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CASTELLE \CA\
Form 10-Q
November 09, 2001

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

FORM 10-Q

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

For the quarterly period ended September 28, 2001

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 (IRS Employer Identification No.)
incorporation or organization)

855 Jarvis Drive, Morgan Hill, CA 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 No The number of shares of the Registrant's Common Stock outstanding as of November 6, 2001 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" in the Company's Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2000.

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Part I - Financial Information

Item 1. Financial Statements

CASTELLE AND SUBSIDIARIES
Consolidated Balance Sheets

	(in thousands)	December 31, 2000	September 28, 2001 (unaudited)
Assets:			
Current assets:			
Cash and cash equivalents		\$ 4,105	
Restricted cash		-	
Accounts receivable, net of allowances for doubtful accounts of \$241 in 2001 \$285 in 2000		666	
Inventories, net		1,260	
Prepaid expense and other current assets		161	
		-----	-----
Total current assets		6,192	
Property, plant & equipment, net		653	
Other assets, net		90	
		-----	-----
Total net assets		\$ 6,935	
		=====	=====
Liabilities & Shareholders' Equity:			
Current liabilities:			
Long-term debt, current portion		\$ 17	
Accounts payable		447	
Accrued liabilities		2,244	
		-----	-----
Total current liabilities		2,708	
Long-term debt, net of current portion		69	
		-----	-----
Total liabilities		2,777	
Shareholders' equity:			
Common stock, no par value;			
Authorized: 25,000 shares;			
Issued and outstanding: 4,745 and 4,741, respectively		28,981	
Deferred compensation		(17)	
Accumulated deficit		(24,806)	
		-----	-----
Total shareholders' equity		4,158	
		-----	-----
Total liabilities & shareholders' equity		\$ 6,935	
		=====	=====

See accompanying notes to condensed consolidated financial statements.

CASTELLE AND SUBSIDIARIES
 Consolidated Statements of Operations
 (in thousands, except per share amounts)
 (unaudited)

	Three months ended		Septe
	September 28, 2001	September 29, 2000	
Net sales	\$ 2,559	\$ 3,730	\$
Cost of sales	770	1,314	
Gross profit	1,789	2,416	
Operating expenses:			
Research and development	470	441	
Sales and marketing	919	1,368	
General and administrative	353	383	
Restructuring charges	5	-	
Total operating expenses	1,747	2,192	
Income/(loss) from operations	42	224	
Interest income, net	19	52	
Other income/(expense), net	(8)	(36)	
Income/(loss) before provision for income taxes	53	240	
Provision for income taxes	-	-	
Net income/(loss)	\$ 53	\$ 240	\$

Net Income/(Loss) per share:

Net income/(loss) per common share - basic	\$ 0.01	\$ 0.05	\$
Shares used in per share calculation - basic	4,745	4,741	
Net income/(loss) per common share - diluted	\$ 0.01	\$ 0.05	\$
Shares used in per share calculation - diluted	4,782	5,071	

See accompanying notes to condensed consolidated financial statements.

CASTELLE AND SUBSIDIARIES
 Consolidated Statements of Cash Flows
 (in thousands)
 (unaudited)

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	Nine months ended	
	September 28, 2001	Septemb 200
	-----	-----
Cash flows from operating activities:		
Net income/(loss)	\$ (623)	\$
Adjustment to reconcile net income (loss) to net cash provided by operating activities:		
Loss on disposal of fixed assets	9	
Depreciation and amortization	208	
Provision for doubtful accounts and sales returns	93	
Provision for excess and obsolete inventory	120	
Compensation expense related to grant of stock options	5	
Changes in assets and liabilities:		
Accounts receivable	1,324	
Inventory	(17)	
Prepaid expenses and other current assets	48	
Accounts payable	(567)	
Accrued liabilities	(437)	
Other assets	12	
	-----	-----
Net cash provided by/(used in) operating activities	175	
	-----	-----
Cash flows from investing activities:		
Return of restricted cash	125	
Purchase of property and equipment	(77)	
	-----	-----
Net cash provided by/(used in) investing activities	48	
	-----	-----
Cash flows from financing activities:		
Repayment of notes payable	(11)	
Proceeds from issuance of common stock and warrants, net of repurchases	-	
	-----	-----
Net cash used in financing activities	(11)	
	-----	-----
	212	
Net increase/(decrease) in cash and cash equivalents		
Cash and cash equivalents at beginning of period	3,893	4
	-----	-----
Cash and cash equivalents at end of period	\$ 4,105	\$ 4
	=====	=====
Supplemental information:		
Cash paid for interest	\$ 8	\$
Note payable for fixed asset acquisition	\$ 25	\$

See accompanying notes to condensed consolidated financial statements.

