, unit prices and quantities of the Products actually delivered, (iv) credits (if applicable), (v) shipping charges (if applicable) (vi) name (where applicable), title, phone number and complete mailing address as to where payment is to be sent, and (vii) other substantiating documentation or information as may reasonably be required by Tech Data from time to time. Notwithstanding any pre-printed terms or conditions on Castelle' s invoices, the terms and conditions of this Agreement shall apply to and govern all invoices issued by Castelle hereunder, except that invoices may include other terms and conditions which are consistent with the terms and conditions of this Agreement, or which are mutually agreed to in writing by Tech Data and Castelle.
- 5.4 Taxes. Tech Data shall be responsible for franchise taxes, sales or use taxes or shall provide Castelle with an appropriate exemption certificate. Castelle shall be responsible for all other taxes, assessments, permits and fees, however designated which are levied upon this Agreement or the Products, except for taxes based upon Tech Data' s income. No taxes of any type shall be added to invoices without the prior written approval of Tech Data.
- 5.5 Fair Pricing end Terms. Castelle represents that the prices charged and the terms offered to Tech Data are and will be at least as beneficial to Tech Data as those charged or offered by Castelle to any of its other distributors or customers. If Castelle offers price discounts, payment discounts, promotional discounts or other special prices to its other distributors or customers, Tech Data shall also be entitled to participate and receive notice of the same no later than other distributors or customers.
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Exhibit 10.14

5.6 Price Adjustments.

(a) Price Increase. Castelle shall have the right to increase prices from time to time, upon written notice to Tech Data not less than thirty (30) days prior to the effective date of such increase. All orders placed prior

to the effective date of the increase, for shipment within thirty (30) *days* after the effective date, shall be invoiced by Castelle at the lower price.

(b) Price Decreases. Castelle shall have the right to decrease prices from time to time, upon written notice to Tech Data not less than thirty (30) days prior to the effective date of such decrease. Castelle shall grant to Tech Data Product Management, Inc., its parent, affiliates and subsidiaries and Tech Data's Customers a price credit for the full amount of any Castelle price decrease on all Products on order, in transit and in their inventory on the effective date of such price decrease. Tech Data and its Customers shall, within sixty (60) days after receiving written notice of the effective date of the price decrease, provide a list of all Products for which they claim a credit. Castelle shall have the right to a reasonable audit at Castelle's expense.

5.7 Advertising

(a) Cooperative Advertising. Castelle offers a two percent (2%) co-op program and may offer additional advertising credits, or other promotional programs or incentives to Tech Data as it offers to its other distributors or customers. Tech Data shall have the right, at Tech Data's option, to participate in such programs. Attached as Schedule 5.7 is a copy of Castelle's co-op policy.

(b) Advertising Support. Castelle shall provide at no charge to Tech Data and the Customers of Tech Data, marketing support, and advertising materials in connection with the resale of Products as are currently offered or that may be offered by Castelle. Tech Data reserves the right to charge Castelle for preapproved advertising, marketing and training services which has been approved in writing by Castelle.

ARTICLE VI. WARRANTIES.

INDEMNITIES AND OTHER OBLIGATIONS OF VENDOR

6.1 Warranty. Castelle hereby represents and warrants that Castelle has all right, title, ownership interest and marketing rights necessary to provide the Products to Tech Data. Castelle further represents and warrants that it has not entered into any agreements or commitments which are inconsistent with or in conflict with the rights granted to Tech Data in this Agreement; the Products are new and shall be free and clear of all liens and encumbrances; Tech Data and its Customers and End Users shall be entitled to use the Products without disturbance; the Products have been listed with Underwriters' Laboratories or other nationally recognized testing laboratory whenever such listing is required; the Products meet all FCC

Exhibit 10.14

requirements; the Products do and will conform to all codes, laws or regulations; and the Products conform in all respects to the Product warranties. Castelle agrees that Tech Data shall be entitled to pass through to Customers of Tech Data and End Users of the Products all Product warranties granted by Castelle. Tech Data shall have no authority to alter or extend any of the warranties of Castelle expressly contained or referred to in this Agreement without prior approval of Castelle. Castelle has made express warranties in this Agreement and in Documentation, promotional and advertising materials. EXCEPT AS SET FORTH HEREIN OR THEREIN, VENDOR DISCLAIMS ALL WARRANTIES WITH REGARD TO THE PRODUCTS, INCLUDING WITHOUT LIMITATION, THE IMPLIED WARRANTIES OF

MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. THIS SECTION SHALL SURVIVE TERMINATION OR EXPIRATION OF THIS AGREEMENT.

6.2 Proprietary Rights Indemnification. Castelle hereby represents and warrants that the Products and the sale and use of the Products do not infringe upon any copyright, patent, trademark, trade secret or other proprietary or intellectual property right of any third party, and that there are no suits or proceedings, pending or threatened, alleging any such infringement. Castelle shall indemnify and hold Tech Data, Tech Data's parent, affiliates and subsidiaries and their respective, officers, directors, employees and agents harmless from and against any and all actions, claims, losses, damages, liabilities, awards, costs and expenses, which they or any of them incur or become obligated to pay resulting from or arising out of any breach or claimed breach of the foregoing warranty. Tech Data shall Inform Castelle of any such suit or proceeding filed against Tech Data and shall have the right, but not the obligation, to participate in the defense of any such suit or proceeding at Tech Data's expense. Castelle shall, at its option and expense, either (i) procure for Tech Data, its Customers and End Users the right to continue to use the Product as set forth in this Agreement, or (ii) replace, to the extent Products are available, or modify the Product to make its use non-infringing while being capable of performing the same function without degradation of performance. If neither of the foregoing alternatives (i) or (ii) is reasonably available, Castelle shall accept a return of the Products from Tech Data, at Castelle's sole cost and expense, and shall refund to Tech Data the full amount of the price paid by Tech Data for said returned Products, less any price protection credits, but not including any early payment or prepayment discounts. Castelle shall have no liability under this Section 6.2 for any infringement based on the use of any Product, if the Product is used in a manner or with equipment for which it was not reasonably intended. Castelle's obligations under this Section 6.2 shall survive termination or expiration of this Agreement.

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6.3 Indemnification.

(a) Vendor. Castelle shall be solely responsible for the design, development, supply, production and performance of the Products. Castelle agrees to indemnify and hold Tech Data, its parent, affiliates and subsidiaries and their officers, directors and employees harmless from and against any and all claims, damages, costs, expenses (including, but not limited to, reasonable attorneys' fees and costs) or liabilities that may result, in whole or in part, from any warranty or Product liability claim, or any claim for infringement, or for claims for violation of any of the warranties contained in this Agreement.

(b) Tech Data. Tech Data agrees to indemnify and hold Castelle, its officers, directors and employees harmless from and against any and all claims, damages, costs, expenses (including, but not limited to, reasonable attorneys' fees and costs) or liabilities that may result, in whole or in part, from Tech Data's gross negligence or willful misconduct in the distribution of the Products pursuant to this Agreement, or for representations or warranties made by Tech Data related to the Products in excess of the warranties of Castelle.

6.4 Insurance.

(a) The parties shall be responsible for providing Workers' Compensation insurance in the statutory amounts required by the applicable state laws.

(b) Without in any way limiting Castelle's indemnification obligation as set forth in this Agreement, Castelle shall maintain Commercial General Liability or Comprehensive General Liability Insurance in such amounts as is reasonable and standard for the industry. Either policy form should contain the following coverages: Personal and Advertising Injury, Broad Form Property Damage, Products and Completed Operations, Contractual Liability, employees as Insured and Fire Legal Liability.

(c) Castelle will provide evidence of the existence of insurance coverages referred to in this Section 6.4 by certificates of insurance which should also provide for at least thirty (30) days notice of cancellation, non-renewal or material change of coverage to Tech Data. The certificates of insurance shall name Tech Data Product Management, Inc., its parent, affiliates and subsidiaries as additional insured for the limited purpose of claims arising pursuant to this Agreement.

6.5 Limitation of Liability. NEITHER PARTY SHALL BE LIABLE TO THE OTHER PURSUANT TO THIS AGREEMENT FOR AMOUNTS REPRESENTING INDIRECT, SPECIAL, INCIDENTAL, CONSEQUENTIAL, OR PUNITIVE

Exhibit 10.14

DAMAGES OF THE OTHER PARTY ARISING FROM THE PERFORMANCE OR BREACH OF ANY TERMS OF THIS AGREEMENT.

6.6 ECCN/Export. Castelle agrees to provide Tech Data, upon signing this Agreement and at any time thereafter that Castelle modifies or adds Products distributed or to be distributed by Tech Data, with the Export Control Classification Number (ECCN) for each of Castelle's Products, and information as to whether or not any of such Products are classified under the U.S. Munitions List.

6.7 Financial Statements. Castelle agrees that for the term of this Agreement, Castelle shall, upon Tech Data's request, provide financial statements annually and semi annually as follows:

(a) Within one hundred and twenty (120) days after the end of Castelle's fiscal year audited financial statements for the fiscal year prepared by an independent certified public accountant.

(b) Within sixty (60) days after the end of Castelle's second fiscal quarter, semiannual unaudited financial statements, prepared by Castelle's authorized representative.

Such financial statements shall include profit and loss statement, balance sheets and such other accounting data as may be requested by Tech Data and be acknowledged by Castelle's authorized representative in writing as true and correct. In addition, Castelle shall provide other financial information upon reasonable request by Tech Data.

6.8 Vendor Reports. Castelle shall, if requested, render monthly reports to Tech Data setting forth the separate Products, dollars invoiced for each Product, and total dollars Invoiced to Tech Data for the month, and such other information as Tech Data may reasonably request.

6.9 Tech Data Reports. Tech Data shall, if requested, render monthly sales out reports on Tech Data's BBS system. Information provided will include: month and year sales activity occurred, internal product number (assigned by Tech Data), written description, state and zip-code of Customer's location, unit cost (distributors cost at quantity 1), quantity and extended cost (cost times quantity). A monthly inventory report will be provided on a paper format once a month. Castelle agrees that any such information provided by Tech Data shall be received and held by Castelle in strict confidence and shall be used solely for sell through or compensation reporting information and shall not be used for purposes related to Castelle's direct sales activities.

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6.10 Trademark Usage. Tech Data is hereby authorized to use trademarks and tradenames of Castelle and third parties licensing Castelle, if any, used in connection with advertising, promoting or distributing the Products. Tech Data recognizes Castelle or other third parties may have rights or ownership of certain trademarks, trade names and patents associated with the Products. Tech Data will act consistent with such rights, and Tech Data shall comply with any reasonable written guidelines when provided by Castelle or third parties licensing Castelle related to such trademark or trade name usage. Tech Data will notify Castelle of any infringement of which Tech Data has actual knowledge. Tech Data shall discontinue use of Castelle's trademarks or trade names upon termination of this Agreement, except as may be necessary to sell or liquidate any Product remaining in Tech Data's inventory.

ARTICLE VII. TERMINATION: EXPIRATION

7.1 Termination.

(a) Termination With or Without Cause. Either party may terminate this Agreement, without cause, upon giving the other party thirty (30) days prior written notice. In the event that either party materially or repeatedly defaults in the performance of any of its duties or obligations set forth in this Agreement, and such default is not substantially cured within thirty (30) days after written notice is given to the defaulting party specifying the default, then the party not in default may, by giving written notice thereof to the defaulting party, terminate this Agreement or the applicable purchase order relating to such default as of the date specified in such notice of termination.

(b) Termination for Insolvency or Bankruptcy. Either party may immediately terminate this Agreement and any purchase orders by giving written notice to the other party in the event of (i) the liquidation or insolvency of the other party, (ii) the appointment of a receiver or similar officer for the other party, (iii) an assignment by the other party for the benefit of all or substantially all of its creditors, (iv) entry by the other party into an agreement for the composition, extension, or readjustment of all or substantially all of its obligations, or (v) the filing of a petition in bankruptcy by or against a party under any bankruptcy or debtors' law for its relief or reorganization which is not dismissed within ninety (90) days.

7.2 Rights Upon Termination or Expiration.

(a) Termination or expiration of this Agreement shall not affect Castelle's right to be paid for undisputed invoices for Products already shipped and accepted by Tech Data or Tech Data's rights to any credits or

payments owed or accrued to the date of termination or expiration. Tech Data's rights to credits upon termination or

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expiration shall include credits against which Tech Data would, but for termination or expiration, be required under this Agreement to apply to future purchases.

