

DIGI INTERNATIONAL INC

Form 10-Q

February 07, 2007

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**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: December 31, 2006**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 0-17972**

**DIGI INTERNATIONAL INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

**41-1532464**

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

**11001 Bren Road East  
Minnetonka, Minnesota**

**55343**

(Address of principal executive offices)

(Zip Code)

**(952) 912-3444**

(Registrant's telephone number, including area code)

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, and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

On January 31, 2007, there were 25,148,046 shares of the registrant's \$.01 par value Common Stock outstanding.

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**DIGI INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

|   | Three months ended December 31,              |           |
|---|--|-----------|
|   | 2006   | 2005      |
|   | (in thousands, except per common share data) |           |
| Net sales   | \$ 41,811                                    | \$ 33,376 |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 18,650                                       | 14,010    |
| Amortization of purchased and core technology   | 1,148  | 1,168     |
| <br>  |  |           |
| Gross profit  | 22,013                                       | 18,198    |
| <br>  |  |           |
| Operating expenses:   |  |           |
| Sales and marketing   | 8,158  | 6,752     |
| Research and development  | 5,972  | 4,815     |
| General and administrative  | 3,578  | 3,753     |
| <br>  |  |           |
| Total operating expenses  | 17,708                                       | 15,320    |
| <br>  |  |           |
| Operating income  | 4,305  | 2,878     |
| <br>  |  |           |
| Other income (expense):   |  |           |
| Interest income   | 796  | 417       |
| Interest expense  | (25)   | (41)      |
| Other expense   |  | (43)      |
| <br>  |  |           |
| Total other income, net   | 771  | 333       |
| <br>  |  |           |
| Income before income taxes  | 5,076  | 3,211     |
| Income tax provision  | 1,274  | 1,028     |
| <br>  |  |           |
| Net income  | \$ 3,802                                     | \$ 2,183  |
| <br>  |  |           |
| Net income per common share:  |  |           |
| Basic   | \$ 0.15                                      | \$ 0.10   |
| <br>  |  |           |
| Diluted   | \$ 0.15                                      | \$ 0.09   |

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|   |        |        |
|---|--------|--------|
| Weighted average common shares, basic   | 25,078 | 22,781 |
| Weighted average common shares, diluted | 25,983 | 23,486 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DIGI INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED)**

|  | December<br>31,<br>2006           | September<br>30,<br>2006 |
|--|-----------------------------------|--------------------------|
|  | (in thousands, except share data) |                          |
| <b>ASSETS</b>  |                                   |                          |
| Current assets:  |                                   |                          |
| Cash and cash equivalents  | \$ 21,468                         | \$ 15,674                |
| Marketable securities  | 40,005                            | 43,207                   |
| Accounts receivable, net   | 19,773                            | 20,305                   |
| Inventories  | 24,636                            | 21,911                   |
| Other  | 6,320                             | 5,528                    |
| Total current assets   | 112,202                           | 106,625                  |
| Property, equipment and improvements, net  | 19,621                            | 19,488                   |
| Identifiable intangible assets, net  | 29,553                            | 31,341                   |
| Goodwill   | 65,941                            | 65,841                   |
| Other  | 2,050                             | 2,026                    |
| Total assets   | \$ 229,367                        | \$ 225,321               |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                                   |                          |
| Current liabilities:   |                                   |                          |
| Capital lease obligations, current portion   | \$ 378                            | \$ 381                   |
| Accounts payable   | 7,557                             | 6,748                    |
| Income taxes payable   | 5,933                             | 4,712                    |
| Accrued expenses:  |                                   |                          |
| Compensation   | 3,771                             | 5,851                    |
| Other  | 4,026                             | 5,592                    |
| Total current liabilities  | 21,665                            | 23,284                   |
| Capital lease obligations, net of current portion  | 625                               | 725                      |
| Net deferred tax liabilities   | 7,559                             | 7,482                    |
| Total liabilities  | 29,849                            | 31,491                   |
| Commitments and contingencies  |                                   |                          |
| Stockholders' equity:  |                                   |                          |
| Preferred stock, \$.01 par value; 2,000,000 shares authorized; none issued and outstanding                           |                                   |                          |
| Common stock, \$.01 par value; 60,000,000 shares authorized; 27,804,591 and 27,748,640 shares issued and outstanding | 278                               | 277                      |

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|   |            |            |
|---|------------|------------|
| Additional paid-in capital                              | 166,165    | 164,782    |
| Retained earnings                                       | 50,811     | 47,009     |
| Accumulated other comprehensive income                  | 1,319      | 940        |
| Treasury stock, at cost, 2,694,045 and 2,711,496 shares | (19,055)   | (19,178)   |
| Total stockholders' equity                              | 199,518    | 193,830    |
| Total liabilities and stockholders' equity              | \$ 229,367 | \$ 225,321 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DIGI INTERNATIONAL INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

|   | Three months ended December<br>31, |             |
|---|------------------------------------|-------------|
|   | 2006                               | 2005        |
|   | (in thousands)                     |             |
| Operating activities:   |                                    |             |
| Net income  | \$ 3,802                           | \$ 2,183    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |             |
| Depreciation of property, equipment and improvements                              | 645                                | 613         |
| Amortization of identifiable intangible assets and other assets                   | 1,947                              | 1,907       |
| Excess tax benefits from stock-based compensation                                 | (60)                               | (187)       |
| Stock-based compensation  | 765                                | 531         |
| Deferred income taxes   | 78                                 | (708)       |
| Other   | 289                                | (143)       |
| Changes in operating assets and liabilities:                                      |                                    |             |
| Accounts receivable   | 657                                | 543         |
| Inventories   | (2,930)                            | (556)       |
| Other assets  | (776)                              | (365)       |
| Accounts payable and accrued expenses   | (2,444)                            | (2,800)     |
| Income taxes payable  | 1,179                              | 1,252       |
| <br>Net cash provided by operating activities                                     | <br>3,152                          | <br>2,270   |
| Investing activities:   |                                    |             |
| Purchase of held-to-maturity marketable securities                                | (16,941)                           | (15,720)    |
| Proceeds from maturities of held-to-maturity marketable securities                | 20,143                             | 11,111      |
| Contingent purchase price payments related to business acquisitions               | (781)                              |             |
| Purchase of property, equipment, improvements and certain other intangible assets | (688)                              | (259)       |
| <br>Net cash provided by (used in) investing activities                           | <br>1,733                          | <br>(4,868) |
| Financing activities:   |                                    |             |
| Payments on capital lease obligations and long-term debt                          | (103)                              | (143)       |
| Excess tax benefits from stock-based compensation                                 | 60                                 | 187         |
| Proceeds from stock option plan transactions                                      | 515                                | 1,684       |
| Proceeds from employee stock purchase plan transactions                           | 191                                | 114         |
| <br>Net cash provided by financing activities                                     | <br>663                            | <br>1,842   |



