CASTELLE \CA\
Form 10-Q
May 14, 2002

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

FORM 10-Q

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

For the quarterly period ended March 31, 2002

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

Commission File Number: 0-220-20

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

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

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

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

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

Securities registered pursuant to Section 12(g) of the Act: COMMON STOCK, NO PAR VALUE

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

The number of shares of Common Stock outstanding as of May 7, 2002 was 4,744,795.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements that involve risks and uncertainties. The Company's operating results may vary significantly from quarter to quarter due to a variety of factors, including changes in the Company's product and customer mix, constraints in the Company's manufacturing and assembling operations, shortages or increases in the prices of raw materials and components, changes in pricing policy by the Company or its competitors, a slowdown in the growth of the networking market, seasonality, timing of expenditures and economic conditions in the United States, Europe and Asia. Words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Unless the context otherwise requires, references in this Form 10-Q to "we," "us," or the "Company" refer to Castelle. Readers are cautioned that the forward-looking statements reflect management's analysis only as of the date hereof, and the Company assumes no obligation to update these statements. Actual events or results may differ materially from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to the risks and uncertainties discussed herein, as well as other risks set forth under the caption "Risk Factors" below and in the Company's Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001.

PART I - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

CASTELLE
CONSOLIDATED BALANCE SHEETS
(unaudited)
(in thousands)

	March 31, 2002	Dece
Assets:		
Current assets:		
Cash and cash equivalents	$ 4,462	
Accounts receivable, net of allowance for doubtful accounts of $224 in 2002 and $206 in 2001	758	
Inventories, net	774	
Prepaid expense and other current assets	116	
Total current assets	6,110	
Property, plant & equipment, net	546	
Other non-current assets	108	
Total assets	$ 6,764	
Liabilities & Shareholders' Equity:		
Current liabilities:		
Long-term debt, current portion	$ 18	
Accounts payable	138	
Accrued liabilities	2,314	
Total current liabilities	2,470	
Long term debt, net of current portion	60	
Total liabilities	2,530	

Shareholders' equity:	
Common stock, no par value:	
Authorized: 25,000 shares	
Issued and outstanding: 4,745	28,976
Deferred compensation	-
Accumulated deficit	(24,742)
Total shareholders' equity	4,234
Total liabilities & shareholders' equity	$ 6,764

See accompanying notes to consolidated financial statements.

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

	Three months end
	March 31, 2002
Net sales	$ 2,368
Cost of sales	777
Gross profit	1,591
Operating expenses:	
Research and development	413
Sales and marketing	763
General and administrative	404
Restructuring charges	-
Total operating expenses	1,580
Income/(loss) from operations	11
Interest income, net	10
Other income, net	11
Income/(loss) before provision for income taxes	32
Provision for income taxes	-
Net income/(loss)	$ 32

Earnings per share:

Net income/(loss) per common share - basic	$ 0.01
Shares used in per share calculation - basic	4,745
Net income/(loss) per common share - diluted	$ 0.01
Shares used in per share calculation - diluted	4,774

See accompanying notes to consolidated financial statements..

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

	Three months ended	
	March 31, 2002	March 30
Cash flows from operating activities:		
Net income (loss)	$ 32	$
Adjustment to reconcile net income (loss) to net cash provided by/(used in) operating activities:		
Depreciation and amortization	54	
Provision for doubtful accounts and sales returns	111	
Provision for excess and obsolete inventory	(50)	
Compensation expense related to grant of stock options	-	
Loss on disposal of fixed assets	1	
Changes in assets and liabilities:		
Accounts receivable	(189)	
Inventories	202	
Prepaid expenses and other current assets	14	
Accounts payable	(142)	
Accrued liabilities	(132)	
Decrease in other assets	-	
Net cash used in operating activities	(99)	
Cash flows from investing activities:		
Return of restricted cash	-	
Acquisition of property, plant and equipment	(3)	
Net cash provided by/(used in) investing activities	(3)	
Cash flows from financing activities:		
Repayment of long-term debt	(4)	
Net cash used in financing activities	(4)	
Net decrease in cash and cash equivalents	(106)	

Cash and cash equivalents at beginning of period	4,568	3
Cash and cash equivalents at end of period	$ 4,462	$ 3

See accompanying notes to consolidated financial statements.

CASTELLE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Basis of Presentation and Significant Accounting Policies:

The accompanying unaudited consolidated financial statements include the accounts of Castelle and its wholly-owned subsidiaries in the United Kingdom and the Netherlands, and have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions have been eliminated. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated have been included. The results of operations for the interim period presented are not necessarily indicative of the results for the year ending December 31, 2001. Because all of the disclosures required by accounting principles generally accepted in the United States of America are not included in the accompanying consolidated financial statements and related notes, they should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Form 10-K and Form 10-K/A for the fiscal year-ended December 31, 2001. The year ended condensed balance sheet data was derived from our audited financial statements and does not include all of the disclosures required by accounting principles generally accepted in the United States of America. The income statements for the periods presented are not necessarily indicative of results that we expect for any future period, nor for the entire year. Prior year amounts have been reclassified to conform with current presentation.