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CASTELLE AND SUBSIDIARIES
Notes To Condensed Consolidated Financial Statements
(unaudited)

1. Basis of Presentation:

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 adjustments) 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 periods 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, 2000. 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.

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.

2. 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.

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Basic and diluted income/loss per share are calculated as follows for the third quarter and first nine months of 2001 and 2000, respectively:

(in thousands, except per share am

(Unaudited)

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	Three months ended		Nin
	September 28, 2001	September 29, 2000	September 2 2001
Basic:			
Weighted average common shares outstanding	4,745	4,741	4,743
Net income/(loss)	\$ 53	\$ 240	\$ (623)
Net income/(loss) per common share - basic	\$ 0.01	\$ 0.05	\$ (0.13)
Diluted:			
Weighted average common shares outstanding	4,745	4,741	4,743
Common equivalent shares from stock options and warrants	37	330	-
Shares used in per share calculation - diluted	4,782	5,071	4,743
Net income/(loss)	\$ 53	\$ 240	\$ (623)
Net income/(loss) per common share - diluted	\$ 0.01	\$ 0.05	\$ (0.13)

The calculation of diluted shares outstanding for the nine months ended September 28, 2001 excludes 75,304 stock options, as their effect was antidilutive in the period. At September 29, 2000, warrants to purchase 100,000 shares of the Company's common stock were excluded, because their exercise price is greater than the average common stock market price for the period.

3. Inventory:

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

	September 28, 2001 (Unaudited)	December 31, 2000
Raw material	\$ 443	\$ 335
Work in process	167	201
Finished goods	650	827
Total inventory	\$ 1,260	\$ 1,363

4. Revenue Recognition:

Product revenue is recognized upon shipment if a signed contract exists, the fee is fixed and determinable, collection of the resulting receivables

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is probable and product returns are reasonably estimable. 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. Revenues subject to stock rotation rights are reduced by management's estimates of

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anticipated exchanges. Provisions for estimated warranty costs and anticipated retroactive price adjustments are recorded at the time products are shipped. The Company recognizes revenue from the sale of extended warranty contracts ratably over the period of the contracts. In January 2001, the Company entered into a separate agreement with a Japanese distributor to sell the Company's fax server products in Japan. The Company is entitled to receive a royalty on sales of products by the distributor. Royalty is not recognized as revenue by the Company until the products are sold by the distributor.

5. Segments 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):

	(Unaudited)			
	Three months ended		Nine months ended	
	September 28, 2001	September 29, 2000	September 28, 2001	September 29, 2000
North America	\$2,129	\$ 2,867	\$ 5,880	\$8,811
Europe	232	251	709	994
Pacific Rim	198	612	689	1,786
Total Revenues	\$2,559	\$ 3,730	\$ 7,278	\$ 11,591

6. Comprehensive Income:

Under the Statement of Financial Accounting Standards ("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. Restructuring:

In April 2001, the Company terminated 17 regular, temporary and contractor positions, which constituted approximately 25% of our workforce. This action resulted in a severance charge of \$243,000 in the first nine months of fiscal 2001. 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.

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Of the total restructuring charge of \$243,000, approximately \$213,000 represented cash charges and the remaining \$30,000 represented the write-down of assets in the Company's UK operations. The restructuring activities were as follows:

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	Total charge	Non-cash charges	Cash payments	Accrued restructuring charges as of September 28, 2001
	-----	-----	-----	-----
Severance and benefits	\$ 100	-	\$ (63)	\$ 37
Facilities	89	\$(30)	(35)	24
Other	54	-	(15)	39
	-----	-----	-----	-----
	\$ 243	\$(30)	\$ (113)	\$ 100
	-----	-----	-----	-----

The remaining restructuring charges largely relate to additional costs to be incurred following the closure of the UK operations as well as the final severance payments to certain employees. There was no restructuring charge in fiscal 2000.

8. Commitments and contingencies:

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. In the opinion of management, there are no pending claims of which the outcome is expected to result in a material adverse effect in the financial position or results of operations of the Company.

9. New accounting pronouncements:

Under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," companies are required to recognize all derivatives as either assets or liabilities in the statement of financial position and to measure those instruments at fair value. Changes in fair value shall be recognized currently in earnings. This standard was effective for the Company from January 1, 2001. At that time, the Company did not have any derivative instruments, nor has it engaged in hedging activities to date.