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|  |           |           |
|--|-----------|-----------|
| Effect of exchange rate changes on cash and cash equivalents | 246       | (276)     |
| Net increase (decrease) in cash and cash equivalents         | 5,794     | (1,032)   |
| Cash and cash equivalents, beginning of period               | 15,674    | 12,990    |
| Cash and cash equivalents, end of period                     | \$ 21,468 | \$ 11,958 |

The accompanying notes are an integral part of the condensed consolidated financial statements.

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**DIGI INTERNATIONAL INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

**1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES**

*Basis of Presentation*

The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the Company or Digi) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted, pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including the summary of significant accounting policies, presented in the Company's 2006 Annual Report on Form 10-K as filed with the SEC.

The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments necessary for a fair statement of the condensed consolidated financial position and the condensed consolidated results of operations and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year.

*Recently Issued Accounting Pronouncements*

In July, 2006 the FASB issued Interpretation No. 48 ( FIN 48 ) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning October 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its consolidated financial statements. However, the Company does expect to reclassify a portion of its unrecognized tax benefits from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date.

**2. COMPREHENSIVE INCOME**

For the Company, comprehensive income is comprised of net income and foreign currency translation adjustments. Foreign currency translation adjustments are charged or credited to accumulated other comprehensive income within stockholders' equity.

Comprehensive income was as follows (in thousands):

|  | Three months ended<br>December 31, |          |
|--|------------------------------------|----------|
|  | 2006                               | 2005     |
| Net income                               | \$ 3,802                           | \$ 2,183 |
| Foreign currency translation gain (loss) | 379                                | (254)    |
| Comprehensive income                     | \$ 4,181                           | \$ 1,929 |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****3. NET INCOME PER COMMON SHARE**

Basic net income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares of the Company's stock result from dilutive common stock options and shares purchased through the employee stock purchase plan.

The following table is a reconciliation of the numerators and denominators in the net income per common share calculations (in thousands, except per common share data):

|  | Three months ended December<br>31, |          |
|--|------------------------------------|----------|
|  | 2006                               | 2005     |
| Numerator:   |                                    |          |
| Net income   | \$ 3,802                           | \$ 2,183 |
| Denominator:   |                                    |          |
| Denominator for basic net income per common share — weighted average shares outstanding            | 25,078                             | 22,781   |
| Effect of dilutive securities:   |                                    |          |
| Employee stock options and employee stock purchase plan  | 905                                | 705      |
| Denominator for diluted net income per common share — adjusted weighted average shares outstanding | 25,983                             | 23,486   |
| Net income per common share, basic   | \$ 0.15                            | \$ 0.10  |
| Net income per common share, diluted   | \$ 0.15                            | \$ 0.09  |

Potentially dilutive common shares related to stock options to purchase 562,613 and 1,365,513 common shares at December 31, 2006 and 2005, respectively were not included in the computation of diluted earnings per common share because the options' exercise prices were greater than the average market price of common shares and, therefore, their effect would be anti-dilutive.

**4. STOCK-BASED COMPENSATION**

Stock-based awards are granted under the terms of the 2000 Omnibus Stock Plan as Amended and Restated as of November 27, 2006 (the Omnibus Plan) which was ratified on January 22, 2007 at the Annual Meeting of Stockholders, as well as the Company's Stock Option Plan as Amended and Restated as of November 27, 2006 (the Stock Option Plan) and Non-Officer Stock Option Plan as Amended and Restated as of November 27, 2006 (the Non-Officer Plan), both of which expired during the first quarter of fiscal 2007. Additional awards cannot be made under the Stock Option Plan or the Non-Officer Plan. The authority to grant options under all of the Company's plans and set other terms and conditions rests with the Compensation Committee of the Board of Directors.

The Stock Option Plan and the Non-Officer Plan include nonstatutory stock options (NSOs) and the Stock Option Plan also includes incentive stock options (ISOs) to employees and others who provide services to the Company, including consultants, advisers and directors. Options

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****4. STOCK-BASED COMPENSATION (CONTINUED)**

granted under these plans generally vest over a four year service period and will expire if unexercised after ten years from the date of grant. The exercise price for ISOs and non-employee director options granted under the Stock Option Plan is set at the fair market value of the Company's common stock based on the closing price on the date of grant. The exercise price for NSOs granted under the Stock Option Plan or the Non-Officer Plan is set by the Compensation Committee of the Board of Directors and is not less than 50% of the fair market value based on the closing price on the date of grant.

The Omnibus Plan authorizes the issuance of up to 3,250,000 common shares in connection with awards of stock options, stock appreciation rights, restricted stock, performance units or stock awards. Eligible participants include the Company's employees, non-employee directors, consultants and advisors. Awards may be granted under the Omnibus Plan until November 27, 2016. Options under the Omnibus Plan can be granted as either ISOs or NSOs. The exercise price shall be determined by the Compensation Committee but shall not be less than the fair market value of the Company's common stock based on the closing price on the date of grant.

Additionally, the Company has outstanding stock options for shares of the Company's stock under various plans assumed in connection with its prior acquisition of NetSilicon, Inc. (the Assumed Plans). Additional awards cannot be made by the Company under the Assumed Plans.

Also, the Company sponsors an Employee Stock Purchase Plan as Amended and Restated as of November 27, 2006 (the Purchase Plan), covering all domestic employees with at least 90 days of continuous service and who are customarily employed at least 20 hours per week. The Purchase Plan allows eligible participants the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period. The Purchase Plan was ratified on January 22, 2007 at the Annual Meeting of Stockholders and provides for the issuance of up to 1,750,000 shares of Common Stock of the Company that may be purchased under the plan.