The preparation of financial statements in conformity with generally accepted accounting principles 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.

The Company believes that its existing cash balances, anticipated cash flows from operations and available lines of credit will be sufficient to meet its anticipated capital requirements for the next 12 months. However, a decline in future orders and revenues might require us to seek additional capital to meet our working capital needs during or beyond the next twelve months if we are unable to reduce expenses to the degree necessary to avoid incurring losses. 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 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. 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 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.

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Revenue Recognition

Castelle recognizes revenue based on the provisions of Staff Accounting Bulletin ("SAB") No. 101 "Revenue Recognition in Financial Statements" and Statement of Financial Accounting Standards ("SFAS") No. 48 "Revenue Recognition When Right of Return Exists".

Product revenue is recognized upon shipment if a signed contract exists, the fee is fixed and determinable, collection of the resulting receivables is probable and product returns are reasonably estimable. Shipment generally occurs when product is delivered to a common carrier.

The Company enters into agreements with certain of its distributors which 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 the Company's products directly from Castelle also have limited return rights, which expire thirty days from the date of product shipment. Revenues subject to stock rotation rights are reduced by management's estimates of anticipated exchanges. Castelle establishes its returns allowance policy for distributors based on historic return rates from these distributors.

Pursuant to the Company's distributor agreements, the Company also protects its distributors' exposure related to the impact of price reductions. Price adjustments are recorded at the time products are shipped. Castelle estimates the impact of price reductions based on historical data from these distributors.

The Company recognizes revenue from the sale of extended warranty contracts ratably over the period of the contracts.

Castelle recognizes royalty on the sale of LANpress products by a Japanese distributor. Royalty is not recognized as revenue until the products are sold by the distributor.

Provisions for estimated warranty costs are recorded at the time products are shipped.

2. Accounting Changes

Effective January 1, 2002, Castelle has redefined its fiscal quarter and year end for financial reporting purposes to conform with calendar month ends, i.e., ending on March 31, June 30, September 30 and December 31. Previously, Castelle set its fiscal quarter as ending on the Friday of the thirteenth week into the quarter. Castelle believes that the financial numbers presented below have no significant impact for comparative purposes due to this change.

Effective January 1, 2002, Castelle implemented Emerging Issues Task Force No. 01-09, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products) ("EITF 01-09"), which requires that consideration paid by a vendor to a reseller should be classified on the vendor's income statement as a reduction of sales unless an identifiable benefit can be matched to the consideration, the benefit can be valued and the consideration does not exceed such value. Since Castelle was unable to clearly separate the benefits received from certain marketing development funds it paid to its resellers, these costs have been reclassified as a reduction of sales, and financial statements for prior periods presented for comparative purposes has been reclassified to comply with the new accounting standard. The effect of the implementation of this new accounting standard was a reduction of sales of $88,000 and $56,000 in the first fiscal quarters of 2002 and 2001, respectively, with an equivalent reduction in operating expenses. The new accounting standard has

no impact on the Company's operating margin, net income or earnings per share. The table below reflects the impact of this new accounting standard on fiscal 2001 revenues.

2001 SALES - RESTATED FOR EITF 01-09
(in thousands, unaudited)
QUARTER ENDED

	Mar 30	Jun 29	Sep 28	Dec 31	TOTAL YE
Sales:					
Original	$2,349	$2,370	$2,559	$2,342	$9,6
Restated	$2,293	$2,313	$2,500	$2,248	$9,3
Difference	($56)	($57)	($59)	($94)	($2

3. Net Income/(Loss) Per Share:

Basic net income/(loss) per share is computed by dividing net income/(loss) available to common shareholders by the weighted average number of common shares outstanding for that period. Diluted net income per share reflects the potential dilution from the exercise or conversion of other securities into common stock that were outstanding during the period. Diluted net loss per share excludes shares that are potentially dilutive as their effect is anti-dilutive. Shares that are potentially dilutive consist of incremental common shares issuable upon exercise of stock options and warrants.

Basic and diluted earnings per share are calculated as follows for first quarters of fiscal 2002 and 2001:

	(in thousands, except per share amounts) (unaudited)	
	March 31, 2002	March 30,
Basic:		
Weighted average common shares outstanding	4,745	4,7
Net income/(loss)	$ 32	$ (40
Net income/(loss) per common share - basic	$ 0.01	$ (0.0
Diluted:		
Weighted average common shares outstanding	4,745	4,7
Common equivalent shares from stock options	29	
Shares used in per share calculation - diluted	4,774	4,7
Net income/(loss)	$ 32	$ (40
Net income/(loss) per common share - diluted	$ 0.01	$ (0.0

The calculation of diluted shares outstanding excludes 1,235,000 and 1,314,000 shares of common stock issuable upon exercise of outstanding stock options at March 31, 2002 and March 30, 2001, respectively, as their effect was antidilutive in the periods.