(b) Castelle shall accept purchase orders from Tech Data for additional Products which Tech Data is contractually obligated to furnish to its Customers and does not have in its inventory upon the termination or expiration of this Agreement; provided Tech Data notifies Castelle of any and all such transactions in writing within sixty (60) days following the termination or expiration date.

(c) Upon termination or expiration of this Agreement, Tech Data shall discontinue holding itself out as a distributor of the Products.

7.3 Repurchase of Products Upon Termination or Expiration. Upon the effective date of termination or expiration of this Agreement for any reason, Castelle agrees to repurchase all Products in Tech Data's inventory and Products which are returned to Tech Data by its Customers within one hundred and twenty (120) days following the effective date of termination or expiration. Castelle will repurchase such Products at the original purchase price, less any deductions for price protection. The repurchase price shall not be reduced by any deductions or offsets for early pay or prepay discounts. Such returns shall not reduce or offset any co-op payments or obligations owed to Tech Data. Within sixty (60) days following the effective date of termination or expiration, Tech Data shall return to Castelle for repurchase all Product held in Tech Data's inventory as of the effective date of termination or expiration. Additional returns shall be sent at reasonable intervals thereafter, provided all returns of Product by Tech Data under this Section 7.3 shall be shipped within one hundred and twenty-five (125) days following the effective date of termination or expiration. Castelle will issue an RMA to Tech Data for all such Products; provided, however, that Castelle shall accept returned Products in accordance with this Section absent an RMA if Castelle fails to issue said RMA within five (5) business days of Tech Data's request. Castelle shall credit any outstanding balances owed to Tech Data. If such credit exceeds amounts due from Tech Data, Castelle shall remit in the form of a check to Tech Data the excess within ten (10) business days of receipt of the Product. Customized Products shall not be eligible for repurchase pursuant to this Section.

7.4 Survival of Terms. Termination or expiration of this Agreement for any reason shall not release either party from any liabilities or obligations set forth in this Agreement which (i) the parties have expressly agreed shall survive any such termination or expiration, or (ii) remain to be performed or by their nature would be intended to be applicable following any such termination or expiration. The termination or expiration of this Agreement shall not affect any of Castelle's warranties, indemnification obligations or obligations relating to returns, co-op advertising payments, credits or any other matters set forth in this Agreement that

should survive termination or expiration in order to carry out their intended purpose, all of which shall survive the termination or expiration of this Agreement.

ARTICLE VIII. MISCELLANEOUS

- 8.1 Binding -Nature, Assignment, and Subcontracting. This Agreement shall be binding on the parties and their respective successors and assigns. Neither party shall have the power to assign this Agreement without the prior written consent of the other party.
- 8.2 Counterparts. This Agreement may be executed in several counterparts, all of which taken together shall constitute one single agreement between the parties.
- 8.3 Headings. The Article and Section headings used in this Agreement are for reference and convenience only and shall not affect the interpretation of this Agreement.
- 8.4 Relationship of Parties. Tech Data is performing pursuant to this Agreement only as an independent contractor. Nothing set forth in this Agreement shall be construed to create the relationship of principal and agent between Tech Data and Castelle. Neither party shall act or represent itself, directly or by implication, as an agent of the other party.
- 8.5 Confidentiality. Each party acknowledges that in the course of performance of its obligations pursuant to this Agreement, it may obtain certain information specifically marked as confidential or proprietary. Each party hereby agrees that all such information communicated to it by the other party, its parent, affiliates, subsidiaries, or Customers, whether before or after the Effective Date, shall be and was received in strict confidence, shall be used only for purposes of this Agreement, and shall not be disclosed without the prior written consent of the other party, except as may be necessary by reason of legal, accounting or regulatory requirements beyond either party's reasonable control. The provisions of this Section shall survive termination or expiration of this Agreement for any reason for a period of one (1) year after said termination or expiration.
- 8.6 Arbitration. Any disputes arising under this Agreement shall be submitted to arbitration in accordance with such rules as the parties jointly agree. If the parties are unable to agree on arbitration procedures, arbitration shall be conducted in Pinellas County, Florida, in accordance with the Commercial Arbitration Rules of the American Arbitration Association. Any such award shall be final and binding upon both parties.
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- 8.7 Notices. Wherever one party is required or permitted to give notice to the other party pursuant to this Agreement, such notice shall be deemed given when actually delivered by hand, by telecopier (if and when immediately confirmed in writing by any of the other means provided herein ensuring acknowledgment of receipt thereof for purposes of providing notice of default or termination), via

overnight courier, or when mailed by registered or certified mail, return receipt requested, postage prepaid, and addressed as follows:

In the Case of Castelle:

Castelle
3255-3 Scott Boulevard
Santa Clara, CA 95054
Attn: Randy Bambrough
C.F.O.

In the Case of Tech Data:

Tech Data Product Management, Inc.
5350 Tech Data Drive
Clearwater, FL 34620
Attn: Tamra Muir
Vice President-Marketing Operations
cc: Contracts Administration

Either party may from time to time change its address for notification purposes by giving the other party written notice of the new address and the date upon which it will become effective.

8.8 Force Majeure. The term "Force Majeure" shall be defined to include fires or other casualties or accidents, acts of God, severe weather conditions, strikes or labor disputes, war or other violence, or any law, order, proclamation, regulation, ordinance, demand or requirement of any governmental agency.

(a) A party whose performance is prevented, restricted or interfered with by reason of a Force Majeure condition shall be excused from such performance to the extent of such Force Majeure condition so long as such party provides the other party with prompt written notice describing the Force Majeure condition and immediately continues performance until and to the extent such causes are removed.

(b) If, due to a Force Majeure condition, the scheduled time of delivery or performance is or will be delayed for more than ninety (90) days after the scheduled date, the party not relying upon the Force Majeure condition may terminate, without liability to the other party, any purchase order or portion thereof covering the delayed Products.

8.9 Return Material Authorization Numbers. Castelle is required to issue a Return Material Authorization Number ("RMA") to Tech Data within five (5) business days of Tech Data's request; however, if the RMA is not received by Tech Data within five (5) business days, Castelle shall accept returned Products absent an RMA.

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8.10 Credits to Tech Data. In the event any provision of this Agreement or any other agreement between Tech Data and Castelle requires that Castelle grant credits to Tech Data's account, and such credits are not received within thirty (30) days, all such credits shall become effective immediately upon notice to Castelle. In such event, Tech Data shall be entitled to deduct any such credits from the next monies owed to Castelle. In the event credits exceed any balances owed by Tech Data to Castelle, Castelle shall, upon request from Tech Data, issue a check payable to Tech Data within ten (10) days of such notice. Credits owed to Tech Data shall not be reduced by early payment or prepayment discounts. Tech Data shall have the right to set off against any amounts due to Castelle under this Agreement or any invoices issued by

Castelle related to this Agreement any and all amounts due to Tech Data from Castelle, whether or not arising under this Agreement.

- 8.11 Severability. If, but only to the extent that, any provision of this Agreement is declared or found to be illegal, unenforceable or void, then both parties shall be relieved of all obligations arising under such provision, it being the intent and agreement of the parties that this Agreement shall be deemed amended by modifying such provision to the extent necessary to make it legal and enforceable while preserving its intent.
- 8.12 Waiver. A waiver by either of the parties of any covenants, conditions or agreements to be performed by the other party or any breach thereof shall not be construed to be a waiver of any succeeding breach thereof or of any other covenant, condition or agreement herein contained.
- 8.13 Remedies. All remedies set forth in this Agreement shall be cumulative and in addition to and not in lieu of any other remedies available to either party at law, in equity or otherwise, and may be enforced concurrently or from time to time.
- 8.14 Entire Agreement. This Agreement, including any Exhibits and documents referred to In this Agreement or attached hereto, constitutes the entire and exclusive statement of Agreement between the parties with respect to its subject matter and there are no oral or written representations, understandings or agreements relating to this Agreement which are not fully expressed herein. The parties agree that unless otherwise agreed to in writing by the party intended to be bound, the terms and conditions of this Agreement shall prevail over any contrary terms in any purchase order, sales acknowledgment, confirmation or any other document issued by either party affecting the purchase or sale of Products hereunder.
- 8.15 Governing Law. This Agreement shall have Florida as its situs and shall be governed by and construed in accordance with the laws of the State of Florida, without reference to choice of laws. The parties agree that this Agreement

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excludes the application of the 1980 United Nations Convention on Contracts for the International Sale of Goods, if otherwise applicable.

- 8.16 Software Licenses. Whenever the Products described in this Agreement shall include software licenses, Castelle hereby grants to Tech Data a non-exclusive right to market, demonstrate and distribute the software to Customers of Tech Data. Tech Data acknowledges that no title or ownership of the proprietary rights to any software is transferred by virtue of this Agreement notwithstanding the use of terms such as purchase, sale or the like within this Agreement.
- 8.17 Time of Performance. Time is hereby expressly made of the essence with respect to each and every term and condition of this Agreement.

IN WITNESS WHEREOF, the parties have each caused this Agreement to be signed and delivered by its duly authorized officer or representative as of the Effective Date.

CASTELLE, INC.,

a California Corporation

By: /s/ Jerome S. Burke

Printed Name: Jerome S. Burke

Title: Executive Vice President

Date: 6/20/97

TECH DATA PRODUCT MANAGEMENT, INC.,

a Florida Corporation

By: /s/ Peggy K. Caldwell

Printed Name: Peggy K. Caldwell

Title: Senior Vice President, Marketing

Date: 9/29/97

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SCHEDULE 5.7

CO-OP GUIDELINES

To increase the effectiveness of advertising and sales promotions Tech Data has developed the following advertising requirements:

HOW CO-OP IS EARNED:

- Co-op dollars will be at least 2% of the purchases made by Tech Data, net of returns.
- Co-op dollars will be accrued on a monthly basis.

HOW CO-OP IS SPENT:

- Tech Data will obtain Vendor' s prior approval for all co-op expenditures.
- Tech Data will be reimbursed for 100% of the cost for ads or promotions that feature vendor products.
- Co-op dollars will be used within the 12 months immediately following the month in which they are earned.

HOW CO-OP IS CLAIMED:

- Claims for co-op will be submitted to vendor within 60 days of the event date.
- Claims for co-op will be submitted with a copy of vendor prior approval and proof of performance.
- Payment must be remitted within 30 days of the claim date, or Tech Data reserves the right to deduct from the next invoice.

CO-OP REPORTING:

- Vendor will submit a monthly co-op statement outlining (i) co-op earned, (ii) co-op used and (iii) co-op claims paid.

Accepted:

/s/ Jerome S. Burke

Name: Jerome S. Burke

Title: Executive Vice President

Date: 6/20/97

**CASTELLE
DISTRIBUTOR AGREEMENT**

DISTRIBUTOR AGREEMENT dated as of the 31st day of May between Macnica, Inc. hereafter referred to as “Distributor” with its principal office located at Hakusan Hi-tech Park 1-22-2 Hakusan Midori-ku Yokohama Japan and Castelle, a California corporation having its place of business at 855 Jarvis Drive, Suite 100, Morgan Hill, California, 95037, hereinafter referred to as “Castelle” .

WHEREAS, Distributor desires to purchase from Castelle and Castelle desires to sell to Distributor upon the terms and conditions set forth herein the products listed in the Castelle Price List for Distributors set forth in Appendix A (“Products” and “Price”);

NOW THEREFORE, the parties agree as follows:

1. APPOINTMENT OF DISTRIBUTOR

1.1 Castelle hereby appoints Distributor as an exclusive Distributor of Products. For a period of one (1) year commencing from the date of this Agreement. Castelle hereby appoints Macnica as its exclusive distributor for the sale of the product(s) set forth below in Japan. This exclusivity is contingent upon meeting requirements set forth in Appendix B.

FaxPress Family of FaxServers

Castelle represents and warrants to Macnica that it has the exclusive right to appoint Macnica as its exclusive distributor and such appointment and any subsequent sale by Macnica of such Castelle products will not violate any third party concerning any of the Castelle products or their components. Macnica acknowledges that Castelle retains ownership and proprietary rights to the Castelle products and that Castelle retains the right to manufacture, distribute and sell the Castelle products worldwide.

1.2 Castelle reserves the right to negotiate and sell direct on OEM accounts. Castelle reserves the right to negotiate and sell direct on OEM accounts which Distributor brings to Castelle subject to mutual compensation discussions with distributor.

1.3 Distributor shall use its best efforts to solicit and to service customers in the Territory so as to promote the goodwill, name and interest of Castelle and its Products.