Effective October 1, 2005 the Company adopted Statement of Financial Accounting Standard No. 123 as amended, (FAS No. 123R), using the modified prospective method of application. Under this method, compensation expense is recognized both for (i) awards granted, modified or settled subsequent to September 30, 2005 and (ii) the nonvested portion of awards granted prior to October 1, 2005. Compensation expense recorded during the quarters ended December 31, 2006 and 2005 includes approximately \$0.5 million and \$0.1 million, respectively related to awards issued subsequent to September 30, 2005 and \$0.3 million and \$0.4 million, respectively, related to nonvested awards issued prior to October 1, 2005 using the intrinsic value method of accounting.

Stock-based compensation expense (pre-tax) is included in the consolidated results of operations for the three months ended December 31, 2006 and 2005 as follows (in thousands):

|                                | Three months ended December<br>31, |        |
|--------------------------------|------------------------------------|--------|
|                                | 2006                               | 2005   |
| Cost of sales                  | \$ 31                              | \$ 20  |
| Sales and marketing            | 219                                | 126    |
| Research and development       | 149                                | 127    |
| General and administrative     | 366                                | 258    |
| Total stock-based compensation | \$ 765                             | \$ 531 |

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****4. STOCK-BASED COMPENSATION (CONTINUED)**

FAS 123R also requires that the excess windfall tax benefit resulting from the tax deductibility of the increase in the value of share-based arrangements be presented as a component of cash flows from financing activities in the Condensed Consolidated Statement of Cash Flows.

A summary of option activity under the Plans as of December 31, 2006 and changes during the three months then ended is presented below (in thousands, except per common share amounts):

|                                  | Available<br>for<br>Grant | Options<br>Outstanding | Weighted<br>Average<br>Exercise Price<br>per<br>Common<br>Share | Weighted<br>Average<br>Contractual<br>Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------------|------------------------|---|--|---------------------------------|
| Balances, September 30, 2006     | 597                       | 4,240                  | \$ 10.54  |  |                                 |
| Granted                          | (485)                     | 485                    | 13.42   |  |                                 |
| Exercised                        |                           | (56)                   | 9.21  |  |                                 |
| Cancelled                        | 27                        | (27)                   | 11.54   |  |                                 |
| Balances, December 31, 2006      | 139                       | 4,642                  | \$ 10.85  | 5.66   | \$ 16,070                       |
| Exercisable at December 31, 2006 |                           | 3,425                  | \$ 10.19  | 4.46   | \$ 14,579                       |

The intrinsic value of an option is the amount by which the fair value of the underlying stock exceeds its exercise price. The total intrinsic value of all options exercised during the quarter was \$0.3 million. The weighted average fair value of options granted during the three months ended December 31, 2006 was \$5.93 and was determined based upon the fair value of each option on the grant date, utilizing the Black-Scholes option-pricing model and the following assumptions:

|                                |               |
|--------------------------------|---------------|
| Risk free interest rate        | 4.44% - 4.65% |
| Expected option holding period | 4 - 5 years   |
| Expected volatility            | 48% - 52%     |
| Weighted average volatility    | 49%           |
| Expected dividend yield        | 0             |

The fair value of each option award granted during the periods presented was estimated using the Black-Scholes option valuation model that uses the assumptions noted in the table above. Expected volatilities are based on the historical volatility of the Company's stock. The Company uses historical data to estimate option exercise and employee termination information within the valuation model; separate groups of grantees that have similar historical exercise behaviors are considered separately for valuation purposes. The expected term of options granted is derived from the vesting period and historical information and represents the period of time that options granted are expected to be outstanding. The risk-free rate used is based on the zero-coupon U.S. Treasury bond rate in effect at the time of the grant whose maturity equals the expected term of the option. These rates have been converted to continuously compounded equivalent rates.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****4. STOCK-BASED COMPENSATION (CONTINUED)**

A summary of the Company's nonvested options as of December 31, 2006 and changes during the three months then ended is presented below (in thousands, except per common share amounts):

|                                 | Number<br>of<br>Options | Weighted<br>Average<br>Grant Date<br><br>Fair Value per<br>Common Share |
|---------------------------------|-------------------------|---|
| Nonvested at September 30, 2006 | 940                     | \$ 5.33   |
| Granted                         | 485                     | 5.93  |
| Vested                          | (188)                   | 3.13  |
| Forfeited                       | (20)                    | 4.97  |
| Nonvested at December 31, 2006  | 1,217                   | \$ 5.92   |

The Company used historical data to estimate pre-vesting forfeiture rates. The pre-vesting forfeiture rate used in the first quarter of fiscal 2007 was 2.5%. As of December 31, 2006 the total unrecognized compensation cost related to nonvested stock-based compensation arrangements net of expected forfeitures was \$6.9 million and the related weighted average period over which it is expected to be recognized is approximately 3.0 years.

**5. ACQUISITIONS****MaxStream, Inc.**

On July 27, 2006, the Company acquired MaxStream, Inc. (MaxStream), a privately held corporation and a leader in the wireless device networking market. The total purchase price of \$40.5 million included \$19.8 million in cash (excluding cash acquired of \$3.7 million) and \$20.7 million in common stock, in exchange for all outstanding shares of MaxStream's preferred and common stock and outstanding stock options. This purchase consideration includes an adjustment of \$0.6 million pertaining to the closing working capital of MaxStream as of July 27, 2006. The Company did not replace MaxStream's outstanding options with Digi options. The value of the Company's common stock was based on a per share value of \$12.35, calculated as the average market price of the common stock during the two business days immediately preceding July 27, 2006 when the parties reached agreement on terms and announced the acquisition.