4. Inventories:

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

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	(in thousands) (unaudited)	
	March 31, 2002	December 31, 2001
Raw material	$ 220	$ 295
Work in process	171	182
Finished goods	832	978
Inventory Reserve	(449)	(529)

Total Inventory, net	$ 774	$ 926

5. Segmental Disclosure:

The Company has determined that it operates in one segment. Revenues by geographic area are determined by the location of the end user and are summarized as follows (in thousands):

(in thousands)	(unaudited)	
	March 31, 2002	March 30, 2001
North America	$ 1,978	$ 1,842
Europe	232	319
Pacific Rim	158	132
Total Revenue	$ 2,368	$ 2,293

6. Comprehensive Income:

Under SFAS No. 130, "Reporting Comprehensive Income" disclosure of comprehensive income and its components is required in financial statements. Comprehensive income is the change in equity from transactions and other events and circumstances other than those resulting from investments by owners and distributions to owners. There are no significant components of comprehensive income excluded from net income, therefore, no separate statement of comprehensive income has been presented.

7. New accounting pronouncements:

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations." SFAS 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The adoption of SFAS 141 has not had a significant impact on the Company's financial statements.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective for fiscal years beginning after March 15, 2001. SFAS 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. The adoption of SFAS 142 has not had a significant impact on the Company's financial statements.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 supercedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS 144 is effective for the Company for all financial statements issued in fiscal 2002. The adoption of SFAS 144 has not had a significant impact on the Company's financial statements.

In November 2001, the Emerging Issues Task Force ("EITF") reached consensus on EITF No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer or Reseller of the Vendor's Products." EITF No. 01-9 addresses the accounting for consideration given by a vendor to a customer and is a codification of EITF No. 00-14, "Accounting for Certain Sales Incentives", EITF No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentives Offers and Offers for Free Products or Services to be Delivered in the Future", and EITF No. 00-25, "Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor's Products." EITF 01-09 presumes that consideration from a vendor to a customer or reseller of the vendor's products to be a reduction of the selling prices of the vendor's products and, therefore, should be characterized as a reduction of revenue when recognized in the vendor's income statement and could lead to negative revenue under certain circumstances. Revenue reduction is required unless consideration relates to a separate identifiable benefit and the benefit's fair value can be established. This issue should be applied no later than in annual or interim financial statements for periods beginning after December 15, 2001, which is the Company's first quarter ended March 31, 2002. Upon adoption, the Company is required to reclassify all prior period amounts to conform to the current period presentation. The Company has implemented this accounting standard in its fiscal quarter ended March 31, 2002 and has restated its prior year numbers for comparative purposes (see Note 2).

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that are subject to many risks and uncertainties that could cause actual results to differ significantly from expectations. For more information on forward-looking statements, refer to the "Special Note on Forward-Looking Statements" at the front on this Form 10-Q. The following discussion should be read in conjunction with the Financial Statements and the Notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and in the Company's Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001.

Critical Accounting Policies

Castelle's financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, sales, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for Castelle include revenue recognition; credit, collection and allowances for doubtful accounts and inventories and related allowance for obsolete and excess inventory, which are discussed in more details under the caption "Critical Accounting Policies" in the Company's Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001.

Consolidated Statements of Income - As a Percentage of Net Sales

	(unaudited) THREE MONTHS ENDED	
	March 31, 2002	March 30, 20
Net sales	100%	100%
Cost of sales	33%	30%
Gross profit	67%	70%
Operating expenses:		
Research and development	17%	17%
Sales and marketing	32%	47%
General and administrative	17%	19%
Restructuring charges	--	8%
Total operating expense	66%	91%
Income/(loss) from operations	*	(21%
Interest income, net	*	1%
Other income, net	*	2%
Income/(loss) before provision for income taxes	1%	(18%
Provision for income taxes	--	*
Net Income/(loss)	1%	(18%

* Less than 1%

Results of Operations

Net Sales

Net sales for the first quarter of fiscal 2002 were $2.4 million, as compared to $2.3 million for the same period in fiscal 2001. This moderate increase was primarily attributable to an increase in shipments of our products to domestic channels of $130,000, offset partially by a decrease in shipments to the international regions of $55,000.

Sales in the first quarter of fiscal 2002 reflected the implementation of the new accounting rule, EITF No. 01-09, related to the classification of certain marketing development funds as reductions to revenue rather than as operating expenses. The effect of this change to sales was a reduction of $88,000 and $56,000 in the first quarters of fiscal 2002 and 2001, respectively, with a corresponding reduction in operating expenses.

Domestic sales in the first quarter of fiscal 2002 were $2.0 million as compared to $1.8 million for the same period in fiscal 2001, representing 83% and 80%, respectively, of total net sales. Shipments of both of our fax server products and print server products in the first quarter of fiscal 2002 increased slightly over the same period last year.

International sales in the first quarter of fiscal 2002 were $390,000 as compared to $451,000 for the same period in fiscal 2001, representing 17% and 20%, respectively, of total net sales. The shortfall was primarily due to lower sales of our fax server products to the European channels.

Cost of Sales; Gross Profit

Gross profit was $1.6 million, or 67% of net sales, for the first quarter of fiscal 2002, as compared to $1.6 million, or 70% of net sales for the same period in fiscal 2001. The lower gross profit percentage in the first quarter of fiscal 2002 was primarily due to the mix of products sold at a slightly lower average selling price. The change in gross profit percentage due to the implementation of EITF No. 01-09 was a reduction of 1.2% and 0.7% in the first quarters of fiscal 2002 and 2001, respectively.