2. TERM OF AGREEMENT

The initial term of this Agreement shall be for a period of one (1) year, beginning on the date first above written. Thereafter, this agreement shall be renewed for successive periods of one year without further notice, unless terminated sooner as provided under the provisions of this agreement.

3. DISTRIBUTOR' S RESPONSIBILITIES

The Distributor recognizes that expertise and commitment on its part are necessary for the effective marketing, promotion and support of the Products. Distributor agrees that it will act as follows:

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Distributor will use its best efforts to develop business and promote the sale and licensing of Products. Distributor shall maintain a sales organization knowledgeable in the products which actively solicits the sale of Products. Distributor will support Castelle sales promotion programs when and if such are made available. Distributor will effectively demonstrate appropriately configured Products from each product family it purchases for resale.

3.2 **Reports/Rescheduling**

Distributor agrees to provide Castelle at Castelle' s request within the first week of each quarter with a forecast of its projected requirements for each Product, by model, for the next six (6) months. Such forecast shall not be binding on either Distributor or Castelle. Distributor, agrees, however, that faulty forecasting by Distributor may affect Castelle' s ability to deliver Product in a timely manor.

4. **PRICING**

4.1. **Distributor' s Prices**

Subject to adjustments described herein, Distributor' s prices for Products shall be as set forth in Appendix A attached hereto. All prices are stated in U.S. dollars, ex-factory: Castelle Inc, Santa Clara, California, U.S.A.

4.2 **Price Adjustments**

Castelle may change its prices set forth on Appendix A attached hereto at any time, provided that no such price increase shall be effective until thirty (60) days after notice by Castelle to Distributor of such change. Price decreases may be effective immediately on the date of notification by Castelle. All price adjustments shall apply to Products ordered, but not shipped, after the effective date of such change.

4.3 **Product List Price In Distributor' s Territory**

Castelle and Distributor agree that it is in the best interest of both parties that the end user recommended Retail Prices for the Product' s quoted by the Distributor, or Distributor' s resellers, in the Territory be competitive to motivate and promote the purchases by end users of Castelle Products. Distributor shall exercise its best efforts to quote and promote competitive prices in the currency of the Territory.

5. **Discontinuance And Cancellation Of Products**

- 5.1 If during the term of this Agreement, Castelle discontinues a product, Castelle agrees to place an order for such discontinued Product (s) during the notification period for delivery within six (6) months after the end of such notice period, but Castelle' s acceptance of such orders shall be on an "as available" basis. Distributor may with ninety (90) days after receipt of such notice, notify Castelle in writing of Distributor' s intention to return any or all products in its inventory which have been so discontinued. Distributor shall receive full credit for all such products so returned. Any such credit shall be in the amount of the actual net invoice price paid by Distributor for the discontinued products less any prior credits.
- 5.2 If during this agreement, Castelle discontinues an OEM product, Castelle agrees to provide distributor with ninety (90) days prior written notice of product' s discontinuance.

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Castelle will continue to provide technical support and repair parts for 5 years after the date of discontinuance.

- 5.3 Distributor may, by prior written notice to Castelle, defer and/or cancel non-OEM product delivery once without penalty, provided such notice is received by Castelle not less than thirty (30) days prior to the scheduled ship date. Distributor may assess a fee equal to five percent (5%) of the net invoice price on all other changes.

6. Stock Rotation

- 6.1 At the beginning of each calendar quarter during the term of this Agreement Distributor may return one (1) consolidated shipment of Products to Castelle, freight prepaid, for credit against future orders provided Distributor meets the following criteria: (i) The total value of the returned products shall not exceed five percent of the net Product purchases by Distributor during the immediate prior calendar quarter, (ii) All returned products must be in their unopened, original packaging: be in new condition; be on Castelle' s currently available Product Price List; be on the Distributor' s inventory for less than six (6) months; and not have been abused or damaged; (iii) Distributor shall not return any Products for the same identical product model; (iv) At the time of the return, distributor must place an irrevocable Purchase order with Castelle having a net value of not less than the value of the returned product. (v) Any Products that have been customized cannot be returned to Castelle.
- 6.2 Castelle shall, at its sole option, repurchase Distributor' s inventory which is current, saleable and in Castelle' s original shipping carton at the same prices which Distributor paid for such products less aggregate amount of all credits previously issued with respect to such Products. Castelle shall promptly inspect all products returned by Distributor and shall advise distributor of any Product which is damaged and not acceptable to Castelle for repurchase.

7. PRODUCT ALLOCATION

In the event of a shortage of any Product for any reason, Castelle shall have the right to allocate available Products in such manner as Castelle chooses.

8. SHIPMENT

All products delivered pursuant to the terms of this Agreement shall be suitable packed in Castelle's standard shipping cartons, marked for shipment at Distributor's address set forth above, and delivered to Distributor or its carrier F.O.B. Castelle's manufacturing plant, at which time title to such Products and risk of loss shall pass to Distributor. Unless otherwise instructed in writing by Distributor, Castelle shall select the carrier. All freight, insurance, and other shipping expenses, as well as any special packing expense, shall be paid by Distributor. Distributor shall also bear all applicable taxes, duties, and similar charges that may be assessed against the Products after delivery to the carrier at Castelle's plant.

9. Payment Terms

9.1 Products

Payment by Distributor for all Products hereunder shall be by Telephonic Transfer ("TT") for payment in the United States to Castelle at a bank approved by Castelle.

Terms of payment shall be the 20th of each month for orders shipped in the previous month.

9.2 Past Due Accounts

In the event that Distributor's account is past due, Castelle may, ipso jure and without notice, charge and Distributor shall pay a finance charge equal to one and one-half percent (1 ½ %) per month, or the maximum amount allowed by law, whichever is less upon the unpaid balance. until the date of payment, provided, however, that no such finance charge shall be assessed on any invoice disputed in good faith by Distributor and for which Distributor has notified Castelle by confirmed telefax with in ten (10) days of receipt of invoice. Distributor shall pay all of Castelle's costs and expenses (including reasonable attorney's fees incurred in enforcing Castelle's right under Section 7.)

9.3 Taxes and Duties

The prices stated are exclusive of Taxes and Duties. Any Taxes and Duties related to this Agreement shall be paid by Distributor (other than a tax measured by Castelle's net income) or in lieu thereof. Distributor shall provide an exemption certificate of acceptable to the local taxing authorities. All Taxes and Duties shall be billed as a separate item on the invoice.

9.4 Withholding

In the event that any Government in the Territory shall require the withholding of any sums, however designated, which may be payable hereunder, there shall be added to amounts due the amount of such withholding, so that Castelle shall receive from Distributor the same and equal amount as it would have received with such withholding.

9.5 **Currency**

All prices and charges under this Agreement are stated and shall be paid in United States dollars. Distributor agrees to take all necessary actions required, including registration of this Agreement and appellation for permission to make payments to Castelle hereunder, with the appropriate government authorities of Distributor ' s jurisdiction, or such other institution or official, and to take such other measures as may be necessary to comply with any government currency controls in effect in Distributor ' s jurisdiction, as soon as reasonably practicable after execution of this Agreement.

9.6 **Currency Control**

Distributor represents and warrants that no currency control laws applicable in the Territory will prevent the payment to Castelle of any sums due under this Agreement.

10. **WARRANTY**

10.1 **Standard Limited Warranty**

Castelle grants to Distributor Castelle' s standard limited warranty for the Products, including the limitations set forth in Subsections 10.2 and 10.3 below. The Software and associated hardware will operate substantially in accordance with specifications (but no warranty of error free or uninterrupted use is made) for a period of one (1) year from the date of end-user installation. In addition, hardware components of the Product are warranted to be free from defect in materials and workmanship for a period of one year from the date of end-user installation. Any software or associated hardware which does not meet this warranty may be returned to Castelle for repair, replacement or refund at

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Castelle' s option. This warranty is contingent upon proper use of a Product in the application for which it was intended and does not cover Products that were modified without Castelle' s approval or that were subjected to unusual physical or electrical stress.

In consideration of the time required to ship, test and install the product at the customer site, the warranty period will be deemed to begin on the earlier of actual installation or ninety (90) days after product shipment to Distributor.

10.2 **No Other Warranty**

EXCEPT FOR THE EXPRESS WARRANTY SET FORTH ABOVE, CASTELLE GRANTS NO OTHER WARRANTIES, EXPRESS OR IMPLIED, BY STATUTE OR OTHERWISE, REGARDING THE PRODUCTS, THEIR FITNESS FOR ANY PURPOSE, THEIR QUALITY, THEIR MERCHANTABILITY, OR OTHERWISE.

10.3 **Limitation of Liability**

CASTELLE'S LIABILITY UNDER THE WARRANTY SHALL BE LIMITED TO A REFUND OF DISTRIBUTOR'S PURCHASE PRICE. IN NO EVENT SHALL CASTELLE BE LIABLE FOR THE COST OF PROCUREMENT OF SUBSTITUTE GOODS BY DISTRIBUTOR OR DISTRIBUTOR'S CUSTOMER FOR ANY SPECIAL, INDIRECT, CONSEQUENTIAL OR INCIDENTAL DAMAGES FOR BREACH OF WARRANTY OR FOR ANY LOSS OF DATA, PROFITS OR USE OF THE PRODUCT. THESE LIMITATIONS SHALL APPLY DESPITE THE FAILURE OF ESSENTIAL PURPOSE OF ANY LIMITED REMEDY.

11. **Patent Indemnification**

Castelle shall defend any claim, suit or proceeding brought against Distributor so far as it is based on a claim that the use of any products delivered hereunder infringes a U.S. patent or copyright, provided that Castelle is given prompt written notice of the claim, all necessary information and assistance and sole authority to defend or settle the claim and Castelle shall pay all damages and cost awarded against Distributor but shall not be responsible for any cost, expense or compromise incurred by Distributor without Castelle's prior written consent.

If any product is in Castelle's opinion likely to or does become the subject of a claim for patent infringement, Castelle may at its option and expense procure for Distributor the right to continue using the product, modify it so that it becomes non-infringing, or grant Distributor a credit for the purchase price of the product, as depreciated.

12. **LIMITATION ON LIABILITY**

In the event of termination by either party in accordance with any of the provisions of this Agreement, neither party shall be liable to the other, because of such termination, for compensation, reimbursement of damages on account of the loss of prospective profits or anticipated sales or an account of expenditures, inventory, investments, leases or commitment in connection with the business or goodwill of Castelle or Distributor. Termination shall not, however, either party of obligations incurred prior to the termination.

13. **LIMITATIONS OF REMEDIES**

The remedies provided herein are Distributor's sole and exclusive remedies.

DISTRIBUTOR FOR THE PARTICULAR PRODUCTS OR SERVICES WHICH ARE THE SUBJECT OF A SPECIFIC CLAIM. IN NO EVENT WILL CASTELLE BE LIABLE TO DISTRIBUTOR OR ANY THIRD PARTY INCLUDING, BUT NOT LIMITED TO ANY SUBSEQUENT PURCHASER OR USER OR ANY SALES REPRESENTATIVE OF ANY DAMAGES INCLUDING ANY LOST PROFITS, LOST SAVINGS OR OTHER INCIDENTAL, SPECIAL, INDIRECT, COVER OR CONSEQUENTIAL DAMAGES ARISING OUT OF THE USE OF OR INABILITY TO USE THE PRODUCT EVEN IF CASTELLE OR AN AUTHORIZED CASTELLE DISTRIBUTOR HAS BEEN APPRISED OF THE POSSIBILITY OF SUCH DAMAGES. THESE LIMITATION SHALL APPLY NOTWITHSTANDING THE FAILURE OF ESSENTIAL PURPOSE OF ANY LIMITED REMEDY.

14. **SALES SUPPORT MATERIALS**

Castelle will provide Distributor with an initial package of sales literature. Additional sales promotional literature and marketing materials will be available at a fee. Distributor will also pay shipping charges of these materials.

15 **TERMINATION**

This Agreement may be terminated ;

- (a) by either party in the event that either party ceases to function as a going concern or to conduct its operations in the normal course of business, or a receiver for it is appointed or applied for, or a petition under the Federal Bankruptcy Act is filed by or against it, or it makes an assignment for the benefit or creditors.
- (b) by Castelle, if Distributor assigns this Agreement or any of its rights hereunder, the word “assign” to include, without limiting the generality thereof, a transfer of a majority interest in Distributor or a sale of substantially all of the assets of the Distributor.
- (c) by either party, upon ninety (90) days written notice if the other party shall fail in any material respect to perform or observe any of its obligations hereunder (including the obligations in Section 11 regarding distribution of the warranty policy of Castelle and the obligations in Section 4 and Appendix B regarding minimum purchase requirements in the Territory) or fail to pay any amounts due and such party has failed to cure such default after receipt of written notice of such default.