Cash in the amount of \$1.925 million and 165,090 shares of common stock have been deposited to an escrow fund established at Wells Fargo Bank, Minnesota. These amounts will be held in escrow for a period not to exceed one year from the date of closing to satisfy possible claims that may arise pursuant to specific representation and warranty sections of the merger agreement. The escrowed amounts of cash and stock have been included in the determination of the purchase consideration on the date of acquisition because management believes the outcome of the representation and warranty matters is determinable beyond a reasonable doubt.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in goodwill of \$26.4 million and a charge of \$2.0 million for acquired in-process research and development. The Company believes that the acquisition resulted in the recognition of goodwill primarily because MaxStream's wireless technologies and products significantly expand

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****5. ACQUISITIONS (CONTINUED)**

Digi's wireless offering, covering both short and medium range distances using embedded modules and boxed/package solutions and provides the capability to provide our customers end-to-end wireless solutions. The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition of MaxStream had occurred as of October 1, 2005. Pro forma adjustments include amortization of identifiable intangible assets associated with the MaxStream acquisition. Had the Company acquired MaxStream as of October 1, 2005, net sales, net income and net income per share would have changed to the pro forma amounts below (in thousands, except per common share amounts):

|                                      | Three months ended December 31,<br>2005 |             |
|--------------------------------------|---|-------------|
|                                      | Pro forma                               | As Reported |
| Net sales                            | \$ 36,609                               | \$ 33,376   |
| Net income                           | \$ 2,211                                | \$ 2,183    |
| Net income per common share, basic   | \$ 0.09                                 | \$ 0.10     |
| Net income per common share, diluted | \$ 0.09                                 | \$ 0.09     |

The unaudited pro forma condensed consolidated results of operations are not necessarily indicative of results that would have occurred had the acquisition occurred as of the beginning of fiscal 2006, nor are they necessarily indicative of the results that will be obtained in the future.

**6. SELECTED BALANCE SHEET DATA (in thousands)**

|                                      | December<br>31,<br>2006 | September<br>30,<br>2006 |
|--------------------------------------|-------------------------|--------------------------|
| Accounts receivable, net:            |                         |                          |
| Accounts receivable                  | \$ 20,409               | \$ 20,800                |
| Less allowance for doubtful accounts | 636                     | 495                      |
|                                      | \$ 19,773               | \$ 20,305                |
| Inventories:                         |                         |                          |
| Raw materials                        | \$ 18,467               | \$ 16,491                |
| Work in process                      | 1,260                   | 606                      |
| Finished goods                       | 4,909                   | 4,814                    |
|                                      | \$ 24,636               | \$ 21,911                |
| Other accrued expenses:              |                         |                          |
| Product warranty accrual             | \$ 964                  | \$ 1,104                 |
| Accrued professional fees            | 630                     | 879                      |
| Other accrued expenses               | 2,432                   | 3,609                    |
|                                      | \$ 4,026                | \$ 5,592                 |

Inventories are stated at the lower of cost or market value, with cost determined using the first-in, first-out method.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****7. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS**

Amortized identifiable intangible assets were comprised of the following (in thousands):

|                                | December 31, 2006     |               |          | September 30, 2006    |               |          |
|--------------------------------|-----------------------|---------------|----------|-----------------------|---------------|----------|
|                                | Gross carrying amount | Accum. amort. | Net      | Gross carrying amount | Accum. amort. | Net      |
| Purchased and core technology  | \$48,046              | \$(32,653)    | \$15,393 | \$48,022              | \$(31,492)    | \$16,530 |
| License agreements             | 2,440                 | (1,990)       | 450      | 2,440                 | (1,890)       | 550      |
| Patents and trademarks         | 7,704                 | (3,103)       | 4,601    | 7,608                 | (2,837)       | 4,771    |
| Customer maintenance contracts | 700                   | (341)         | 359      | 700                   | (324)         | 376      |
| Customer relationships         | 11,512                | (2,762)       | 8,750    | 11,470                | (2,356)       | 9,114    |
| Total                          | \$70,402              | \$(40,849)    | \$29,553 | \$70,240              | \$(38,899)    | \$31,341 |

Amortization expense was \$1.9 million and \$1.8 million for the three months ended December 31, 2006 and 2005, respectively.

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2007 and the five succeeding fiscal years is as follows (in thousands):

|                    |          |
|--------------------|----------|
| 2007 (nine months) | \$ 5,644 |
| 2008               | 5,386    |
| 2009               | 4,036    |
| 2010               | 3,640    |
| 2011               | 3,072    |
| 2012               | 2,514    |

The changes in the carrying amount of goodwill were as follows (in thousands):

|   | Three months ended December 31, |           |
|---|---------------------------------|-----------|
|   | 2006                            | 2005      |
| Beginning balance, October 1            | \$ 65,841                       | \$ 38,675 |
| Purchase price adjustment FS Forth      |                                 | (147)     |
| Foreign currency translation adjustment | 100                             | (33)      |
| Ending balance, December 31             | \$ 65,941                       | \$ 38,495 |

During the three months ended December 31, 2005, the purchase price of FS Forth, acquired in fiscal year 2005, was reduced as a result of a change in certain tax liabilities, as defined in the purchase agreement. A payment of \$0.8 million was made in October 2006 as contingent consideration based on the achievement of the milestones identified in the merger agreement. Future contingent consideration of up to \$1.2 million may be payable to FS Forth based upon the achievement of certain milestones (see Note 10).

**8. INCOME TAXES**

For the first quarter of fiscal 2007 income taxes have been provided at an effective rate of 25.1% compared to 32.0% for the first quarter of fiscal 2006. On December 9, 2006, Congress passed H.R. 6111, the Tax Relief and Health Care



Act of 2006 , which included an extension of the research credit that previously expired on December 31, 2005. As a result of the extension, the Company recorded a benefit of \$0.5 million in the first quarter of fiscal 2007 for research and development credits earned during the last three fiscal quarters of 2006. The additional

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****8. INCOME TAXES (CONTINUED)**

research and development credits were accounted for as a discrete event in the first quarter of fiscal 2007. The effective tax rates for both the first three months of fiscal 2007 and 2006 are lower than the U.S. statutory rate of 35.0% primarily due to the utilization of income tax credits and the combined phase-out of the extraterritorial income exclusion and the phase-in of the U.S. domestic production activities deduction.

The Company expects its annualized 2007 income tax rate to be approximately 33% to 33.5%.

**9. FINANCIAL GUARANTEES**

The Company, in general, warrants its products to be free from defects in material and workmanship under normal use and service for a period of up to five years from the date of receipt. The Company has the option to repair or replace products it deems defective with regard to material or workmanship. Estimated warranty costs are accrued in the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidence and are evaluated on an ongoing basis to ensure the adequacy of the warranty reserve. The following table summarizes the activity associated with the product warranty accrual (in thousands):

|      | Balance at | Warranties | Settlements | Balance at |
|------|------------|------------|-------------|------------|
|      | October 1  | issued (1) | made        | December   |
| 2006 | \$ 1,104   | \$ 85      | \$ (225)    | \$ 964     |
| 2005 | \$ 1,187   | \$ (1)     | \$ (118)    | \$ 1,068   |

- (1) Warranties issued includes a decrease in estimate adjustment of \$132,000 and \$117,000 in the first quarter of fiscal 2007 and 2006, respectively.