Research & Development

Research and product development expenses were $413,000 or 17% of net sales for the first quarter of fiscal 2002, as compared to $385,000 or 17% of net sales for the same period in fiscal 2001. The increase was primarily due to an increase in compensation of $94,000 due to additional personnel, offset in part by a decrease in outside consulting and other office expenses of $62,000.

Sales & Marketing

Sales and marketing expenses were $763,000 or 32% of net sales for the first quarter of fiscal 2002 as compared to $1.1 million or 47% of net sales for the same period in fiscal 2001. Sales and marketing expenses in the first quarters of fiscal 2002 and 2001 have been reduced by $88,000 and $56,000 due to the implementation of EITF 01-09. The other reduction in sales and marketing expenses were primarily associated with a decrease in compensation expenses of $121,000 and a decrease in advertising and promotion expenses of $119,000.

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General & Administrative

General and administrative expenses were $404,000 or 17% of net sales for the first quarter of fiscal 2002, as compared to $444,000 or 19% of net sales for the first quarter of fiscal 2001. The lower general and administrative expenses were largely attributable to a decrease in employee compensation of $43,000 and provision for doubtful accounts of $34,000, offset partially by an increase in legal and accounting fees of $25,000.

Restructuring

In response to the continuing economic slowdown and decrease in demand for our products, we terminated 17 regular, temporary and contractor positions in April 2001, which constituted approximately 25% of our workforce. This action resulted in a severance charge of $239,000 in fiscal 2001 of which $180,000 was incurred in the first quarter. The restructuring included an asset write-off and other direct expenses associated with the consolidation of our operations in the United Kingdom and El Dorado Hills, California. As of March 31, 2002, remaining restructuring costs were $40,000. The movement of the reserve balance from $89,000 at December 31, 2001 was primarily due to cash payments against severance of $36,000 and other costs of $13,000. The Company believes that these costs will be incurred during fiscal 2002.

Liquidity and Capital Resources

As of March 30, 2002, we had approximately $4.5 million of cash and cash equivalents, an increase of $891,000 from March 31, 2001 and a decrease of $106,000 from December 31, 2001. The increase in cash and cash equivalents from March 30, 2001 was mostly attributable to operating cash inflows of $933,000 from improved collection of outstanding balances owed to us by our customers, reduced inventory to meet the current revenue projections, offset in part by more timely payments to our vendors. The decrease of cash and cash equivalents from December 31, 2001 was mainly due to cash used in operating activities of $99,000. Working capital of $3.6 million at March 31, 2002 was consistent with the balance at March 30, 2001 and December 31, 2001.

In August 2000, we entered into a lease for a new facility in Morgan Hill, California and relocated our corporate headquarters in December 2000 after our former lease at the Santa Clara, California location expired at the same time. The lease on the Morgan Hill facility has a term of five years, expiring in December 2005, with one conditional three-year option, which if exercised would extend the lease to December 2008 commencing with rent at ninety-five percent of fair market value. As of March 31, 2002, the future minimum payments under the lease were $979,000.

In December 2000, as a source of capital asset financing, we entered into a loan and security agreement with a finance company for an amount of $75,000. This loan is subject to interest of 12.8% and is repayable by December 2006. As of March 31, 2002, the aggregate value of future minimum payments was $81,000.

In April 2001, as a source of capital asset financing, we entered into a loan and security agreement with a finance company for an amount of $25,000. This loan is subject to interest of 12.5% and is repayable by April 2004. As of March 31, 2002, the aggregate value of future minimum payments was $20,000.

In addition to the commitments shown above, we have a $3.0 million collateralized revolving line of credit with a bank, which expires in March 2003, pursuant to which we may borrow 100% against pledges of cash at the bank's prime rate. Borrowings under this line of credit agreement are collateralized by all of our assets. We are in compliance with the terms of the agreement, and as of March 31, 2002, had no borrowings under the line of credit.

As of March 31, 2002, net accounts receivable were $758,000, slightly higher than the balance as of December 31, 2001 of $680,000. The increase in net accounts receivable was primarily attributed to higher sales at the end of the first quarter of fiscal 2002.

Net inventories as of March 31, 2002 were $774,000, as compared to the balance of $926,000 as of December 31, 2001. The reduction in inventory was mainly due to more components being used up in production as compared to purchases in the same period. Inventory turnover for the first fiscal quarter of 2002 improved to an equivalent of 4.0 turns per year from 3.4 turns per year in the prior quarter.

