

DIGI INTERNATIONAL INC

Form 10-Q

August 08, 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: June 30, 2007**

**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 July 31, 2007, there were 25,408,107 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 June                             |           | Nine months ended June 30, |            |
|---|---|-----------|----------------------------|------------|
|   | 2007  | 2006      | 2007                       | 2006       |
|   | 30,<br>(in thousands, except per common share data) |           |                            |            |
| Net sales   | \$ 43,527   | \$ 35,860 | \$ 128,193                 | \$ 103,616 |
| Cost of sales (exclusive of amortization of purchased and core technology shown separately below) | 19,392  | 15,222    | 57,257                     | 44,126     |
| Amortization of purchased and core technology   | 1,132   | 1,171     | 3,409                      | 3,507      |
| Gross profit  | 23,003  | 19,467    | 67,527                     | 55,983     |
| Operating expenses:   |   |           |                            |            |
| Sales and marketing   | 8,517   | 7,277     | 25,102                     | 20,830     |
| Research and development  | 6,039   | 5,402     | 18,079                     | 15,227     |
| General and administrative  | 3,349   | 3,037     | 10,229                     | 10,084     |
| Total operating expenses  | 17,905  | 15,716    | 53,410                     | 46,141     |
| Operating income  | 5,098   | 3,751     | 14,117                     | 9,842      |
| Other income (expense):   |   |           |                            |            |
| Interest income   | 872   | 685       | 2,444                      | 1,744      |
| Interest expense  | (17)  | (24)      | (59)                       | (92)       |
| Other expense   |   | (86)      |                            | (191)      |
| Total other income, net   | 855   | 575       | 2,385                      | 1,461      |
| Income before income taxes  | 5,953   | 4,326     | 16,502                     | 11,303     |
| Income tax (benefit) provision  | (845)   | 978       | 2,305                      | 3,205      |
| Net income  | \$ 6,798  | \$ 3,348  | \$ 14,197                  | \$ 8,098   |
| Net income per common share:  |   |           |                            |            |
| Basic   | \$ 0.27   | \$ 0.14   | \$ 0.56                    | \$ 0.35    |
| Diluted   | \$ 0.26   | \$ 0.14   | \$ 0.55                    | \$ 0.34    |
| Weighted average common shares, basic   | 25,294  | 23,124    | 25,186                     | 22,968     |

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|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Weighted average common shares, diluted | 26,152 | 23,904 | 26,032 | 23,695 |
|---|--------|--------|--------|--------|

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)**

|  | June 30,<br>2007                  | September 30,<br>2006 |
|--|-----------------------------------|-----------------------|
|  | (in thousands, except share data) |                       |
| <b>ASSETS</b>  |                                   |                       |
| Current assets:  |                                   |                       |
| Cash and cash equivalents  | \$ 34,068                         | \$ 15,674             |
| Marketable securities  | 43,898                            | 43,207                |
| Accounts receivable, net   | 21,892                            | 20,305                |
| Inventories  | 25,305                            | 21,911                |
| Other  | 4,856                             | 5,528                 |
| <b>Total current assets</b>  | <b>130,019</b>                    | <b>106,625</b>        |
| Property, equipment and improvements, net  | 19,848                            | 19,488                |
| Identifiable intangible assets, net  | 25,971                            | 31,341                |
| Goodwill   | 65,642                            | 65,841                |
| Other  | 2,184                             | 2,026                 |
| <b>Total assets</b>  | <b>\$ 243,664</b>                 | <b>\$ 225,321</b>     |
| <br><b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |                                   |                       |
| Current liabilities:   |                                   |                       |
| Capital lease obligations, current portion   | \$ 375                            | \$ 381                |
| Accounts payable   | 7,911                             | 6,748                 |
| Income taxes payable   | 5,445                             | 4,712                 |
| Accrued expenses:  |                                   |                       |
| Compensation   | 5,523                             | 5,851                 |
| Other  | 3,568                             | 5,592                 |
| <b>Total current liabilities</b>   | <b>22,822</b>                     | <b>23,284</b>         |
| Capital lease obligations, net of current portion  | 444                               | 725                   |
| Net deferred tax liabilities   | 5,996                             | 7,482                 |
| <b>Total liabilities</b>   | <b>29,262</b>                     | <b>31,491</b>         |
| <br>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; 28,021,122 and 27,748,640 shares issued and outstanding | 280                               | 277                   |
| Additional paid-in capital   | 170,049                           | 164,782               |
| Retained earnings  | 61,206                            | 47,009                |
| Accumulated other comprehensive income   | 1,426                             | 940                   |