The Company is not responsible and does not warrant that custom software versions created by original equipment manufacturer (OEM) customers based upon the Company's software source code will function in a particular way, will conform to any specifications or are fit for any particular purpose and does not indemnify these customers from any third-party liability as it relates to or arises from any customization or modifications made by the OEM customer.

**10. CONTINGENCIES***Contingent obligations*

Effective April 1, 2005, the Company acquired FS Forth-Systeme GmbH/Sistemas Embebidos S.A. (collectively referred to as FS Forth) from Embedded Solutions AG of Germany. The purchase price of \$5.6 million in cash includes \$0.8 million of contingent consideration paid in October 2006, based on the achievement of milestones identified in the merger agreement. Additional contingent consideration of up to \$1.2 million is payable on October 1, 2007 if FS Forth achieves certain future milestones.

*Legal Proceedings*

On April 19, 2002, a consolidated amended class action complaint was filed in the United States District Court for the Southern District of New York asserting claims relating to the initial public offering (IPO) of NetSilicon and approximately 300 other public companies. The complaint



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**10. CONTINGENCIES (CONTINUED)**

names as defendants the Company, NetSilicon, certain of its officers and certain underwriters involved in NetSilicon's IPO, among numerous others, and asserts, among other things, that NetSilicon's IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon's IPO underwriters in allocating shares in NetSilicon's IPO to the underwriters customers. The Company believes that the claims against the NetSilicon defendants are without merit and has defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002.

In June 2003, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against the Company and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants.

Consummation of the proposed settlement remains conditioned upon obtaining approval by the Court. On September 1, 2005, the Court preliminarily approved the proposed settlement and directed that notice of the terms of the proposed settlement be provided to class members. Thereafter, the Court held a fairness hearing on April 24, 2006, at which objections to the proposed settlement were heard. After the fairness hearing, the Court took under advisement whether to grant final approval to the proposed settlement.

On December 5, 2006, the U.S. Court of Appeals for the Second Circuit issued a decision in In re Initial Public Offering Securities Litigation that six purported class action lawsuits containing allegations substantially similar to those asserted against the Company may not be certified as class actions due, in part, to the Appeals Court's determination that individual issues of reliance and knowledge would predominate over issues common to the proposed classes. On January 8, 2007, the plaintiffs filed a petition seeking rehearing en banc of the Second Circuit Court of Appeals' December 5, 2006 ruling. U.S. District Judge Scheindlin has ordered that all proceedings in the consolidated cases brought against the Company and against the roughly 300 other issuers sued in substantially similar cases (including proceedings relating to the proposed settlement) will be stayed pending the ruling by the Court of Appeals on whether to entertain that petition for rehearing. As a result of that filing, the impact, if any, of the Court of Appeals' ruling on the viability of the proposed settlement cannot yet be determined.

If the proposed settlement is not consummated, the Company intends to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, there can be no guarantee as to the ultimate outcome of this pending lawsuit. The Company maintains liability insurance for such matters and expects that the liability insurance will be adequate to cover any potential unfavorable outcome, less the applicable deductible amount of \$250,000 per claim. As of December 31, 2006, the Company has accrued a liability for the deductible amount of \$250,000 which the Company believes reflects the amount of loss that is probable. In the event the Company has losses that exceed the limits of the liability insurance, such losses could have a material effect on the business, or consolidated results of operations or financial condition of the Company.

In the normal course of business, the Company is subject to various claims and litigation, including patent infringement and intellectual property claims. Management of the Company expects that these various claims and litigation will not have a material adverse effect on the consolidated results of operations or financial condition of the Company.

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

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This Form 10-Q contains certain statements that are forward-looking statements as that term is defined under the Private Securities Litigation Reform Act of 1995, and within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

The words believe, anticipate, intend, estimate, target, may, will, expect, plan, project, should, negative thereof or other expressions, which are predictions of or indicate future events and trends and which do not relate to historical matters, identify forward-looking statements. Such statements are based on information available to management as of the time of such statements and relate to, among other things, expectations of the business environment in which the Company operates, projections of future performance, perceived opportunities in the market and statements regarding the Company's mission and vision. Forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

The future operating results and performance trends of the Company may be affected by a number of factors, including, without limitation, those described under Item 1A, Risk Factors in the Company's Annual Report on Form 10-K for the year ended September 30, 2006. Those risk factors, and other risks, uncertainties and assumptions identified from time to time in the Company's filings with the Securities and Exchange Commission, including without limitation, its quarterly reports on Form 10-Q and its registration statements, could cause the Company's actual future results to differ from those projected in the forward-looking statements as a result of the factors set forth in the Company's various filings with the Securities and Exchange Commission and of changes in general economic conditions, changes in interest rates and/or exchange rates and changes in the assumptions used in making such forward-looking statements.

**CRITICAL ACCOUNTING POLICIES**

A description of the Company's critical accounting policies was provided in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of the Company's Annual Report on Form 10-K for the year ended September 30, 2006.

**OVERVIEW**

Digi operates in the communications technology industry, which is characterized by rapid technological advances and evolving industry standards. The market can be significantly affected by new product introductions and marketing activities of industry participants. Digi places a high priority on development of innovative products that provide differentiated features and functions and allow for ease of integration with customers' applications. The Company competes for customers on the basis of existing and planned product features, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**  
**OVERVIEW (CONTINUED)**

The Company intends to continue to extend its current product lines with next generation commercial grade device networking products and technologies for targeted vertical markets, including but not limited to point of sale, industrial automation, office automation, medical and building controls. The Company believes that there is a market trend of device connectivity in these vertical commercial applications that will require communications intelligence or connectivity to the network or the Internet. These devices will be used for basic data communications, management, monitoring and control, and maintenance. The Company believes that it is well positioned to leverage its current products and technologies to take advantage of this market trend.

The Company anticipates that growth in the future will result from both products that are developed internally as well as from products that are acquired, and that the growth rate from products developed internally will increase as the multi-port serial adapters and the network interface cards (NICs) near the end of their product life cycles.