In June 2001, the FASB issued Emerging Issues Task Force ("EITF") No. 00-25, "Vendor Income Statement Characterization of Consideration Paid to Reseller of the Vendor's Products," which is effective for annual or interim financial statements beginning after December 15, 2001. The issue addresses whether consideration paid by a vendor to a reseller for the vendor's products is an adjustment of the selling price and should therefore be deducted from revenue or a cost incurred by the vendor for assets or services received. The Company is currently assessing but has not yet determined the impact of EITF 00-25 on its statement of operations.

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS

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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. We believe that the adoption of SFAS 141 will not have a significant impact on our 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. We believe that the adoption of SFAS 142 will not have a significant impact on our financial statements.

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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 Company is currently assessing but has not yet determined the impact of SFAS 144 on its statement of operations.

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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, 2000.

Consolidated Statements of Operations - As a Percentage of Sales

Three months ended		Nine months ended
September 28, 2001	September 29, 2000	September 28, 2001

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Net sales	100%	100%	100%
Cost of sales	30%	35%	32%
Gross profit	70%	65%	68%
Operating expenses:			
Research and development	18%	12%	18%
Sales and marketing	36%	37%	42%
General and administrative	14%	10%	15%
Restructuring charges	*	--	3%
Total operating expenses	68%	59%	78%
Income/(loss) from operations	2%	6%	(10%)
Interest income, net	*	*	1%
Other income/(expense), net	*	*	*
Income/(loss) before provision for income taxes	2%	6%	(9%)
Provision for income taxes	--	--	--
Net income/(loss)	2%	6%	(9%)

* Less than 1%

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Results of Operations

Net Sales

Net sales for the third quarter of fiscal 2001 were \$2.6 million, as compared to \$3.7 million for the same period in fiscal 2000. The shortfall in net sales was primarily due to a reduction in the sales of our fax server products of \$800,000, or 25%, and the continued decline in the sales of the print server products by \$371,000, or 73%.

Net sales were \$7.3 million and \$11.6 million for the first nine months of fiscal 2001 and 2000, respectively. The decrease in net sales over the previous year was mostly attributable to the \$3.4 million decline, or 34%, in demand for our fax server products, and a decrease in the sales of our print server products of \$920,000, or 58%.

Domestic sales in the third quarter of fiscal 2001 were \$2.1 million, as compared to \$2.9 million in the same period in fiscal 2000, representing 83% and 77%, respectively, of total net sales. For the first nine months of fiscal 2001, domestic sales were \$5.9 million, as compared to \$8.8 million in the same nine months of fiscal 2000, representing 81% and 76%, respectively, of total net sales. The decrease in domestic sales in the first nine months of fiscal 2001 was primarily due to lower demand for products in the fax server product line.

International sales in the third quarter of fiscal 2001 were \$430,000, as compared to \$863,000 for the same period in 2000, representing 17% and 23%, respectively, of total net sales. International sales for the

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first nine months of fiscal 2001 and 2000 were \$1.4 million and \$2.8 million, respectively, representing 19% and 24%, respectively, of total net sales. This decline in international sales in the first nine months of fiscal 2001 was mainly the result of reduced demand for our fax server product line of \$478,000, or 30%, and our print server products of \$904,000, or 75%.

Cost of Sales; Gross Profit

Gross profit of \$1.8 million, or 70% of net sales, for the third quarter of fiscal 2001, decreased, as compared to gross profit of \$2.4 million, or 65%, for the same period in fiscal 2000. The higher gross profit percentage in the third quarter of fiscal 2001 was largely due to the increasingly favorable mix from the sales of our fax server products, which has a higher gross profit contribution, as compared to the sales of our print server products, which yields a lower gross margin.

Gross profits for the first nine months of fiscal 2001 and 2000 were \$5 million, or 68% of net sales and \$7.3 million, or 63% of net sales, respectively. The increase in gross profit percentage for the nine months of fiscal 2001 was primarily due to the mix of products that were sold at a higher average selling price. The change in the first quarter of fiscal 2001 from directly selling our print server products to our distributor in Japan to a royalty collection model also contributed to the higher gross profit, even though the amount of royalties received was not significant.

Research & Development

Research and product development expenses were \$470,000, or 18%, of net sales for the third quarter of fiscal 2001, as compared to \$441,000, or 12%, of net sales for the same period in fiscal 2000. Research and product development expenses for the first nine months of 2001 were \$1.3 million, or 18% of net sales, as compared to \$1.4 million, or 12% of net sales, for the same period in fiscal 2000. This reduction of \$99,000 in the nine-month period was mostly due to lower compensation expenses.