Upon termination of the Agreement for other than Distributor’ s breach, Castelle shall continue to fill, subject to the terms of Sections 3, 4 and 5 above, all orders accepted by Castelle prior to the date of termination.

Upon termination of this Agreement, Distributor agrees to remove all references describing Distributor as a Distributor of Castelle products on brochures, advertisements and other printed materials, and to cease representing itself as the same.

16. PROPERTY RIGHTS AND CONFIDENTIALITY

16.1 Property Rights

Distributor agrees that Castelle owns all right, title, and interest in the product lines that include the Products and in all of Castelle' s patents, trademarks, trade names, inventions, copyrights, know-how and trade secrets relating to the design, manufacture, operation or service of the products.

16.2 Trade Mark

Subject to terms and conditions of this agreement, the Distributor shall use and is hereby authorized to use the same product names and other trademarks of which Castelle remains ownership as the company uses to market and identify the product.

16.3 Sale Conveys no Right to Manufacture or Copy

The Products are offered for sale and are sold by Castelle subject in every case to the condition that such sale does not convey any license, expressly or by implication, to manufacture, duplicate or otherwise copy or reproduce any of the Products, except as permitted in Subsection 12.1 above. Distributor shall take appropriate steps with its customers, as Castelle may request, to inform them of and assure compliance with the restrictions contained in this Subsection 17 (b).

16.4 Confidentiality

The Distributor and its employees shall not directly or indirectly, divulge or reveal to any person any information deemed confidential by Castelle without Castelle' s prior written consent. For purposes of this Agreement, the term "confidential information" shall mean information deemed proprietary to Castelle or not generally known in Castelle' s industry and disclosed by Castelle to the Distributor, or known to the Distributor as a consequence of this Agreement or actions taken pursuant hereto.

17. GENERAL

17.1 This Agreement shall be governed by the laws of the State of California as applied to contracts entered into and performance within that state by residents thereof. Distributor may not assign any of its rights under the Agreement without the express written consent of Castelle. All rights and remedies conferred under the Agreement shall be cumulative and may be exercised singularly or concurrently. This Agreement constitutes the entire agreement between the parties with respect to the subject mater hereof and shall supersede all previous writings and communications between the parties. No changes to these terms be binding unless expressly confirmed in writing by an authorized representative of Castelle. Failure by either party to enforce any Agreement term shall not be deemed a waiver of future enforcement of that or any other term.

17.2 Distributor agrees to comply with all applicable laws and regulations. Distributor understands that Castelle is subject to regulation by agencies of the U.S. Government,including the U.S. Department of Commerce and U.S. Department of Defense, which

prohibit export or diversion of Castelle' s Products to certain countries. Distributor warrants that it shall not sell any Products in countries or to users not approved to receive classified or sensitive technical equipment or data under applicable U.S. laws and regulations, and that it will abide by such laws and regulations. Distributor shall hold harmless and indemnify Castelle for any damages resulting to Castelle from a breach of this Section 18.2 by Distributor.

18. **SURVIVAL**

Sections 11 (Warranty), 12 (Patent Indemnification), 17 (Property Rights and Confidentiality) and Distributor' s obligations to pay for Products received will survive termination of this agreement.

IN WITNESS TIHEREOF, the parties have executed this Agreement by their duly authorized representatives.

CASTELLE

By

/s/ Donald L. Rich

Name (please print)

Donald L.Rich

Title

President, Chief Executive Officer

Date

May 31, 2001

DISTRIBUTOR

By

/s/ Haruki Kamiyama

Name (please print)

Haruki Kamiyama

Title

President

Date

May 22, 2001

AMENDED AND RESTATED INTERNATIONAL DISTRIBUTOR AGREEMENT

This Amended and Restated International Distribution Agreement (“Agreement”) is made and entered this 8th day of July, 2002 (“Effective Date”) by and between Castelle, Inc., a California corporation having its principal place of business located at 855 Jarvis Drive, Suite 100,, Morgan Hill, California 95037, U.S.A. (hereinafter referred to as “Castelle”), and AMS, Ltd., having its principal place of business located at Bournemouth, England (hereinafter referred to as “Distributor”). Castelle and Distributor are collectively referred to below as the “parties” and individually as a “party”.

WHEREAS, the parties have previously executed an International Distribution Agreement effective as of 24 April 2001 (the “Prior Agreement”); and

WHEREAS the parties now wish to modify and expand their relationship, and they have thus set forth the terms of their expanded relationship within this Agreement below, with the intent and desire that this Agreement shall replace and supercede the Prior Agreement;

NOW THEREFORE, the parties agree as follows:

1. APPOINTMENT OF DISTRIBUTOR AND TERRITORY

- 1.1 **Purpose.** The purpose of this Agreement is to appoint a Distributor to promote the sale of Castelle’ s Products set forth in Exhibit A in the Territory.
- 1.2 **Appointment.** Subject to the terms and conditions set forth herein, Castelle hereby appoints Distributor as Castelle’ s non-exclusive, authorized distributor for the Products to Customers in the Territory during the term of this Agreement, and Distributor hereby accepts such appointment. “Customers” means both Resellers and End Users in the Territory. “Resellers” means independent companies or persons who have the competence, training and resources to distribute the Products, and who Distributor contracts with for the distribution of the Products to other Resellers or End Users. “End Users” means the ultimate customer that acquires the Products for ordinary business or personal use and not for further distribution or resale.
- 1.3 **Territory.** The Distributor’ s Territory shall be as set forth within Exhibit B.
- 1.4 **Territorial Responsibility.** Distributor will pursue sales policies and procedures appropriate and sufficient to realize maximum sales potential for the Products in the Territory. Distributor will maintain sufficient inventory of the Products to provide competitive delivery schedules to Customers.

2. TERM OF AGREEMENT

- 2.1 **Initial Term.** This Agreement shall become effective on the Effective Date set forth above and shall continue for an initial term of one (1) year (“Initial Term”) subject to the terms and conditions set forth herein.
- 2.2 **Effective Date.** The Effective Date of this Agreement shall be the date it is signed as accepted by a duly authorized officer of Castelle.

2.3 Renewal of Agreement. This Agreement shall thereafter be renewed for successive periods of one year (each a “Renewal Term”), unless terminated by either party pursuant to the provisions of Section 15(“Termination”) below, or by notice, in writing, addressed to the other party, no less than 3 months prior to the expiration of the term, and no more than six (6) months prior to the expiration of the Initial term or Renewal Term as the case may be.

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3. PRICING

- 3.1 Distributor’ s Prices.** Subject to adjustments described herein, Distributor’ s prices for Products shall be based upon a percentage of the U.S. Suggested List Price attached hereto as Exhibit A. Castelle prices to Distributor shall not be greater than Castelle’ s prices to any other U.K. Distributor for the term of this Agreement. All prices are stated in U.S. dollars, F.O.B. Castelle, Morgan Hill, California, U.S.A.
- 3.2 Minimum Purchase Commitment.** The Minimum Purchase Commitment, set forth in Exhibit C, shall be the total purchase price, net of taxes, duties, transportation and other charges, which Distributor has committed to purchase in each Time Period and under the parameters as set forth and defined in Exhibit C of this Agreement. Castelle reserves the right, upon thirty (30) days prior written notice, based upon its review and valuation of the market, the Territory and the results achieved, to review and adjust the Minimum Purchase Commitment for the Time Period following the current fiscal quarter. In the event Distributor fails to meet the Minimum Purchase Commitment for any Time Period and/or the total annual commitment, Castelle may, at its sole option and without notice, either (i) upon thirty (30) days prior written notice, increase the base price to Distributor or (ii) terminate this Agreement.
- 3.3 Price Adjustments.** Castelle may change its prices set forth on Exhibit A attached hereto at any time, provided that no such price increase shall be effective until thirty (30) days after notice by Castelle to Distributor of such change. Price decreases may be effective immediately on the date of notification by Castelle. Price increases will not be applied to Product that does not ship within the thirty (30) day notice period as a result of any delays caused by Castelle. In addition, Castelle reserves the right to adjust Distributor’ s prices in the event that Distributor fails to meet the Minimum Purchase Commitments set forth in Exhibit C. All price adjustments shall apply to Products ordered, but not shipped, after the effective date of such change.
- 3.4 Price Protection.** In the event Castelle should lower its Product prices to Distributor, Castelle will grant Distributor a price protection credit to be applied against future orders equal to Distributor’ s net unit price difference between the higher and lower price on all new, unsold eligible Products in Distributor’ s inventory that Castelle has shipped to Distributor within ninety (90) days before the effective date of the price reduction.
- 3.5 Product List Price in Distributor’ s Territory.** Castelle and Distributor agree that it is in both parties best interests that the End User prices for the Products quoted by the Distributor, or offered to or by Distributor’ s Resellers, in the Territory be competitive to motivate and promote

purchases by end users of Castelle Products. Castelle has provided Distributor with Castelle's U.S. Suggested List Price for Castelle Products in Exhibit A. Distributor shall exercise its best efforts to quote and promote Castelle's Suggested List Price in the currency of the Territory for sales to End Users. Distributor shall develop and set the prices to be offered for the Products to its Resellers in the Territory, and shall obtain Castelle's review of such prices prior to implementation and roll-out.

4. ORDERS

- 4.1 Purchase Orders.** Distributor shall purchase all Products hereunder by issuing written Purchase Orders to Castelle not less than thirty (30) days prior to Distributor's requested ship date identifying the Products to be purchased, the quantity, price, total Purchase Order price, shipping instructions, requested ship dates and any other special information. Distributor may place additional interim Purchase Orders at any time and with no notice requirement as the market demand may from time to time require. Castelle will use its commercially reasonable best efforts to comply with Distributor's Product shipment requirements for any orders submitted with short notice delivery requirements.
- 4.2 Acceptance of Purchase Orders.** Castelle, at its place of business in the U.S.A., or at any other place Castelle may select, may, at Castelle's option, accept or reject Distributor's Purchase Order within ten (10) days of Castelle's receipt thereof. Castelle intends to accept all Purchase Orders that are issued in

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conformance with the provisions of this Agreement. Acceptance of Purchase Orders shall be confirmed to Distributor by first class mail, telex or confirmed telefax.

- 4.3 Terms of Purchase Orders.** Distributor's Purchase Orders submitted to Castelle from time to time with respect to Products to be purchased hereunder shall be governed by the terms and conditions of this Agreement, and notwithstanding the content of Distributor's Purchase Order, this Agreement shall take precedence over such Purchase Orders, and any conflicting, inconsistent, or additional terms of Distributor's Purchase Order shall be null and void, and are hereby waived by Distributor.
- 4.4 Order Deferral, Cancellation and Modification.** Distributor may, by prior written notice to Castelle, defer and/or cancel delivery of a Purchase Order once without penalty, provided such notice is received by Castelle not less than ten (10) business days prior to the scheduled ship date for order cancellation and five (5) business days prior to the scheduled ship date for order deferrals. Distributor may not cancel or defer orders placed for immediate shipment.

5. DISTRIBUTOR REPORTS, FORECASTS AND MINIMUM INVENTORY

- 5.1 Reports and Forecasts.** Distributor shall submit to Castelle a three (3) month rolling forecast five (5) days before the end of each calendar month. In addition, Distributor shall within five (5) days after the end of each calendar month submit a written and electronic report to Castelle setting

forth the previous month's sales unit volume ("POS" data) and current inventory by Product model. POS data to be reported to Castelle on a monthly basis should include, at a minimum, "Product Number", "Product Description", "Serial Number", "Quantity", "Order Date", "Name of Company Sold To", "Country of Name of Company", "Reseller/End User". Service, software upgrades and support contracts should also be included in the POS report to include the above information as appropriate. Inventory data to be reported to Castelle on a monthly basis should include, at a minimum, "Product Number", "Product Description", "Serial Number", "Quantity", "Date Received", "Evaluation or Not". Failure to provide monthly sales unit volume and current inventory by Product model reports may forfeit the Distributor's right to claim price protection credit (reference section 3.4).

5.2 Inventory. Distributor shall, at all times, maintain minimum inventory levels of each Castelle Product sold by Distributor, sufficient to satisfy Distributor's and Customers' order demands, and shall use its best efforts to always have Castelle inventory on hand. Distributor shall maintain sufficient minimum inventory levels of each Castelle Product to satisfy the demands of the Territory.