Net sales of \$41.8 million, for the three months ended December 31, 2006, represented an increase of \$8.4 million, or 25.3%, compared to net sales of \$33.4 million for the three months ended December 31, 2005.

Gross profit margin decreased to 52.6% compared to 54.5% for the three months ended December 31, 2006 and 2005, respectively.

Total operating expenses for the three months ended December 31, 2006 were \$17.7 million, or 42.3% of net sales, compared to \$15.3 million, or 45.9% of net sales, for the three months ended December 31, 2005, an increase of \$2.4 million or 15.6%.

Net income increased \$1.6 million to \$3.8 million, or \$0.15 per diluted share, for the three months ended December 31, 2006, compared to \$2.2 million, or \$0.09 per diluted share for the three months ended December 31, 2005. As a result of the extension of the research and development credit for two additional years beyond calendar 2005, a benefit for research and development credits earned during the last three quarters of fiscal 2006 was recorded during the first quarter of fiscal 2007, resulting in an additional tax benefit of \$0.5 million or \$0.02 per diluted share.

The Company's net working capital position (total current assets less total current liabilities) increased \$7.2 million to \$90.5 million during the three months ended December 31, 2006 and its current ratio was 5.2 to 1 as of that date. Cash and cash equivalents and marketable securities increased \$2.6 million to \$61.5 million during the period. At December 31, 2006, the Company had no debt other than capital lease obligations.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**  
**CONSOLIDATED RESULTS OF OPERATIONS**

The following table sets forth selected information derived from the Company's interim condensed consolidated statements of operations expressed in dollars, as a percentage of net sales and as a percentage of change from period-to-period for the periods indicated (dollars in thousands):

|   | Three months ended December 31, |        |           |        | %                      |
|---|---------------------------------|--------|-----------|--------|------------------------|
|   | 2006                            |        | 2005      |        | increase<br>(decrease) |
| Net sales   | \$ 41,811                       | 100.0% | \$ 33,376 | 100.0% | 25.3%                  |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 18,650                          | 44.6   | 14,010    | 42.0   | 33.1                   |
| Amortization of purchased and core technology   | 1,148                           | 2.8    | 1,168     | 3.5    | (1.7)                  |
| Gross profit  | 22,013                          | 52.6   | 18,198    | 54.5   | 21.0                   |
| Operating expenses:   |                                 |        |           |        |                        |
| Sales and marketing   | 8,158                           | 19.5   | 6,752     | 20.2   | 20.8                   |
| Research and development  | 5,972                           | 14.3   | 4,815     | 14.4   | 24.0                   |
| General and administrative  | 3,578                           | 8.5    | 3,753     | 11.3   | (4.7)                  |
| Total operating expenses  | 17,708                          | 42.3   | 15,320    | 45.9   | 15.6                   |
| Operating income  | 4,305                           | 10.3   | 2,878     | 8.6    | 49.6                   |
| Interest income and other, net  | 771                             | 1.8    | 333       | 1.0    | 131.5                  |
| Income before income taxes  | 5,076                           | 12.1   | 3,211     | 9.6    | 58.1                   |
| Income tax provision  | 1,274                           | 3.0    | 1,028     | 3.1    | 23.9                   |
| Net income  | \$ 3,802                        | 9.1%   | \$ 2,183  | 6.5%   | 74.2%                  |

**NET SALES**

Net sales for the three months ended December 31, 2006 were \$41.8 million compared to net sales of \$33.4 million for the three months ended December 31, 2005, or an increase of \$8.4 million or 25.3%. Net sales of products acquired as a result of the MaxStream acquisition were \$4.6 million in the first quarter of fiscal 2007.

The following summarizes the Company's net sales for the periods indicated:

|                   | Three months ended December 31, |        |           |        | Increase | %     |
|-------------------|---------------------------------|--------|-----------|--------|----------|-------|
| (\$ in thousands) | 2006                            |        | 2005      |        |          |       |
| Non-embedded      | \$ 25,166                       | 60.2%  | \$ 19,335 | 57.9%  | \$ 5,831 | 30.2% |
| Embedded          | 16,645                          | 39.8   | 14,041    | 42.1   | 2,604    | 18.5  |
| Total net sales   | \$ 41,811                       | 100.0% | \$ 33,376 | 100.0% | \$ 8,435 | 25.3% |

The Company's non-embedded products net sales, including MaxStream product net sales, increased \$5.8 million or 30.2% for the three months ended December 31, 2006 compared to the three months ended December 31, 2005.

Product introductions associated with net sales of network connected products, USB, cellular gateways and

MaxStream non-embedded products increased net sales by \$6.1 million for the three months ended December 31, 2006 as compared to the three months ended December 31, 2005. Multi-port serial adapter products net sales declined by \$0.3 million in the comparable three month periods described above as this product line continues to mature. Embedded products net sales, including MaxStream product net sales, increased \$2.6 million or 18.5% for the three months ended December 31, 2006 compared to the three months ended December 31, 2005. Net sales of embedded modules and microprocessors increased net sales by \$3.8 million for the three months ended December 31, 2006 compared to the three months ended December 31, 2005, offsetting the decline of \$1.2 million of NIC net sales for the three months ended December 31, 2006 as compared to the three months ended December 31, 2005. We expect sales of NICs to be less than 1% of quarterly net sales in the future since our OEM customers have migrated from NICs to software only solutions.



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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**NET SALES (CONTINUED)**

Fluctuation in foreign currency rates compared to the same period one year ago had a favorable impact on net sales of \$0.5 million in the three month period ended December 31, 2006 and an unfavorable impact on net sales of \$0.4 million in the three month period ended December 31, 2005.

**GROSS PROFIT**

Gross profit margin for the three months ended December 31, 2006 was 52.6% compared to 54.5% for the three months ended December 31, 2005. The decrease in gross profit margin was primarily due to lower sales of multi-port serial adapters and NICs with higher gross profit margins, as well as higher manufacturing expenses.

The Company anticipates that its gross profit margins will continue to be consistent with current levels, including amortization of purchased and core technology of 2.5% - 3%.

**OPERATING EXPENSES**

Total operating expenses for the three months ended December 31, 2006 were \$17.7 million, or 42.3% of net sales, compared with \$15.3 million, or 45.9% of net sales, for the three months ended December 31, 2005. The increase in operating expenses is attributable to the inclusion of operating expenses pertaining to MaxStream and variable compensation expenses related to the increase in revenue, partially offset by a reduction in legal fees compared to the first quarter of fiscal 2006. Operating expenses as a percent of net sales decreased by 3.6 percentage points, or 15.6%, in the first quarter of 2007 compared to the first quarter of 2006 as the Company continues to focus on controlling expenses while increasing revenue.