Although we believe that our existing capital resources, anticipated cash flows from operations and available lines of credit will be sufficient to meet our capital requirements for at least the next 12 months, we may be required to seek additional equity or debt 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 the pace of technological change in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We considered the provision of Financial Reporting Release No. 48 "Disclosure of Accounting Policies for Derivative Financial Instruments and Derivative Commodity Instruments, and Disclosure of Quantitative and Qualitative Information about Market Risk Inherent in Derivative Financial Instruments, Other Financial Instruments and Derivative Commodity Instruments." We had no holdings of derivative financial or commodity instruments at March 31, 2002. However, we are exposed to financial market risks, including changes in interest rates and foreign currency exchange rates. While much of our revenue is transacted in U.S dollars, some revenues and capital spending are transacted in Pounds Sterling. These amounts are not currently material to our financial statements; therefore we believe that foreign currency exchange rates should not materially affect our overall financial position, results of operations or cash flows. The fair value of our money market account or related income would not be significantly impacted by increases or decreases in interest rates due mainly to the highly liquid nature of this investment. However, sharp declines in interest rates could seriously harm interest earnings on this account. The Company believes that there have been no material changes in the reported market risks faced by the Company since the fiscal year ended December 31, 2001. These and other risk factors are discussed below under the caption "Risk Factors" and elsewhere in this Quarterly Report on Form 10-Q and in our Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001 under the section "Risk Factors".

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company has been contacted by a third party claiming that the Company needs to obtain licenses of certain patents held by that party for certain of the Company's fax server products. The Company is continuing to assess the validity and strength of the claims, believes it has adequate legal defenses and that the ultimate outcome of any possible action will not have a material effect on the Company's financial position, results of operations or cash flows although there can be no assurance as to the outcome of any possible litigation.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None.

ITEM 5. OTHER INFORMATION

RISK FACTORS

The risks and uncertainties described below are not the only ones facing the Company. Additional risks and uncertainties not presently known to the Company or that the Company currently deems immaterial also may impair the Company's business operations. If any of the following risks or such other risks actually occur, our business could be adversely affected.

Fluctuations in Operating Results

The Company's revenue and operating results have fluctuated in the past and the Company's future revenues and operating results are likely to fluctuate significantly in the future, particularly on a quarterly basis.

The Company's operating results may vary significantly from quarter to quarter due to a variety of factors, some of which are outside the control of the Company, including changes in the Company's product and customer mix, constraints in the Company's manufacturing and assembling operations, shortages or increases in the prices of raw materials and components, changes in pricing policy by the Company or its competitors, a slowdown in the growth of the networking market, seasonality, timing of expenditures and economic conditions in the United States, Europe and Asia. The Company's sales will often reflect orders shipped in the same quarter in which they are received. The Company's backlog at any given time is not necessarily indicative of actual sales for any succeeding period. In addition, significant portions of the Company's expenses are relatively fixed in nature, and planned expenditures are based primarily on sales forecasts. Therefore, if the Company inaccurately forecasts demand for its

products, the impact on net income may be magnified by the Company's inability to adjust spending quickly enough to compensate for the net sales shortfall.

Other factors contributing to fluctuations in the Company's quarterly operating results include changes in the demand for the Company's products, customer order deferrals in anticipation of new versions of the Company's products, the introduction of new products and product enhancements by the Company or its competitors, the effects of filling the distribution channels following such introductions, 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, changes in foreign currency exchange rates, the timing of acquisitions and associated costs, and the timing of significant marketing and sales promotions. Based on the foregoing, the Company believes that quarterly operating results are likely to vary significantly in the future and that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be viewed upon as indications of future performance.

History of Losses; Accumulated Deficit

The Company has experienced significant operating losses and, as of March 31, 2002, had an accumulated deficit of $24.7 million. The development and marketing by the Company of its current and new products will continue to require substantial expenditures. There can be no assurance that growth in net sales or profitability will be achieved or sustained in future years. Related risk factors are discussed elsewhere in the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this Quarterly Report on Form 10-Q and in the Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001.

Nasdaq SmallCap Listing; Risk associated with Limited Market

The Company's Common Stock has been listed on the Nasdaq SmallCap Market since April 1999. In order to maintain it's listing on the Nasdaq SmallCap Market, the Company must maintain total assets, capital and public float at specified levels, and generally must maintain a minimum bid price of $1.00 per share. If the Company fails to maintain the standard necessary to be quoted on the Nasdaq SmallCap Market, the Company's Common Stock could become subject to delisting. On March 12, 2002, the Company received a notice from the Nasdaq Stock Market that its common stock had failed to maintain the minimum bid price of $1.00 per share required for continued listing on the Nasdaq SmallCap Market. If the Company's common stock fails to meet the $1.00 bid price per share for a minimum of ten consecutive trading days prior to September 9, 2002, the Company's Common Stock will be delisted from the Nasdaq SmallCap Market. If the Common Stock is delisted, trading in the 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 the Common Stock or to obtain accurate quotations as to the price of the Common Stock. Lack of any active trading market would have an adverse effect on a shareholder's ability to liquidate an investment in the Company's Common Stock easily and quickly at a reasonable price. It might also contribute to volatility in the market price of the Company's Common Stock and could adversely affect the Company's 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 the Company's business, financial condition and results of operations.