6. PACKAGING, SHIPMENT, RISK OF LOSS AND ACCEPTANCE OF ORDERS

6.1 Packaging. All Products delivered pursuant to the terms of this Agreement shall be suitably packaged for shipment in Castelle's standard shipping cartons, marked for shipment to Distributor's address, and delivered to Distributor or its carrier agent. In the absence of shipping instructions from Distributor, Castelle shall ship via air freight and shall select the carrier.

6.2 Ship Dates. Shipping dates committed by Castelle require prompt receipt of all necessary documents from Distributor. Where existing priorities and schedules prevent strict compliance with requested ship dates, Purchase Orders will be scheduled as close as is practical to the requested ship date.

6.3 Shipment Terms. Shipments from Castelle shall be made Ex Works, Castelle's manufacturing plant, freight, duties and taxes collect, to distributor's address set forth on Distributor's Purchase Orders. In no event shall Castelle have any liability in connection with shipment, nor shall the carrier be deemed to be an agent of Castelle. Castelle shall not be liable for damages or penalty for delay in delivery or for failure to give notice of any delay.

6.4 Title and Risk of Loss. Risk of loss with respect to Products and Software shall pass from Castelle to Distributor upon delivery. Delivery shall be deemed made upon transfer of possession to the initial

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common carrier or Distributor's representative at Castelle's manufacturing plant. Transfer of ownership and title to the Products and Software shall pass from Castelle to Distributor only after payment in full by Distributor for the Products and Software ordered by Distributor and shipped by Castelle.

6.5 Acceptance. Distributor shall inspect all Products promptly upon receipt thereof at the ship-to location and may reject any Product that is defective. Any Product not properly rejected by Distributor shall be deemed accepted. To reject a Product, Distributor shall notify Castelle of its rejection, by telefax, within ten (10) days of receipt of the shipment, and request a Return Material Authorization (“RMA”) number. Distributor shall return the rejected Product(s), freight collect, in its original shipping carton with the RMA number displayed on the outside of the carton. Castelle may refuse to accept any Product that does not bear a valid RMA number on the carton. Rejected Product(s) must be shipped to arrive at Castelle no later than 60 days after the issuance of the RMA number; the RMA number will no longer be valid after that time.

7. PAYMENT

7.1 Products. Payment by Distributor for all Products hereunder shall be by Telephone Transfer (“TT”) for payment in the United States to Castelle at a bank approved by Castelle.

7.2 Distributor Credit and Payment Terms. Distributor shall complete Castelle’s Credit Application and apply for credit. Payment terms shall be net thirty (30) days. In the event that Distributor’s account is past due, Castelle may and without notice, charge and distributor shall pay a finance charge equal to one and one-half percent (1½%) per month, or the maximum amount allowed by law, whichever is less, upon the unpaid balance, until the date of payment, provided, however, that no such finance charge shall be assessed on any invoice disputed in good faith by Distributor and for which Distributor has notified Castelle by confirmed telefax within ten (10) days of receipt of invoice with a detailed explanation of the reason for the dispute. Distributor shall pay all of Castelle’s costs and expenses (including reasonable attorney’s fees) incurred in enforcing Castelle’s right under this Section 7.

7.3 Taxes and Duties. The prices stated are exclusive of Taxes and Duties. Any Taxes and Duties related to this Agreement shall be paid by distributor (other than a tax measured by Castelle’s net income) or in lieu thereof, Distributor shall provide an exemption certificate acceptable to the local taxing authorities. All Taxes and Duties shall be billed as a separate item on the invoice.

7.4 Withholding. In the event that any Government in the Territory shall require the withholding of any sums, however designated, which may be payable hereunder, there shall be added to amounts due the amount of such withholding, so that Castelle shall receive from Distributor the same and equal amount as it would have received without such withholding. No such withholding as described above shall become due as a result of actions taken by Castelle except as may be otherwise defined herein.

7.5 Currency. All prices and charges under this Agreement are stated and shall be paid in United States dollars. Distributor agrees to take all necessary actions required, including registration of this Agreement and application for permission to make payments to Castelle hereunder, with the appropriate government authorities of Distributor’s jurisdiction, or such other institution or official, and to take such other measures as may be necessary to comply with any government currency controls in effect in Distributor’s jurisdiction, as soon as reasonably practicable after execution of this Agreement.

8. LIMITED WARRANTY

8.1 Castelle Warranty. The Distributor shall provide and abide by Castelle’s warranty. Castelle warrants that it has the right and interest in the Products to make the sales and licenses contemplated herein. Castelle warrants the Products against defects in materials and/or

workmanship for one (1) year from purchase by the end-user customer or fifteen (15) months from Castelle' s initial shipment to Distributor, whichever is less. This warranty is contingent upon proper use of a Product in the application for which

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it is intended and is voided if Products are modified without Castelle' s approval or are subjected to unusual physical or electrical stress.

When a defective Product is returned, freight prepaid, validly to Castelle' s factory in Morgan Hill, California, U.S.A., during the warranty period, Castelle, at its sole option, shall repair or replace the defective Product at no charge. Castelle will furnish repair parts and replacement Products on an exchange basis. Such parts and replacement Products may be either reconditioned or new. After repair or replacement Castelle will return the Products, freight paid, promptly at its expense by a carrier or method of delivery of its choosing.

CASTELLE DOES NOT WARRANT THAT THE PRODUCTS OR SPARE PARTS SHALL OPERATE UNINTERRUPTED OR WITHOUT ERROR. THE WARRANTY SHALL BE VOID ON PRODUCTS WHICH HAVE BEEN SUBJECTED TO ABUSE, MISUSE, ACCIDENT, ALTERATION, NEGLIGENCE, UNAUTHORIZED REPAIR OR INSTALLATION. Castelle shall make the final determination as to the existence and cause of any alleged defect. Expendable items (such as lamps and fuses) are not warranted.

- 8.2 **No Other Warranty.** EXCEPT FOR THE LIMITED WARRANTY REFERENCED ABOVE, CASTELLE GRANTS NO OTHER WARRANTIES, EXPRESS OR IMPLIED, BY STATUTE OR OTHERWISE, REGARDING THE PRODUCTS, AND SPECIFICALLY DISCLAIMS ANY IMPLIED WARRANTY OF FITNESS FOR ANY PURPOSE, QUALITY, MERCHANTABILITY, OR OTHERWISE.

9. CHANGES, IMPROVEMENTS AND DISCONTINUANCE

- 9.1 **Changes and Improvements.** During the term of this Agreement, Castelle agrees to inform Distributor on a timely basis of changes and improvements in the Products' performance, serviceability, uses and applications. Castelle reserves the right to make any changes to the Products which it deems appropriate.
- 9.2 **Discontinued Product.** If during the term of this Agreement, Castelle discontinues a Product(s), Castelle agrees to provide Distributor with sixty (60) days prior written notice of Product' s discontinuance. Distributor may place an order for such discontinued Product(s) during the notification period for delivery within six (6) months after the end of such notice period, but Castelle' s acceptance of such orders shall be on an "as available" basis.

10. STOCK ROTATION

- 10.1 At the beginning of each calendar quarter during the term of this Agreement, Distributor may return one (1) consolidated shipment of Products to Castelle, freight prepaid, for credit against

future orders provided Distributor meets the following criteria: (i) the value of the returned Product(s) shall be no greater than the purchase value of the returned Product(s) based on Castelle' s then current Distributor Price List; (ii) all returned Products must be in their unopened, original packaging, be in new condition, be on Castelle' s currently available Product Price List and not have been abused or damaged; (iii) Distributor shall not return any Products for the same identical Product model; (iv) at the time of the return, Distributor must place an irrevocable Purchase Order with Castelle having a net value of not less than the value of the returned Product; (v) the total value of the returned Product shall not exceed 20% of the value of the previous quarter' s net shipments to the Distributor. Distributor shall request a Return Material Authorization ("RMA") number for the return of the Product(s). Distributor shall return the Product(s), in its original shipping carton with the RMA number displayed on the outside of the carton. Castelle may refuse to accept any Product that does not bear a valid RMA number on the carton. Product(s) must be shipped to arrive at Castelle no later than 60 days after the issuance of the RMA number; the RMA number will no longer be valid after that time.

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11. INTERNET WEB SITE AND PRODUCT DOCUMENTATION

- 11.1 **Castelle Web Site.** Castelle agrees to provide Distributor with a current copy and future updates of relevant portions of its Castelle U.S. web site to be replicated by Distributor in a format appropriate for the U.K. market.
- 11.2 **Distributor Web Site.** Distributor shall review and get approval from Castelle prior to making modifications to the Castelle U.S. web site for implementation in the U.K. market. Distributor web site may be listed as castelle.uk.co and have links to appropriate Castelle U.S. web pages such the technical support data base, product evaluation downloads, email newsletters, lead generation email blast tools, etc. Castelle also agrees that Distributor shall have access to the URL www.castelle.com/eu.
- 11.3 **Distributor Web Site Statistics and Information.** Distributor shall make available to Castelle information from its castelle.uk.co web site including page hits, leads generated and other information that may be deemed relevant.
- 11.4 **Product Documentation.** Castelle agrees to provide Distributor with a reasonable initial quantity of Castelle' s advertising and promotional materials and technical data related to the Products ("Product Documentation") at no charge. Distributor may purchase from Castelle any Product Documentation related to Castelle' s Products which it requires to promote such Products.
- 11.5 **Localization and Distribution of Product Materials.** Distributor shall use its best efforts to localize the Product Documentation for effective use within the various countries of the Territory.

12. TRAINING, SUPPORT AND SERVICES

- 12.1 **Services by Distributor.** Distributor shall train its Customers with respect to the Products sold. The services to be performed under this Agreement ("Services") shall be performed only

by specially and properly trained personnel of Distributor. Distributor will maintain sufficient inventory of the Products to provide competitive delivery schedules and satisfactory replacement services for DOA (“Dead-On-Arrival”) products to its Customers. DOA products are those that are on the current price list, and have failed within 30 days of shipment from the Distributor to the Distributor’s customer.

- 12.2 **Services by Castelle.** Castelle shall provide technical training for a reasonable number of Distributor’s personnel at no charge. Such personnel shall have the appropriate technical knowledge and English language skills to benefit from such training. In addition, Castelle shall provide periodic sales, service and installation training classes to Distributor at no charge. Sales and service training shall be held at such places and times as Distributor and Castelle shall mutually agree.
- 12.3 **Spare Parts.** Castelle agrees to provide spare parts for Products sold hereunder for a period of not less than one (1) year from the last date of shipment of such Product to Distributor. Spare parts shall be made available to Distributor at Castelle’s then current price in effect at the time Distributor orders such spare parts.
- 12.4 **Support by Castelle.** Castelle agrees to provide during the principal period from 06:00 to 17:00 Pacific Standard Time, Monday through Friday, excluding Castelle holidays, secondary technical support assistance to Distributor by telephone, telefax and Internet for problem identification and resolution.
- 12.5 **Support in Territory.** Distributor shall be responsible for supporting all Products which it distributes to its Customers. Distributor shall maintain support personnel sufficiently knowledgeable with respect to the Products to answer customer inquiries regarding the use and operation of the Products. Distributor shall ensure that all customer questions are initially addressed to and answered by Distributor.

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- 12.6 **Support Transition and Fees.** Distributor shall assume support responsibility for the current Castelle support contract customers in the Territory and provide support through the customer’s contract period without additional charge. Prior to the expiration of the support contract date Distributor shall renew the support agreement and bill, collect and receive all renewal fees.
- 12.7 **Support Policy.** Distributor shall follow U.S. support policy guidelines and provide similar support to its Customers, including its End User, VAR and Alliance Partner Customers.
- 12.8 **Reseller Management.** Upon the Effective Date of this Agreement, Distributor shall take over the management, Support and Services of resellers who are currently purchasing Products directly from Castelle within the Territory, whether those resellers are under contract to Castelle or not (“Castelle Resellers”). Instead of and in the place of Castelle, Distributor will provide all necessary Services, support, management, sales guidance and assistance for Castelle Resellers. Distributor will also be responsible for such services and support to current Resellers of Distributor, and Resellers appointed by Distributor in the future. Distributor and Castelle will

coordinate their efforts to optimize Distributor's ability to accomplish a smooth and orderly transition for Castelle Resellers. Distributor shall report to Castelle and otherwise keep Castelle informed with information regarding all Resellers it manages, and its progress in effecting the transition of Castelle Resellers.