Sales and marketing expenses for the three months ended December 31, 2006 were \$8.1 million, or 19.5% of net sales, compared to \$6.8 million, or 20.2% of net sales for the three months ended December 31, 2005. The net increase in sales and marketing expenses of \$1.3 million is primarily due to increased ongoing expenses of \$0.7 million as the result of the acquisition of Maxstream in the fourth quarter of fiscal 2006 and \$0.6 million of salaries, commissions and other compensation related expenses.

Research and development expenses for the three months ended December 31, 2006 were \$6.0 million, or 14.3% of net sales, compared to \$4.8 million, or 14.4% of net sales for the three months ended December 31, 2005. The net increase in research and development expenses of \$1.2 million is due primarily to increased ongoing expenses of \$0.4 million as a result of the acquisition of MaxStream in the fourth quarter of fiscal 2006, an increase of \$0.4 million in compensation related expenses and an increase of \$0.4 million due to various chip development projects.

General and administrative expenses were \$3.6 million, or 8.5% of net sales, for the three months ended December 31, 2006 compared to \$3.8 million, or 11.3% of net sales for the three months ended December 31, 2005. The net decrease in general and administrative expenses of \$0.2 million was due primarily to decreased legal fees of \$0.7 million compared to the three months ended December 31, 2005, offset by increased ongoing expenses of \$0.4 million as a result of the MaxStream acquisition.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

**INTEREST INCOME AND OTHER, NET**

Interest income and other, net was \$0.8 million for the three months ended December 31, 2006 compared to \$0.3 million for the three months ended December 31, 2005. The Company realized interest income on marketable securities and cash and cash equivalents of \$0.8 million and \$0.4 million for the three month periods ended December 31, 2006 and 2005, respectively, due to higher average interest rates in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006, and an increase in the average invested balance.

**INCOME TAXES**

For the three months ended December 31, 2006, income taxes have been provided at an effective rate of 25.1% compared to 32.0% for the three months ended December 31, 2005. On December 9, 2006, Congress passed H.R. 6111, the Tax Relief and Health Care Act of 2006, which included an extension of the research credit previously expired on December 31, 2005. As a result of the extension, the Company recorded a benefit of \$0.5 million in the first quarter of fiscal 2007 for research and development credits earned during the last three fiscal quarters of 2006. The additional research and development credits were accounted for as a discrete event in the first quarter of fiscal 2007. The effective tax rates for both the first three months of fiscal 2007 and 2006 are lower than the U.S. statutory rate of 35.0% primarily due to the utilization of income tax credits and the combined phase-out of the extraterritorial income exclusion and the phase-in of the U.S. domestic production activities deduction.

The Company expects its annualized 2007 income tax rate to be approximately 33% to 33.5%.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company has financed its operations principally with funds generated from operations. At December 31, 2006, the Company had cash, cash equivalents and marketable securities of \$61.5 million compared to \$58.9 million at September 30, 2006. The Company's working capital increased \$7.2 million to \$90.5 million at December 31, 2006 compared to \$83.3 million at September 30, 2006.

Net cash provided by operating activities was \$3.2 million and \$2.3 million for the three months ended December 31, 2006 and 2005, respectively. The increase in net cash provided by operating activities of \$0.9 million for the comparable three month periods ended December 31, 2006 and 2005 is primarily due to an increase in net income of \$1.6 million adjusted for non-cash expenses of \$1.7 million, primarily related to stock-based compensation and deferred income taxes, offset by a \$2.4 million usage of working capital resulting from increased inventory at December 31, 2006 due to additional material purchases and production builds in order to fulfill order demand.

Net cash provided by investing activities was \$1.7 million during the three months ended December 31, 2006 compared to net cash used by investing activities of \$4.9 million during the same period in the prior fiscal year. Net settlements of marketable securities were \$3.2 million during the three months ended December 31, 2006 compared to net purchases of marketable securities of \$4.6 million during the same period one year ago. Purchases of property, equipment, improvements and certain other intangible assets were \$0.7 million and \$0.3 million for the three months ended December 31, 2006 and 2005, respectively. During the three months ended December 31, 2006, the Company used \$0.8 million for contingent purchase price payments related to the FS Forth acquisition (see Note 10 to Condensed Consolidated Financial Statements).

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)**

The Company anticipates total fiscal 2007 capital expenditures to approximate \$2.6 million.

The Company generated \$0.7 million from financing activities during the three months ended December 31, 2006 compared to \$1.8 million during the same period a year ago, primarily as a result of proceeds from stock option and employee stock purchase plan transactions in both periods, and the reflection of cash provided by the excess tax benefits related to the exercise of stock options.

The Company's management believes that current financial resources, cash generated from operations and the Company's potential capacity for additional debt and/or equity financing will be sufficient to fund operations in the foreseeable future.

The following summarizes the Company's contractual obligations at December 31, 2006 (in thousands):

|                                    | Total   | Payments due by fiscal period |           |           |            |
|------------------------------------|---------|-------------------------------|-----------|-----------|------------|
|                                    |         | Less than<br>1 year           | 1-3 years | 3-5 years | Thereafter |
| Operating leases                   | \$6,716 | \$2,385                       | \$2,343   | \$1,157   | \$831      |
| Capital leases                     | 1,177   | 449                           | 728       |           |            |
| Total contractual cash obligations | \$7,893 | \$2,834                       | \$3,071   | \$1,157   | \$831      |

The lease obligations summarized above relate to various operating lease agreements for office space and equipment. The capital leases summarized above are for manufacturing equipment located in Davis, California and Breisach, Germany. The table above excludes a potential \$1.2 million installment on October 1, 2007 of additional contingent purchase price payments related to the FS Forth acquisition if certain future milestones are achieved (see Note 10 to Condensed Consolidated Financial Statements).

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In July, 2006 the FASB issued Interpretation No. 48 ( FIN 48 ) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning October 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its consolidated financial statements. However, the Company does expect to reclassify a portion of its unrecognized tax benefits from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date.