Rapid Technological Change; Risks Associated with New Products

The market for the Company's products is affected by rapidly changing networking technology and evolving industry standards and the emergence of the Internet and other new communication technologies. The Company believes that its future success will depend upon its ability to enhance its 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 the Company will be successful in these efforts. The Company has incurred, and the Company expects 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, the Company is dependent upon timely access to information about new technological developments and standards. There can be no assurance that the Company will have such access or that it will be able to develop new products successfully and respond effectively to technological change or new product announcements by others. Furthermore, the Company expects that printer and other peripheral manufacturers will add features to their products that make them more network accessible, which may reduce demand for the Company's print servers. There can be no assurance that products or technologies developed by others will not render the Company's products non-competitive or obsolete. The fax-on-demand market in general has been negatively affected by the growth of the Internet. Although the Company has new Web/fax/email products in development, there can be no assurance these products will compete successfully. Complex products such as those offered by the Company may contain undetected or unresolved hardware defects or software errors when they are first introduced or as new versions are released. Changes in the Company's or its suppliers' manufacturing processes or the inadvertent use of defective components by the Company or its suppliers could adversely affect the Company's ability to achieve acceptable manufacturing yields and product reliability. The Company has in the past discovered hardware defects and software errors in certain of its new products and enhancements after their introduction. There can be no assurance that despite testing by the Company and by third-party test sites, errors will not be found in future releases of the Company's products, which would result in adverse product reviews and negatively affect market acceptance of these products.

The introduction of new or enhanced products requires the Company to manage the transition, both internally and for customers, from the older products to the new or enhanced products or versions. The Company 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. The Company has from time to time experienced delays in the shipment of new products. There can be no assurance that future product transitions will be managed successfully by the Company.

Key Personnel

The Company's success depends to a significant degree upon the continued contributions of the Company's key management, marketing, product development and operational personnel. The success of the Company will depend to a large extent upon its ability to retain and continue to attract highly skilled personnel. Competition for employees in the computer industry is intense, and there can be no assurance that the Company will be able to attract and retain enough qualified employees. The Company's inability to retain and attract key employees could have a material adverse effect on the Company's product development, business, operating results and financial condition. The Company does not carry key person life insurance with respect to any of its personnel.

On April 22, 2002, the Company announced the retirement of Donald L. Rich, 60, from the CEO post he has held since November of 1998. Scott C. McDonald, 48, a member of the Board of Directors since April of 1999 will assume the CEO position and continue to serve on

the Board. Donald L. Rich will continue on as Chairman of the Board, a post he has held since May 1999 and will stay active with the Company in that role.

Competition and Price Erosion

The network enhancement products and computer software markets are highly competitive, and the Company believes 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. The Company currently competes principally in the market for network fax servers and network print servers and fax-on-demand software. Increased competition, direct and indirect, could adversely affect the Company's business and operating results through pricing pressure, loss of market share and other factors. In particular, the Company expects that, over time, average selling prices for its print server products will continue to decline, as the market for these products becomes increasingly competitive. Any material reduction in the average selling prices of the Company's products would adversely affect gross margins. There can be no assurance the Company will be able to maintain the current average selling prices of its products or the related gross margins.

The principal competitive factors affecting the market for the Company's 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 the Company's existing and potential competitors, most notably the Hewlett-Packard Company ("Hewlett-Packard") and Intel Corporation ("Intel"), have substantially greater financial, engineering, manufacturing and marketing resources than the Company. The Company also experiences competition from a number of other software, hardware and service companies. In addition to its current competitors, the Company may face substantial competition from new entrants into the network enhancement market, including established and emerging computer, computer peripherals, communications and software companies. In the fax server market the Company competes with companies such as Captaris Inc., Omtool, Ltd. and Computer Associates International, Inc. There can be no assurance that competitors will not introduce products incorporating technology more advanced than the technology used by the Company in its products. In addition, certain competing methods of communications such as the Internet or electronic mail could adversely affect the market for fax products. Certain of the Company's existing and potential competitors in the print server market are manufacturers of printers and other peripherals, and these competitors may develop closed systems accessible only through their own proprietary servers. There can be no assurance that the Company will be able to compete successfully or that competition will not have a material adverse effect on the Company's business, operating results and financial condition.

International Sales

Sales to customers located outside Canada and the United States accounted for approximately 20%, 25% and 31% of the Company's net sales in fiscal 2001, 2000 and 1999, respectively. The Company sells its products in approximately 40 foreign countries through approximately 50 international distributors. Macnica, the Company's principal Japanese distributor, accounted for approximately 46%, 60% and 60% of the Company's international sales in fiscal 2001, 2000 and 1999, respectively, and 10%, 15% and 18% of the Company's total net sales in fiscal 2001, 2000 and 1999, respectively. The Company expects that international sales will continue to represent a significant portion of the Company's product revenues and that the Company 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 the Company will not experience difficulties resulting from changes in foreign laws relating to the

export of its products in the future. In addition, because the Company primarily invoices its foreign sales in U.S. dollars, fluctuations in exchange rates could affect demand for the Company's products by causing its prices to be out of line with products priced in the local currency. Additionally, any such difficulties would have a material adverse effect on the Company's international sales and a resulting material adverse effect on the Company's business, operating results and financial condition. In fiscal 2001, the Company consolidated its operations in the United Kingdom and entered into an agreement with a distributor to service the region. In addition, the Company entered into a separate agreement in fiscal 2001 with a Japanese distributor to sell the Company's LANpress products in Japan, from which the Company is entitled to receive a royalty on sales of these products. The Company 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 the Company will be able to maintain the level of international sales in the future. Any fluctuations in international sales will greatly affect the Company's operating results and financial condition.