13. TRADEMARKS AND TRADENAMES

- 13.1 **License.** During the term of this Agreement, Distributor shall have the right to indicate that it is an Authorized Castelle Distributor. Distributor shall also have the right to use Castelle's Trademarks for the purpose of (i) localizing Product Documentation within the various countries of the Territory, and (ii) advertising and distributing Product Documentation in the sale or marketing of Products in the Territory consistent with Distributor's requirements hereunder, provided, however, that any Product Documentation created by or for Distributor or its Resellers shall be reviewed and approved by Castelle prior to adoption and use. Nothing herein shall grant to Distributor any right, title or interest in the Trademarks, except as specifically set forth herein.
- 13.2 **No Registration.** At no time during or after the term of this Agreement shall Distributor attempt or assist others to register any trademarks, slogans, designs or trade names confusingly similar to those of Castelle, or challenge or assist others to challenge Castelle's Trademarks or registrations thereof.
- 13.3 **No Removal.** Distributor shall not remove, alter, deface or otherwise obscure any Castelle trademark or trade name appearing on any Product or documentation without the express written permission of Castelle.
- 13.4 **Approval of Representations.** All representations of Castelle Trademarks which Distributor intends to use shall be first submitted to Castelle for approval (which shall not be unreasonably withheld) of design, color and other details or shall be exact copies of those used by Castelle. Distributor shall use all Castelle Trademarks only in accordance with the sales of Castelle Products and consistent with Castelle's standards for the use of Castelle Trademarks by the Distributor.

14. PROMOTION

- 14.1 **Distributor Promotion.** Distributor agrees to undertake during the term of the Agreement such promotion and advertising campaigns and marketing strategies, including advertising in local trade media, direct mail campaigns, Internet marketing and trade show participation, as are necessary to stimulate and promote the sale of the Products in the Territory. Distributor will make available to Castelle copies of all sales literature, brochures and advertising media relating to the Products.
- 14.2 **Distributor Focus.** Distributor has been a successful VAR in the territory and understands it needs to focus on expanding the business through strong promotion and support to other resellers, some of whom

may be viewed at times as competitors. A cooperative balance needs to be established between “Castelle U.K.”, AMS and other Resellers.

- 14.3 **Cooperative Promotion Allowance.** Subject to Distributor stocking Products at satisfactory levels, fulfilling Minimum Purchase Commitments under Section 3.2 hereinabove on a run-rate basis, and otherwise complying with the terms and conditions of this Agreement, Castelle agrees to allocate 2% of the previous quarters net sales as a product promotion allowance. Distributor shall submit proposed promotion materials and projects to Castelle for review prior to any initial release. Upon receipt of reasonable evidence of such promotion expenditures, Castelle will credit the amount against Distributor purchases.
- 14.4 **Other Market Development Funds.** Castelle may, from time to time at its own discretion, provide additional funding, on a split-the-cost basis, for other market development projects. Approval and credit procedures would be the same as for the Cooperative Promotion Allowance.

15. TERMINATION

- 15.1 **Termination for Insolvency.** To the extent permitted by law, Castelle may terminate this Agreement effective immediately and without liability upon written notice to Distributor if any one of the following events occurs: (i) Distributor files a voluntary petition in bankruptcy or otherwise seeks protection under any law for the protection of debtors; (ii) a proceeding is instituted against Distributor under any provision of any bankruptcy, insolvency or debtor's relief law which is not dismissed within sixty (60) days; (iii) a court assumes jurisdiction of the assets of Distributor; (iv) a trustee or receiver is appointed by a court for all or a substantial portion of the assets of Distributor; (v) Distributor becomes insolvent is unable to or ceases to pay its debts in the normal course, or suspends business, or (vi) Distributor makes an assignment of its assets for the benefit of its creditors.
- 15.2 **Termination for Cause.** If either party fails to perform any material obligation under this Agreement, including, in the case of Distributor, the failure to meet the Minimum Purchase Commitments set forth in Exhibit C, then upon thirty (30) days written notice to the breaching party specifying such default, the non-breaching party may terminate this Agreement, without liability, unless: (i) the breach specified in the notice has been cured within the thirty (30) day period; or (ii) the default is not of an urgent nature in the sole discretion of the nonbreaching party and reasonably requires more than thirty (30) days to correct (and specifically excluding any failure to Minimum Purchase Commitments or pay money), and the defaulting party has, in the reasonable judgment of the nonbreaching party begun substantial corrective action to correct the default within such thirty (30) day period and diligently pursues such action, in which event, termination shall not be effective unless ninety (90) days has expired from the date of the notice without corrective action being completed and the default remedied.
- 15.3 **Termination for Convenience.** Either party may terminate this Agreement for their convenience following the Initial Term by providing the other party with sixty (60) days prior written notice.
- 15.4 **Effect of Termination.**
- (a) Distributor's Rights and Responsibilities. Upon termination or cancellation of this Agreement Distributor shall have no further right to purchase Products for resale or to represent itself as an Authorized Castelle Distributor except as specifically permitted in Paragraph 15.4 (b) below. All unshipped orders shall be cancelled by Castelle without liability. Distributor shall, within ten

(10) business days after termination, pay all outstanding and unpaid invoices issued by Castelle, less the costs of Products to be returned to Castelle to the extent authorized under Section 15.4 (b) herein below.

(b) Inventory. Distributor may, unless notified otherwise in writing on or before the effective date of termination, sell its remaining inventory of the Products after termination of this Agreement. In the event that Distributor should elect not to sell its remaining inventory, Castelle may, at its sole

Exhibit 10.16

discretion, repurchase Distributor's inventory which is fit, merchantable and in Castelle's original shipping carton at Castelle's then current U.K. Distributor prices, less the aggregate amount of all credits previously issued with respect to such Products. Castelle shall promptly inspect all Products returned by Distributor and shall advise Distributor of any Product that is damaged and not acceptable to Castelle for repurchase.

16. LIMITED LIABILITY

IN NO EVENT SHALL CASTELLE'S TOTAL LIABILITY HEREUNDER EXCEED THE AMOUNT PAID BY DISTRIBUTOR FOR PRODUCTS HEREUNDER, AND IN NO EVENT SHALL CASTELLE BE LIABLE FOR COSTS OF PROCUREMENT OF SUBSTITUTE GOODS OR SERVICES BY ANYONE, OR FOR ANY SPECIAL CONSEQUENTIAL, INCIDENTAL OR OTHER DAMAGES, HOWEVER CAUSED, WHETHER FOR BREACH OF CONTRACT, NEGLIGENCE OR OTHERWISE, AND WHETHER OR NOT CASTELLE HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGE. THIS LIMITATION SHALL APPLY NOTWITHSTANDING ANY FAILURE OF ESSENTIAL PURPOSE OF ANY LIMITED REMEDY PROVIDED HEREIN.

17. INDEMNITY

- 17.1 **Indemnity by Castelle.** Subject to the restrictions set forth in this Paragraph, Castelle agrees to defend and indemnify Distributor from and against all actions or proceedings brought against Distributor arising out of any actual or alleged infringement by the Products of any patent, copyright, trade secret or other intellectual property right.
- 17.2 **Distributor Obligations.** Distributor shall promptly notify Castelle of any claim hereunder upon becoming aware of the same and shall cooperate with and provide all reasonable assistance to Castelle upon Castelle's request and, at Castelle's expense, in the defense or settlement of such claim. Castelle shall have sole authority to defend and/or settle any claim under this Paragraph, provided, however, that Distributor may at its own cost, retain separate representation.
- 17.3 **Remedy for Infringement.** If any Product, or any portion thereof, is finally adjudged to infringe a patent, copyright, trade secret or other intellectual property right, or if in Castelle's opinion is likely to become the subject of such a claim, Castelle shall, at its option, either: (i) procure for Distributor the right to continue using the Product(s); or (ii) replace or modify the Product(s) so that it becomes non-infringing; or (iii) upon return of all infringing Product(s), refund to

Distributor the price actually paid by Distributor for the infringing Products; or (iv) substitute for the infringing Products(s) other suitable, non-infringing equipment.

17.4 **Entire Liability.** THE FOREGOING PROVISIONS OF THIS SECTION 17 STATE THE ENTIRE LIABILITY AND OBLIGATIONS OF CASTELLE AND THE EXCLUSIVE REMEDY OF DISTRIBUTOR WITH RESPECT TO ANY ALLEGED INTELLECTUAL PROPERTY RIGHT INFRINGEMENT BY THE PRODUCTS.

17.5 **Indemnity by Distributor.** Distributor agrees to indemnify, defend and hold harmless Castelle from claims, losses, costs and liabilities arising out of the acts, omissions, Services, and sales of Distributor and its Customers. Castelle will promptly notify the Distributor of any such claims, losses, costs and liabilities, render reasonable assistance as required, and subject to Distributor selecting competent counsel and skillfully protecting Castelle hereunder in Castelle' s sole discretion, Castelle will permit the Distributor to direct the defense or settlement negotiations, and subject to Castelle' s approval of settlement details, to actually settle such claims.

18. GENERAL TERMS AND CONDITIONS

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18.1 **Notices.** All notices and requests required or authorized hereunder shall be given in writing either by personal delivery, by registered or certified mail, return receipt requested, or by telefax. Such notice shall be deemed to have been given upon such date that it is so personally delivered; the date seven (7) days after it is deposited in the mail; or the date the same is sent by telefax, irrespective of the date appearing therein.

18.2 **Title.** Castelle warrants that is owns all right, title and interest in the Products, including any Products hereafter made subject to this Agreement, and in all of Castelle' s patents, trademarks, trade names, inventions, copyrights, know-how and trade secrets relating to the design, manufacture, operation or service of the products. Distributor understands and agrees that the use of any of these proprietary rights is authorized solely for the purposes set forth herein, and shall cease upon termination or expiration of this Agreement.

18.3 **Confidentiality and Proprietary Information.**

(a) Confidential relationship. The parties agree and understand that by execution of this Agreement a confidential relationship is created by which either party may have access to confidential information owned or controlled by the other (including, but not limited to, all drawings, blueprints, descriptions, specifications, software, and data) disclosed in any form whether written, oral or on computer readable medium, and such information may contain proprietary details and disclosures ("Confidential Information").

(b) Duty. Each party shall keep and have its agents and employees keep all Confidential Information confidential and shall not copy or disclose the same except as specifically authorized by this Agreement, without the prior written consent of the other. Nothing herein shall limit either party' s use or dissemination of information not derived from the disclosing party or which has

been or is subsequently made public by the disclosing party or a third party with the authority to do so. Upon expiration or termination of this Agreement, each party shall return to the other all copies of all Confidential Information, whether printed or otherwise.

(c) Reverse engineering. Distributor agrees and covenants that it will not disassemble or reverse engineer any Product or portion thereof. No right or license is granted by this Agreement to Distributor to use Confidential Information or information derived from Confidential Information, for any purpose other than as expressly permitted under this Agreement.

18.4 **Export**. The parties agree and understand that all obligations of Castelle to deliver, and of Distributor to accept, Products hereunder shall be specifically subject to Castelle obtaining the necessary approvals and licenses from the United States Government for export of the same. Castelle agrees to use its best commercially reasonable efforts, and Distributor agrees to cooperate in providing information and assistance requested by Castelle to obtain any such necessary approvals.

18.5 **Foreign Law Warranties and Obligations.**

(a) Government consent. Distributor represents and warrants that, as of the date of this Agreement, no consent, approval or authorization of, or designation, declaration or filing with, any governmental authority in the Territory, including the E. C. Commission, which has not been made or obtained by Distributor prior to the date hereof, is required in connection with the valid execution, performance and delivery of this Agreement. Alternatively, if any such actions are required, Distributor agrees to use its best efforts to obtain such consent, approval or authorization and agrees to comply with all applicable laws in its performance under this Agreement.

(b) Import and export control. Distributor understands and acknowledges that Castelle is subject to regulation by agencies of the U.S. government, including the U.S. Department of Commerce, which prohibit export or diversion of certain products and technologies to certain countries. Any and all obligations of Castelle to provide technical information, technical assistance, any media in which any of the foregoing is contained, training and related technical data (collectively "Data") shall be

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subject in all respects to such United States laws and regulations as shall from time to time govern the license and delivery of technology and products abroad subject to the jurisdiction of the United States, including the Export Administration Act of 1979, as amended, any successor legislation, and the Export Administration Regulations issued by the U.S. Department of Commerce, Bureau of Export Administration. Distributor warrants that it will comply in all respects with the export and reexport restrictions set forth in the export license (if necessary) for every item shipped from Castelle and will otherwise comply with the Export Administration Regulations or other United States laws and regulations in effect from time to time.