**RISK FACTORS**

Multiple risk factors exist which could have a material effect on the Company's operations, results of operations, profitability, financial position, liquidity and capital resources. These risk factors are more fully presented in the Company's 2006 Annual Report on Form 10-K as filed with the SEC.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**INTEREST RATE RISK**

The Company's exposure to interest rate risk relates primarily to the Company's investment portfolio. Investments are made in accordance with the Company's investment policy and consist of high grade commercial paper and corporate bonds. The Company does not use derivative financial instruments to hedge against interest rate risk as all investments are held to maturity and the majority of the Company's investments mature in less than a year. A change in interest rates would not have a material effect on the Company's financial statements.

**FOREIGN CURRENCY RISK**

The Company's transactions are executed in the U.S. Dollar, Euro or Japanese Yen. As a result, the Company is exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros or Japanese Yen, and foreign currency translation risk as the financial position and operating results of the Company's foreign subsidiaries are translated into U.S. Dollars for consolidation. The Company has not implemented a hedging strategy to reduce foreign currency risk.

For the three months ended December 31, 2006 and 2005, the Company had approximately \$14.2 million and \$14.1 million, respectively, of net sales to foreign customers including export sales, of which \$6.5 million and \$5.0 million, respectively, were denominated in foreign currency, predominantly Euros. In future periods, a significant portion of sales will continue to be made in Euros.

The average monthly exchange rate for the Euro to the U.S. Dollar increased approximately 8.3% from 1.1902 to 1.2891 and the average monthly exchange rate for the Japanese Yen to the U.S. Dollar remained at .0085 for the first quarter of fiscal year 2007 as compared to the same period one year ago. A 10.0% change from the first quarter fiscal 2007 average exchange rate for the Euro and Yen to the U.S. Dollar would have resulted in a 1.6% increase or decrease in net sales and a 1.1% increase or decrease in stockholders' equity. The above analysis does not take into consideration any pricing adjustments the Company may need to consider in response to changes in the exchange rate.

**CREDIT RISK**

The Company has some exposure to credit risk related to its accounts receivable portfolio. Exposure to credit risk is controlled through regular monitoring of customer financial status, credit limits and collaboration with sales management on customer contacts to facilitate payment.

**ITEM 4. CONTROLS AND PROCEDURES**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)). Based on this evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act was recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to our management, including the principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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**ITEM 4. CONTROLS AND PROCEDURES (CONTINUED)**

**EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES (CONTINUED)**

There was no change in the Company's internal control over financial reporting during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The disclosures set forth in Note 10 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

Multiple risk factors exist which could have a material effect on the Company's operations, results of operations, profitability, financial position, liquidity and capital resources. These risk factors are more fully presented in the Company's 2006 Annual Report on Form 10-K as filed with the SEC.

**ITEM 2. UNREGISTERED SALES OF EQUITY 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**

None

**ITEM 6. EXHIBITS**

| Exhibit No. | Description  |
|-------------|--|
| 3(a)        | Restated Certificate of Incorporation of the Company, as amended (1) |
| 3(b)        | Amended and Restated By-Laws of the Company, as amended (2)          |

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**PART II. OTHER INFORMATION**  
**ITEM 6. EXHIBITS (CONTINUED)**

- 4(a) Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (3)
  - 4(b) Amendment dated January 26, 1999, to Share Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (4)
  - 10(a) Digi International Inc. 2000 Omnibus Stock Plan as Amended and Restated effective as of November 27, 2006, as approved by stockholders on January 22, 2007
  - 10(b) Digi International Inc. Employee Stock Purchase Plan, as Amended and Restated effective as of November 27, 2006, as approved by stockholders on January 22, 2007
  - 31(a) Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
  - 31(b) Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
  - 32 Section 1350 Certification
- (1) Incorporated by reference to Exhibit 3(a) to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972)
  - (2) Incorporated by reference to Exhibit 3(b) to the Company's Form 10-K for the year ended September 30, 2001 (File No. 0-17972)
  - (3) Incorporated by reference to Exhibit 1 to the Company's Registration Statement on

Form 8-A dated  
June 24, 1998  
(File  
No. 0-17972)

- (4) Incorporated by  
reference to  
Exhibit 1 to  
Amendment 1  
to the  
Company's  
Registration  
Statement on  
Form 8-A dated  
February 5,  
1999 (File  
No. 0-17972)

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**SIGNATURE**

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.

DIGI INTERNATIONAL INC.

Date: February 7, 2007

By: /s/ Subramanian Krishnan  
Subramanian Krishnan  
Senior Vice President, Chief Financial  
Officer and Treasurer (Principal  
Financial and Accounting Officer)

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## EXHIBIT INDEX

| Exhibit Number | Document Description  | Form of Filing            |
|----------------|---|---------------------------|
| 3(a)           | Restated Certificate of Incorporation of the Company, as Amended (incorporated by reference to the corresponding exhibit number to the Company's Form 10-K for the year ended September 30, 1993 (File No. 0-17972))  | Incorporated by Reference |
| 3(b)           | Amended and Restated By-Laws of the Company (incorporated by reference to the corresponding exhibit number to the Company's Form 10-K for the year ended September 30, 2001 (File No. 0-17972))   | Incorporated by Reference |
| 4(a)           | Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A dated June 24, 1998 (File No. 0-17972))  | Incorporated by Reference |
| 4(b)           | Amendment dated January 26, 1999, to Share Rights Agreement, dated June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (incorporated by reference to Exhibit 1 to Amendment No. 1 to the Company's Registration Statement on Form 8-A dated February 5, 1999 (File No. 0-17972)) | Incorporated by Reference |
| 10(a)          | Digi International Inc. 2000 Omnibus Stock Plan as Amended and Restated effective as of November 27, 2006, as approved by stockholders on January 22, 2007  | Filed Electronically      |
| 10(b)          | Digi International Inc. Employee Stock Purchase Plan, as Amended and Restated effective as of November 27, 2006, as approved by stockholders on January 22, 2007  | Filed Electronically      |

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|       |  |                      |
|-------|--|----------------------|
| 31(a) | Rule 13a-14(a)/15d-14(a)<br>Certification of Chief Executive Officer | Filed Electronically |
| 31(b) | Rule 13a-14(a)/15d-14(a)<br>Certification of Chief Financial Officer | Filed Electronically |
| 32    | Section 1350 Certification   | Filed Electronically |

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