Lack of Product Revenue Diversification

The Company derives substantially all of its sales from its fax and print server products, with its fax server products accounting for 91% of its total sales in fiscal 2001. The Company is leveraging its expertise in these areas to develop new messaging features and products to support greater integration into corporate network environments and with Internet communications. The Company expects that its current products will continue to account for a majority of the Company's sales in the near future. A decline in demand for these products as a result of competition, technological change or other factors, or a delay in the development and market acceptance of new features and products, would have a material adverse effect on the Company's business, operating results and financial condition.

Product Transition; Risk of Product Returns and Inventory Obsolescence

From time to time, the Company 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 such inventory becomes obsolete. The Company has 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 the Company's allowance for such returns in the future and will not have a material adverse effect on the Company's business, operating results and financial condition.

Concentration of Distributors; Distribution Risks

The Company sells its products primarily through a two-tier domestic and international distribution network. The Company's distributors sell Castelle's 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. In addition, an increasing number of companies are competing for access to these channels. The Company's distributors typically represent other products that are complementary to, or compete with, those of the Company. In particular, certain of its competitors, including Hewlett-Packard and Intel, sell a substantially higher dollar volume of products through several of the Company's large U.S. distributors, and as a result, the Company believes such distributors give higher priority to products offered by such competitors. The Company's distributors are not contractually committed to future purchases of the Company's products and could discontinue carrying the Company's products at any time for any reason. 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. The Company has a stock rotation policy with certain of its distributors that allows them to return marketable inventory against offsetting orders. Should the Company reduce its prices, the Company credits certain of its distributors for the difference between the purchase price of products remaining in their inventory and the Company's reduced price for such products. In addition, due to industry conditions or the actions of competitors, inventory levels of the Company's products held by distributors could become excessive, resulting in product returns and inventory write-downs. Although the Company provides an allowance for anticipated returns and for price protection, and believes its existing policy results in the establishment of an allowance that is adequate, there can be no assurance that in the future returns and price protection will not have a material adverse effect on the Company's business, operating results and financial condition.

Dependence on Third-Party Suppliers and Subcontractors

The Company's products incorporate or require components or sub-assemblies procured from third-party suppliers. Certain of these components or sub-assemblies are available only from a single source, and others are available only from limited sources. Certain key components of the Company's products, including a modem chip set from Conexant Systems, Inc. ("Conexant") and a microprocessor from Motorola, Inc. ("Motorola"), are currently available from single sources. Other product components are currently available from only a limited number of sources. In addition, the Company subcontracts a substantial portion of its manufacturing to third parties, and there can be no assurance that these subcontractors will be able to support the manufacturing requirements of the Company. Other than an agreement with Sercomm Corporation to manufacture certain print server products, the Company does not have material long-term supply contracts with third parties or any other sole or limited source vendors and subcontractors. The Company purchases components or sub-assemblies on a purchase order basis. The Company's ability to obtain these components and sub-assemblies is dependent upon its ability to accurately forecast customer demand for its products and to anticipate shortages of critical components or sub-assemblies created by competing demands upon suppliers. If the Company were unable to obtain a sufficient supply of high-quality components or sub-assemblies from its current sources, the Company could experience delays in obtaining such components or sub-assemblies from other sources. Resulting delays or reductions in product shipments could adversely affect the Company's business, operating results and financial condition and damage customer relationships. Furthermore, a significant increase in the price of one or more of these components or sub-assemblies or the Company's inability to lower component or sub-assembly prices in response to competitive price reductions could adversely affect the Company's business, operating results and financial condition.

The Company augments its product offerings by obtaining access to third-party products and technologies in areas outside of its core competencies or where the Company believes internal development of products and technologies is not cost-effective. The Company's third-party supplier of certain print server products is SerComm. There can be no assurance that these products will produce gross margins comparable to those of the Company's internally generated products or that the parties with which the Company contracts will continue to provide the quantities and quality of products needed by the Company or that they will upgrade their respective products on a timely basis. The termination of the Company's relationships with third-party product suppliers and with SerComm, in particular, could result in delays or reductions in product shipments, which could have a material adverse effect on the Company's business, operating results and financial condition.

Government Regulation

Certain aspects of the networking industry in which the Company competes 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 where telecommunications standards differ from those in the United States, or the inability to obtain regulatory approvals within a reasonable period of time, could have a material, adverse effect on the Company's business, operating results and financial condition. The Company's 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 the Company's business, operating results and financial condition.