(c) Representations of Distributor. Without in any way limiting the provisions of this Agreement, Distributor agrees that, unless prior written authorization is obtained from the U.S. Department

of Commerce, Bureau of Export Administration, it will not resell, export or reexport, either directly or indirectly, any Product, or any portion thereof, to country groups Q,S,W,Y, or Z (as defined in the Export Administration Regulations and which currently consists of Albania, Bulgaria, Cambodia, Cuba, Czechoslovakia, Estonia, Hungary, Laos, Latvia, Libya, Lithuania, Mongolia People' s Republic, North Korea, Poland, Romania, the (former) Union of Soviet Socialist Republics and Vietnam), or Afghanistan or the People' s Republic of China any of the Data (if the direct products are commodities, software, or technical data described on the Control List with a letter "A" following its Export Control Number).

- 18.6 **Independent Contractors.** The relationship of Castelle and Distributor established by this Agreement is that of independent contractors, and nothing contained herein shall be construed to (i) give either party the power to direct and control the day-to-day activities of the other; (ii) constitute the parties as partners, joint venturers, co-owners or otherwise as participants in a joint or common undertaking; or (iii) allow Distributor to create or assume any obligation on behalf of Castelle for any purpose whatsoever. All financial obligations associated with Distributor' s business are the sole responsibility of Distributor. All sales and other agreements between Distributor and its customers are Distributor' s exclusive responsibility and shall have no effect on Distributor' s obligations under this Agreement. Distributor shall be solely responsible for, and shall indemnify and hold Castelle harmless from all claims, damages or lawsuits (including Castelle' s attorney' s fees) arising out of the acts of Distributor, its employees or its agents.
- 18.7 **Force Majeure.** Except for the obligation to pay money properly due and owing, either party shall be excused from any delay or failure in performance hereunder caused by reason of any occurrence or contingency beyond its control, including, but not limited to, an act of God, earthquake, labor disputes, riots war, civil insurrection, expropriation, novelty of product manufacture or other unanticipated manufacturing problems, governmental requirements, inability to secure materials on a timely basis, and transportation difficulties. The obligations and rights of the party so excused shall be extended on a day-to-day basis for the time period equal to the period of such excusable delay. In order to obtain a suspension under this Paragraph, the party delayed shall send written notice of the delay and the reason therefore to the other party within seven (7) days from the time the party delayed knew of the cause of such delay.
- 18.8 **Arbitration.** With the exception of injunctive relief sought by Castelle, and actions for violations of Section 18.3 ("Confidentiality and Proprietary Information"), Section 18.5 ("Foreign Law Warranties and Obligations") or disputes otherwise involving Distributor' s use of Castelle' s Intellectual Property Rights, any dispute or claim arising out of, in relation to, or in connection with this Agreement, or the interpretation, making, performance, breach or termination thereof, shall be finally settled by binding arbitration in Santa Clara, California under the Commercial Arbitration Rules of the American Arbitration Association ("AAA") by three arbitrators appointed in accordance with said AAA Rules. Judgment on the award rendered by the arbitrators may be entered in any court having jurisdiction thereof.
- 18.9 **Governing Law.** This contract shall be governed by the law of the state of California and not by any terms of the Convention in Contracts for International Sales of Goods. Arbitrators shall apply California

law to the merits of any dispute or claim, without reference to rules of conflict of law. Arbitration proceedings shall be governed by the AAA Rules, without reference to state arbitration law.

- 18.10 **Survival of Certain Terms.** The provisions of Paragraphs 8 [Limited Warranty], 13.2 [No Registration], 17 [Intellectual Property Right Indemnity], and 18 [General Terms and Conditions], shall survive the expiration or termination for any reason of this Agreement.
- 18.11 **Waiver.** Any waiver of any right or remedy under this Agreement must be in writing and signed by the party to be bound to be effective. No delay or omission in exercising any right or remedy shall operate as a waiver of such right or remedy or any other right or remedy. A waiver on any one occasion shall not be construed as a waiver of any right or remedy on any future occasion.
- 18.12 **Assignment.** Any assignment of this Agreement, or any of the rights hereunder, either voluntarily or by operation of law, by Distributor shall be void without the joint, prior written consent of Castelle and Distributor.
- 18.13 **Severability.** If any provisions or portion thereof of this Agreement is held to be unenforceable or invalid, the remaining provisions and portions thereof shall nevertheless be given full force and effect, and the parties agree to negotiate in good faith, a substitute valid provision which most nearly effects the parties' intent in entering into this Agreement.
- 18.14 **Language.** This Agreement shall be construed and interpreted in English, and any translation hereof to a language other than English shall be for convenience only.

19. ENTIRE AGREEMENT

This Agreement together with the Exhibits attached hereto, constitutes the entire agreement between the parties with respect to the subject matter hereof, taking precedence over and superseding the Prior Agreement entered by the parties as of April 24, 2001, and any other prior or contemporaneous oral or written agreements or understandings. No subsequent alterations, amendments, or additions hereto shall be binding and valid unless reduced to writing and signed by both parties hereto.

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date indicated below:

CASTELLE INCORPORATED

AMS Ltd.

By: /s/ Scott C. McDonald

By: /s/ Dennis Buller

Name: Scott C. McDonald

Name: Dennis Buller

Title: President & CEO

Title: Director

Date:

Date:

EXHIBIT A**PRODUCTS & PRICES****Distributor Price equal to 65% of U.S. Price List MSRP****The Products and U.S. Price List and the U.K. Price List are Included in Attachments 1 and 2 to this Exhibit A**

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ATTACHMENT 1 TO EXHIBIT A
Products and U.S. Price List

FaxPress Network Fax Servers

FaxPress Small Business Edition (SBE), 2500, 5000, 7000 & 7500 Fax Server Integrated network fax servers for Windows NT/2000/Terminal Server, NetWare, Linux

Part Number	Description	MSRP
6629860-1109	Small Business Edition (SBE) Ethernet 8MB memory 1 line 14.4 Kbps	\$ 1495
6629860-1100	FaxPress 2500† Ethernet 8 MB memory 2 lines 14.4 Kbps New!!Reform for FaxPress Software Included with FP5000/7000/7500	\$ 2995
6629860-1055	FaxPress 5000† Ethernet 16MB memory 4 lines 14.4 Kbps	\$ 5995
6629860-1056	FaxPress 5000† Ethernet 32MB memory 8 lines 14.4 Kbps	\$ 7995
6629860-1136	FaxPress 7000† Ethernet 10/100Base-T 32MB memory 8 lines Rackmount	\$ 8495
6629860-1146	FaxPress 7500† Ethernet 10/100Base-T 32MB memory 8L Fax/4L E&M RM	\$ 9995

† FaxPress 2500, 5000, 7000 and 7500 models come with software version 6.x PRO, and include a choice of Exchange Direct, Exchange Connector, or SMTP gateway. The 5000, 7000 and 7500 models now also include Reform for FaxPress software.

FaxPress PRO†† Software for Small Business Edition (SBE)

New Features Include: Single Sign On, Archive, ODBC Phone Books, Fax Approval, Multiprotocol, SNMP Plus choice of Exchange Direct, Exchange Connector or SMTP Gateway

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1084	FaxPress v6.x Basic to v6.x PRO with E-Mail Gateway†††	\$ 495

FaxPress Add-Ons & Upgrades

FaxPress Software Upgrades to v6.x PRO††

New Features Include: Single Sign On, Archive, ODBC Phone Books, Fax Approval, Goldmine, Multiprotocol, SNMP

NOTE: FaxPress 6.x software upgrades can only be sold to customers having FaxPress models 1500N, 3500, OfficeConnect, SBE, 2500, 5000, 7000 or 7500. The purchase of a software upgrade does not entitle the buyer/customer to any support on the FaxPress hardware. In cases where the hardware needs to be upgraded in order to run the new software (including upgrades necessitated by failures that can occur in the flashing of Boot PROM's or modifying of EEPROM's), the cost of the hardware upgrade is the responsibility of the customer - it is not included in the cost of the software. Customers that desire both software and hardware support should investigate Castelle's Extended Support Agreement. Please contact your Castelle Sales Representative for details.

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1095	FaxPress v3.7.3 Upgrade to v6.x PRO with E-Mail Gateway†††	\$ 1990
6629860-1096	FaxPress v4.x Upgrade to v6.x PRO with E-Mail Gateway†††	\$ 1690
6629860-1097	FaxPress v5.x Upgrade to v6.x PRO with E-Mail Gateway††	\$ 1490
6629860-1081	FaxPress v3.7.3 Upgrade to v6.x PRO without E-Mail Gateway	\$ 995
6629860-1082	FaxPress v4.x Upgrade to v6.x PRO without E-Mail Gateway	\$ 695
6629860-1083	FaxPress v5.x Upgrade to v6.x PRO without E-Mail Gateway	\$ 495

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†† Certain features contained in v6.x PRO are activated with a “key code” that is based on the serial number of the FaxPress unit that it will be loaded onto. The serial number will be required when ordering.

††† Purchase of this software upgrade includes choice of Exchange Direct, Exchange Connector or SMTP gateway. Please indicate your choice when ordering.

FaxPress Hardware Upgrades

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
66298600-878	FaxPress 1500/1500-N 1-line Upgrade Kit	\$ 6257
66298600-850	FaxPress 3000/3500 2-line Upgrade Kit	\$ 995
6629860-1049	FaxPress 5000 4-line Upgrade Kit	\$ 2495

FaxPress Software Add-Ons for 5.x and 6.x

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
6629860-1006	FaxPress OCR Software (for v5.x or higher)	\$ 595
6629860.1002	FaxPress cc:Mail 6.x Gateway, Windows Version (for v5.x or higher)	\$ 995
6629860-1092	FaxPress 6.x Lotus Notes Gateway, Windows NT only†	\$ 995
6629860-1099	FaxPress 6.x SMTP Gateway (Windows NT only) †	\$ 995
6629860-1033	FaxPress Exchange Direct Software (for v5.x or higher)†	\$ 995
6629860-1134	FaxPress Exchange Connector Software (for 6.2 SP1 or higher)†	\$ 995
6629660-1152	Reform for FaxPress (for 6.2 SP2 or higher) †† (<i>New!</i>)	\$ 250

† This software is activated with a “key code” that is based on the serial number of the FaxPress unit that it will be loaded onto. The serial number will be required when ordering. For Exchange Direct, please specify your current FaxPress software revision also.

†† This software is activated with a “key code” that is based on the “seed number” of the Reform Software. After installing Reform, you can find the seed number by clicking “Help” and then the “Register” button in the Form Designer.

LANpress Network Print Servers

LANpress MP - High-performance, multi-protocol external print servers

Supports Windows NT, Windows 95, Windows for Workgroups, NetWare 2.x/3.x/4x (NDS), AppleTalk & UNIX

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1108	LANpress Jr. 10/100 Ethernet 10/100Base-T	\$ 199
6629660-1072	2000 2+1 Ethernet 10/100Base-T 2 parallel + 1 serial	\$ 339
66298600-955	LANpress 3P/1 00 Ethernet 10/100Base-T 3 parallel	\$ 345
6629860-1042	LANpress Jr. MP Ethernet 10Base-T	\$ 149
6629860-1154	LANpress 2P Wireless (<i>New!</i>)	\$ 395

OfficeDirect Server Appliances

OfficeDirect Storage and Message Servers

Plug-and-forget server appliances that bring internet and inter-office e-mail and fax communications to small and medium-sized companies

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1130	OfficeDirect Storage Server	\$ 995
6629860-1124	OfficeDirect Message Server	\$ 995

InfoPress Information Delivery Solutions

-Universal document access and delivery via phone, fax, e-mail and the Web

InfoPress Fax-On-Demand for Fax Press

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
117-IP/FaxPress	2 voice and 1 Fax Port Licenses plus ProLine2V, 2 Port Voice Card	\$ 3289

InfoPress Fax-On-Demand Starting Bundles (includes FaxPress Integration Software)

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-HSEBundle	InfoPress Fax-On-Demand, 2x1 Hardware/Software Kit w/Email-On-Demand	\$ 5489
117-HSBundle	InfoPress Fax-On-Demand, 2x1 Hardware/Software Kit	\$ 4389
117-Sbundle	InfoPress Fax-On-Demand, 2X1 Software	\$ 3289

InfoPress Additional Software Licenses

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-V	InfoPress Software License, Voice (price per line)	\$ 1425
117-F	InfoPress Software License, Fax (price per line)	\$ 1425

InfoPress Email-On-Demand Enterprise Edition

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-EMOD1	InfoPress Email-On-Demand, Enterprise Edition, single address	\$ 1095
117-EMOD25	InfoPress Email-On-Demand, Enterprise Edition, 25 addresses	\$ 5495
117-EMOD100	InfoPress Email-On-Demand, Enterprise Edition, 100 addresses	\$ 8245
117-EMOD100+	InfoPress Email-On-Demand, Enterprise Edition, 100+ addresses	\$ 10995

ATTACHMENT 2 TO EXHIBIT A
U.K. Price List

FaxPress Network Fax Servers

FaxPress Small Business Edition (SBE), 2500, 5000, 7000 & 7500 Fax Server Integrated network fax servers for Windows NT/2000/Terminal Server, NetWare, Linux

Part number	Description	MSRP
6629860-1109	Small Business Edition (SBE) Ethernet 8MB memory 1 line 14.4 Kbps	£997
6629860-1100	FaxPress 2500† Ethernet 8MB memory 2 lines 14.4 Kbps <i>New!! Reform for FaxPress Software Included with FP5000/7000/7500</i>	£1997
6629860-1055	FaxPress 5000† Ethernet 16MB memory 4 lines 14.4 Kbps	£3997
6629860-1056	FaxPress 5000† Ethernet 32MB memory 8 lines 14.4 Kbps	£5330
6629860-1136	FaxPress 7000† Ethernet 10/100Base-T 32MB memory 8 lines Rackmount	£5663
6629860-1146	FaxPress 7500† Ethernet 10/100Base-T 32MB memory 8L Fax/4L E&M RM	£6663

t FaxPress 2500, 5000, 7000 and 7500 models come with software version 6.x PRO, and include a choice of Exchange Direct, Exchange Connector, or SMTP gateway.