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Sales & Marketing

Sales and marketing expenses were \$919,000 or 36%, of net sales for the third quarter of fiscal 2001, as compared to \$1.4 million, or 37% of net sales for the same period in fiscal 2000. The reduction of \$449,000 was mostly attributable to lower operating expenses of \$107,000 in our United Kingdom operation as a result of our consolidation efforts earlier in the year, lower compensation and consulting expenses of \$136,000, and decreased promotional expenses of \$127,000. For the first nine months of fiscal 2001, sales and marketing expenses were \$3.1 million, or 42% of net sales, as compared to \$4 million, or 35% of net sales, for the same period in fiscal 2000. This reduction of sales and marketing spending by \$928,000 was mostly attributable to lower operating expenses of \$107,000 in the United Kingdom, lower compensation and consulting expenses of \$260,000, decreased promotional expenses of \$260,000 and a reduction in other general expenses of \$217,000.

General & Administrative

General and Administrative expenses were \$353,000 and \$383,000, or 14% and 10%, respectively, of net sales for the third quarter of fiscal 2001 and 2000, respectively. General and administrative expenses for the

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first nine months of fiscal 2001 decreased to \$1.1 million, or 14% of net sales, as compared to \$1.3 million, or 11%, of net sales for the same period in fiscal 2000. The reduction in general and administration expenses of \$213,000 was primarily due to lower legal and consulting expenses of \$77,000, decreased recruiting expenses of \$45,000 and lower bad debt and collection expenses of \$76,000.

Restructuring

In April 2001, we terminated 17 regular, temporary and contractor positions, which constituted approximately 25% of our workforce. This action resulted in a restructuring charge of \$243,000 in the nine months of fiscal 2001. 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. There was no restructuring charge in fiscal 2000.

Liquidity and Capital Resources

As of September 28, 2001, we had approximately \$4.1 million of cash and cash equivalents as compared to \$3.9 million at December 31, 2000. Working capital improved slightly to \$3.5 million at September 28, 2001 from \$3.3 million at June 29, 2001, but decreased from \$4 million at December 31, 2000. The improvement in cash and cash equivalents from the second quarter of fiscal 2001 was mostly attributable to 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 reduction in working capital, compared to December 31, 2000, was primarily due to the fiscal 2001 year to date net loss, partially offset by improved collections from customers and reduced inventory.

The restricted cash of \$125,000 appearing on our balance sheet as of December 31, 2000, was a certificate of deposit to collateralize a loan and was returned to us in February 2001. The loan was completely paid off as of December 31, 2000.

We have a \$3 million secured revolving line of credit with a bank from which we may borrow 100% against pledges of cash at the bank's prime rate. As of September 28, 2001, we had no borrowings under this line of credit.

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

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interest of 12.8% and is repayable by December 2006. As of September 28, 2001, the future minimum payments were \$90,000.

In April 2001, 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 2003. As of September 28, 2001, the future minimum payments were \$25,000.

As of September 28, 2001, net accounts receivable were \$666,000, down from \$2.1 million at December 31, 2000. The September 28, 2001 balance was net of allowances for doubtful accounts, estimated product returns and price protection of \$760,000, which is in compliance with our revenue recognition policies, as compared to allowances of \$667,000 at December 31, 2000. The decrease in net accounts receivable was largely attributed to improved

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collection of outstanding balances and reduced sales in the nine months of this year.

Net inventory as of September 28, 2001 was \$1.3 million, compared to \$1.4 million at December 31, 2000 and \$1.6 million as of June 29, 2001. The planned inventory reductions were in line with current revenue projections. Inventory turnover reduced from an equivalent of 3.5 turns per year at December 31, 2000 to 2.4 turns per year in this current 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. In order to maximize shareholder value, the Board of Directors continues to evaluate various strategic alternatives that may be available to us.

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

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Changes in Securities and Use of Proceeds

None.

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 September 28, 2001. 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.

Item 4. Submission of Matters to a Vote of Security Holders

None.

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Item 5. Other Information

In April 2001, we terminated 17 regular, temporary and contractor positions, which constituted approximately 25% of our workforce. This action resulted in a restructuring charge of \$243,000 in the nine months of fiscal 2001. 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. There was no restructuring charge in fiscal 2000.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

99.1 Press Release dated October 31, 2001

(b) Reports on Form 8-K

None

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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/ Donald L. Rich
Donald L. Rich
Chairman of the Board and Director
Chief Executive Officer and President
(Principal Executive Officer)

Date: November 9, 2001

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

Date: November 9, 2001

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