Dependence on Proprietary Rights; Uncertainty of Obtaining Licenses

The Company's success depends to a certain extent upon its technological expertise and proprietary software technology. The Company relies upon a combination of contractual rights and copyright, trademark and trade secret laws to establish and protect its technologies. Despite the precautions taken by the Company, it may be possible for unauthorized third parties to copy the Company's products or to reverse engineer or obtain and use information that the Company regards as proprietary. In addition, the laws of some foreign countries either do not protect the Company's 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 the Company's 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 to the Company and divert the efforts of the Company's technical and management personnel, whether or not such litigation is determined in favor of the Company. In the event of an adverse result in any such litigation, the Company 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 the Company would be successful in such development or that any such licenses would be available. The Company also relies on technology licenses from third parties. There can be no assurance that these licenses will continue to be available to the Company upon reasonable terms, if at all. Any impairment or termination of the Company's relationship with third-party licensors could have a material adverse effect on the Company's business, operating results and financial condition. There can be no assurance that the Company's precautions will be adequate to deter misappropriation or infringement of its proprietary technologies. Furthermore, while the Company has obtained federal registration for many of its trademarks in the United States, certain of its trademarks have not been registered in the United States or foreign jurisdictions. There can be no assurance that the Company's use of such registered trademarks will not be contested by third parties in the future.

The Company has received, and may receive in the future, communications asserting that its products infringe the proprietary rights of third parties or seeking indemnification against such infringement. There can be no assurance that third parties will not assert infringement claims against the Company with respect to current or future products or that any such assertion may not require the Company to enter into royalty arrangements or result in costly litigation. As the number of software products in the industry increases and the functionality of these products further overlap, the Company believes that software developers may become increasingly subject to infringement claims. Any such claims, with or without merit, can be time consuming and expensive to defend. There can be no assurance that any such intellectual property litigation that may be brought in the future will not have a material adverse effect on the Company's business,

operating results and financial condition. As a result of such claims or litigation, it may become necessary or desirable in the future for the Company to obtain licenses relating to one or more of its products or relating to current or future technologies, and there can be no assurance that it would be able to do so on commercially reasonable terms.

Possible Volatility of the Company's Common Stock Price

The price of the Company's Common Stock has fluctuated widely in the past. Sales of substantial amounts of the Company's Common Stock, or the perception that such sales could occur, could adversely affect prevailing market prices for the Company's Common Stock. The management of the Company believes that such past fluctuations may have been caused by the factors identified above as well as announcements of new products, quarterly fluctuations in the results of operations and other factors, including changes in the condition of the personal computer industry in general. These fluctuations, as well as general economic, political and market conditions, such as recessions or international currency fluctuations, may adversely affect the market price of the Company's Common Stock. Stock markets have experienced extreme price volatility in recent years. This volatility has had a substantial effect on the market prices of securities issued by the Company and other high technology companies, often for reasons unrelated to the operating performance of the specific companies. The Company anticipates that prices for Castelle Common Stock may continue to be volatile. Such future stock price volatility for Castelle Common Stock may provoke the initiation of securities litigation, which may divert substantial management resources and have an adverse effect on the Company's business, operating results and financial condition.

Future Capital Requirements

The development and marketing of products requires significant amounts of capital. The Company believes that its existing cash balances, anticipated cash flows from operations and available lines of credit will be sufficient to meet its anticipated capital requirements for the next 12 months. However, a decline in future orders and revenues might require us to seek additional capital to meet our working capital needs during or beyond the next twelve months if we are unable to reduce expenses to the degree necessary to avoid incurring losses. 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 the Company's existing and new products 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. 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. Related risk factors are discussed elsewhere in this Quarterly Report on Form 10-Q and in the Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2001.

Recent Terrorist Activity in the United States and the Military Action to Counter Terrorism Could Adversely Impact Our Business

The September 11, 2001 terrorist attacks in the United States, the ensuing declaration of war on terrorism and the continued threat of terrorist activity and other acts of war or hostility appear to be having an adverse effect on business, financial and general economic conditions in the U.S. These effects may, in turn, result in increased costs due to the need to provide enhanced security, which would have a material adverse effect on our business and results of operations. These circumstances may also adversely affect our ability to attract and retain customers and our ability to raise additional capital.

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Voting Control by Officers, Directors and Affiliates

At March 15, 2002, the Company's officers and directors and their affiliates beneficially owned approximately 29% of the outstanding shares of Common Stock. Accordingly, together they had the ability to significantly influence the election of the Company's 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 of the Company.

Certain Charter Provisions

The Company's Board of Directors has authority to issue up to 2,000,000 shares of Preferred Stock and to fix the rights, preferences, privileges and restrictions, including voting rights, of these shares without any further vote or action by the shareholders. The rights of the holders of the Company's 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 the outstanding voting stock of the Company, thereby delaying, deferring or preventing a change in control of the Company. 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 value of the Company's Common Stock.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

10.1* Employment agreement between the Company and Scott C. McDonald.

10.2* Executive Severance and Transition Benefits Agreement between the Company and Scott C. McDonald.

99.1 Press Release dated May 1, 2002.

(b) Reports on Form 8-K

The Company filed a Form 8-K Report dated April 22, 2002, reporting the retirement of Donald L. Rich and the appointment of Scott C. McDonald as CEO.

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

SIGNATURES

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

CASTELLE

By: /s/ Scott C. McDonald Date: May 14, 2002
Scott C. McDonald
Chief Executive Officer and President
(Principal Executive Officer)

By: /s/ Paul Cheng Date: May 14, 2002
Paul Cheng
Vice President of Finance and Administration
Chief Financial Officer
(Principal Financial and Chief Accounting Officer)
Secretary