FaxPress PRO†† Software for Small Business Edition (SBE)

New Features Include: Single Sign On, Archive, ODBC Phone Books, Fax Approval, Multiprotocol, SNMP

PART NUMBER	DESCRIPTION	MSRP
6629860-1084	FaxPress v6.x Basic to v6.x PRO with E-Mail Gateway†††	£330

FaxPress Add-Ons & Upgrades

FaxPress Software Upgrades to v6.x PRO††

New Features Include: Single Sign On, Archive, ODBC Phone Books, Fax Approval, Goldmine, Multiprotocol, SNMP

NOTE: FaxPress 6.x software upgrades can only be sold to customers having FaxPress models 1500N, 3500, OfficeConnect, SBE, 2500, 5000, 7000 or 7500. The purchase of a software upgrade does not entitle the buyer/customer to any support on the FaxPress hardware. In cases where the hardware needs to be upgraded in order to run the new software (including upgrades necessitated by failures that can occur in the flashing of Boot PROM's or modifying of EEPROM's), the cost of the hardware upgrade is the responsibility of the customer - it is not included in the cost of the software. Customers that desire both

software and hardware support should investigate Castelle's Extended Support Agreement. Please contact your Castelle Sales

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1095	FaxPress v3.7.3 Upgrade to v6.x PRO with E-Mail Gateway†††	£1327
6629860-1096	FaxPress v4.x Upgrade to v6.x PRO with E-Mail Gateway†††	£1127
6629860-1097	FaxPress v5.x Upgrade to v6.x PRO with E-Mail Gateway†††	£993
6629860-1081	FaxPress v3.7.3 Upgrade to v6.x PRO without E-Mail Gateway	£663
6629860-1082	FaxPress v4.x Upgrade to v6.x PRO without E-Mail Gateway	£463
6629860-1083	FaxPress v5.x Upgrade to v6.x PRO without E-Mail Gateway	£330

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†† Certain features contained in v6.x PRO are activated with a “key code” that is based on the serial number of the FaxPress unit that it will be loaded onto. The serial number will be required when ordering.

††† Purchase of this software upgrade includes choice of Exchange Direct, Exchange Connector or SMTP gateway.

FaxPress Hardware Upgrades

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
66298600-878	FaxPress 1500/1500-N 1-line Upgrade Kit	£417
66298600-650	FaxPress 3000/3500 2-line Upgrade Kit	£663
6629860-1049	FaxPress 5000 4-line Upgrade Kit	£1663

FaxPress Software Add-Ons for 5.x and 6.x

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1006	FaxPress OCR Software (for v5.x or higher)	£397
6629860-1002	FaxPress cc:Mail 6.x Gateway, Windows Version (for v5.x or higher)	£663
6629860-1092	FaxPress 6.x Lotus Notes Gateway, Windows NT only †	£663
6629860-1099	FaxPress 6.x SMTP Gateway (Windows NT only) †	£663
6629860-1033	FaxPress Exchange Direct Software (for v5.x or higher) †	£663
6629860-1134	FaxPress Exchange Connector Software (for 6.2 SP1 or higher)† (<i>New!</i>)	£663
6629860-1152	Reform for FaxPress (for 6.2 SP2 or higher)†† (<i>New!</i>)	£167

† This software is activated with a “key code” that is based on the serial number of the FaxPress unit that it will be loaded onto. The serial number will be required when ordering. For Exchange Direct, please specify your current FaxPress software revision also.

†† This software is activated with a "key code" that is based on the "seed number" of the Reform Software. After installing Reform, you can find the seed number by clicking “Help” and then the “Register” button in the Form Designer.

LANpress Network Print Servers

LANpress MP - High-performance, multi-protocol external print servers

Supports Windows NT, Windows 95, Windows for Workgroups, NetWare 2.x/3.x/4x (NDS), AppleTalk & UNIX

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1108	LANpress Jr. 10/100 Ethernet 10/100Base-T (<i>New!</i>)	£133
6629860-1072	LANpress 2000 2+1 Ethernet 10/100Base-T 2 parallel + 1 serial (<i>New!</i>)	£226
66298600-955	LANpress 3P/100 Ethernet 10/100Base-T 3 parallel	£230
6629860-1042	LANpress Jr. MP Ethernet 10Base-T	£99
6629860-1154	LANpress 2P Wireless	£263

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OfficeDirect Server Appliances

OfficeDirect Storage and Message Servers

Plug-and-forget server appliances that bring internet and inter-office e-mail and fax communications to small and medium-sized companies

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
6629860-1130	OfficeDirect Storage Server (<i>New!</i>)	£663
6629860-1124	OfficeDirect Message Server (<i>New!</i>)	£663

InfoPress Information Delivery Solutions

-Universal document access and delivery via phone, fax, e-mail and the Web

InfoPress Fax-On-Demand for Fax Press

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	<i>MSRP</i>
117-IP/FaxPress	2 voice and 1 Fax Port Licenses plus ProLine2V, 2 Port Voice Card	£2193

InfoPress Fax-On-Demand Starting Bundles (includes FaxPress Integration Software)

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-HSEBundle	InfoPress Fax-On-Demand, 2x1 Hardware/Software Kit w/Email-On-Demand	£3659
117-HSBundle	InfoPress Fax-On-Demand, 2x1 Hardware/Software Kit	£2926
117-Sbundle	InfoPress Fax-On-Demand, 2X1 Software	£2193

InfoPress Additional Software Licenses

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-V	InfoPress Software License, Voice (price per line)	£950
117-F	InfoPress Software License, Fax (price per line)	£950

InfoPress Email-On-Demand Enterprise Edition

<i>PART NUMBER</i>	<i>DESCRIPTION</i>	
117-EMOD1	InfoPress Email-On-Demand, Enterprise Edition, single address	£730
117-EMOD25	InfoPress Email-On-Demand, Enterprise Edition, 25 addresses	£3663
117-EMOD100	InfoPress Email-On-Demand, Enterprise Edition, 100 addresses	£5497
117-EMOD100+	InfoPress Email-On-Demand, Enterprise Edition, 100+ addresses	£7330

Exhibit 10.16

EXHIBIT B

Territory

Distributor's Territory shall be the "European Community", defined for the purpose of this Agreement as the countries set forth below. Castle shall have the right to revise the Territory upon thirty (30) days written notice in the event that Distributor fails to meet its Minimum Purchase Commitment, or Castle determines in its solereasonable discretion that Distributor has failed to adequately and effectively manage, support and provide Services to Resellers within the Territory.

Group 1	Group 2	Group 2 (Cont' d)
United Kingdom	Spain	Cyprus
Belgium	Denmark	Greece
Denmark	Finland	Monaco
France	Norway	
Germany	Portugal	
Ireland	Hungary	
Italy	Austria	
Netherlands	Portugal	

Exhibit 10.16

EXHIBIT C

Minimum Purchase Commitment

Distributor agrees to purchase Products equal to Distributor's prices at no less than US\$200,000 per calendar quarter (the "Time Period"), to be delivered in the same calendar quarter, excluding stock rotation purchases authorized within Section 10 hereinabove.

Exhibit 10.16

**ADDENDUM TO AMENDED AND RESTATED
INTERNATIONAL DISTRIBUTOR AGREEMENT**

This Addendum to the Amended and Restated International Distributor Agreement ("Agreement") is attached to and made a part of that certain Agreement, dated as of July 8, 2002, between Castelle, a California corporation having its principal place of business located at 855 Jarvis Drive, Suite 100, Morgan Hill, California 95037, U.S.A. ("Castelle") and AMS, Ltd., having its principal place of business located at Bournemouth, England ("Distributor"). References to the "Agreement" shall mean the Agreement as modified, amended and supplemented by the terms of this Addendum.

Castelle and AMS agree to the following changes and additions to the Agreement:

Section 18.5 (c) Representations of Distributor is modified and replaced by the following provisions:

Without in any way limiting the provisions of this Agreement, Distributor agrees that it will not resell, export or re-export, either directly or indirectly, any Product, or any portion thereof, to the embargoed destinations unless prior written authorization is obtained from a) the U.S. Department of Commerce Bureau of Industry and Security, U.S.A., to destinations as published in their then current Export Administration Regulations Part 746, which currently include Cuba, Libya, Iran, Iraq, Rwanda and the Federal Republic of Yugoslavia (Serbia and Montenegro, Bosnia-Herzegovina, Croatia, and Slovenia); b) the Department of the Treasury, Office of Foreign Assets Control, U.S.A., to destinations as published in their then current sanctions program, which currently include Balkans, Burma, Cuba, Iran, Iraq, Liberia, Libya, North Korea, Sierra Leone, Sudan, Taliban, Unita, and Yugoslavia; and c) the U.S. Department of Commerce Bureau of Industry and Security, U.S.A., to persons as

published in their then current Denied Persons List, EAR Part 764, Supplement 2, Specially Designated Nationals List, EAR Part 764, Supplement 3 and Entity List, EAR Part 744, Supplement 4.

Exhibit B Territory. Distributor' s Territory is modified to include Russia.

In all other respects, the terms of the original Agreement remain in full effect. However, if there is a conflict between this Addendum and the original Agreement, the terms of this Addendum will prevail.

Castelle

AMS, Ltd.

/s/ Scott C. McDonald

/s/ Dennis Buller

By: Scott C. McDonald

By: Dennis Buller

President & CEO

Director

Date: September 6, 2002

Date: March 9, 2002

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have issued our report dated March 27, 2007, accompanying the consolidated financial statements and schedule included in the Annual Report of Castelle on Form 10-K for the year ended December 31, 2006. We hereby consent to the incorporation by reference of said report in the Registration Statements of Castelle on Forms S-8 (File No. 333-75247, File No. 333-21845, and File No. 333-06083).

/s/ Grant Thornton LLP
San Francisco, CA
March 27, 2007

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, **SCOTT C. MCDONALD**, certify that:

I have reviewed this annual report on Form 10-K of Castelle;

- 1.
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2007

By: /s/ SCOTT C. MCDONALD

Scott C. McDonald

President and Chief Executive Officer

**CERTIFICATION PURSUANT TO
SECTION 302 OF THE
SARBANES-OXLEY ACT OF 2002**

I, **PAUL CHENG**, certify that:

1. I have reviewed this annual report on Form 10-K of Castelle;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 30, 2007

By: /s/ PAUL CHENG
Paul Cheng
Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Castelle (the "Company") on Form 10-K for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Scott C. McDonald, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Scott C. McDonald

Name: Scott C. McDonald

Title: President and Chief Executive Officer

Date: March 30, 2007

A signed original of this written statement required by Section 906 has been provided to Castelle and will be retained by Castelle and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Castelle (the "Company") on Form 10-K for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Paul Cheng, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Paul Cheng

Name: Paul Cheng

Title: Chief Financial Officer

Date: March 30, 2007

A signed original of this written statement required by Section 906 has been provided to Castelle and will be retained by Castelle and furnished to the Securities and Exchange Commission or its staff upon request.