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|   |            |            |
|---|------------|------------|
| Treasury stock, at cost, 2,647,145 and 2,711,496 shares | (18,559)   | (19,178)   |
| Total stockholders' equity                              | 214,402    | 193,830    |
| Total liabilities and stockholders' equity              | \$ 243,664 | \$ 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)**

|   | Nine months ended June 30, |          |
|---|----------------------------|----------|
|   | 2007                       | 2006     |
|   | (in thousands)             |          |
| Operating activities:   |                            |          |
| Net income  | \$ 14,197                  | \$ 8,098 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                            |          |
| Depreciation of property, equipment and improvements                              | 1,878                      | 1,949    |
| Amortization of identifiable intangible assets and other assets                   | 5,769                      | 5,744    |
| Excess tax benefits from stock-based compensation                                 | (315)                      | (485)    |
| Stock-based compensation expense  | 2,258                      | 1,742    |
| Deferred income taxes   | (1,612)                    | (1,987)  |
| Other   | 18                         | (436)    |
| Changes in operating assets and liabilities:                                      |                            |          |
| Accounts receivable   | (1,109)                    | (696)    |
| Inventories   | (3,543)                    | (1,068)  |
| Other assets  | 709                        | (293)    |
| Accounts payable and accrued expenses   | (903)                      | (2,838)  |
| Income taxes payable  | 1,328                      | 4,121    |
| <br>  |                            |          |
| Net cash provided by operating activities   | 18,675                     | 13,851   |
| <br>  |                            |          |
| Investing activities:   |                            |          |
| Purchase of held-to-maturity marketable securities                                | (56,593)                   | (44,836) |
| Proceeds from maturities of held-to-maturity marketable securities                | 55,902                     | 30,578   |
| Contingent purchase price payments related to business acquisitions               | (781)                      |          |
| Purchase of property, equipment, improvements and certain other intangible assets | (2,329)                    | (1,055)  |
| Proceeds from the sale of property, equipment, improvements                       | 17                         |          |
| <br>  |                            |          |
| Net cash used in investing activities   | (3,784)                    | (15,313) |
| <br>  |                            |          |
| Financing activities:   |                            |          |
| Payments on capital lease obligations and long-term debt                          | (287)                      | (372)    |
| Excess tax benefits from stock-based compensation                                 | 315                        | 485      |
| Proceeds from stock option plan transactions                                      | 2,433                      | 2,931    |
| Proceeds from employee stock purchase plan transactions                           | 954                        | 555      |
| <br>  |                            |          |
| Net cash provided by financing activities   | 3,415                      | 3,599    |

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|  |           |           |
|--|-----------|-----------|
| Effect of exchange rate changes on cash and cash equivalents | 88        | (705)     |
| Net increase in cash and cash equivalents                    | 18,394    | 1,432     |
| Cash and cash equivalents, beginning of period               | 15,674    | 12,990    |
| Cash and cash equivalents, end of period                     | \$ 34,068 | \$ 14,422 |

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, Digi, we, our, or us ) pursuant to the rules and regulations of the Securities 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 our 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. The year-end condensed consolidated balance sheet data were derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

*Recently Issued Accounting Pronouncements*

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ( SFAS 159 )*. This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which for us is the first quarter of fiscal 2009. We are currently evaluating the impact that SFAS 159 could have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements ( FAS 157 )*. FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of FAS 157 are effective for our fiscal year beginning October 1, 2008. We are currently evaluating the impact that SFAS 157 could have on our consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( *FIN 48* ). 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 us beginning October 1, 2007. We are in the process

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

of determining the effect, if any, that the adoption of FIN 48 will have on our consolidated financial statements. However, we expect to reclassify a portion of our 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. 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 our 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 June 30, |          | Nine months ended June 30, |          |
|---|-----------------------------|----------|----------------------------|----------|
|   | 2007                        | 2006     | 2007                       | 2006     |
| Numerator:  |                             |          |                            |          |
| Net income  | \$ 6,798                    | \$ 3,348 | \$ 14,197                  | \$ 8,098 |
| Denominator:  |                             |          |                            |          |
| Denominator for basic net income per common share weighted average shares outstanding | 25,294                      | 23,124   | 25,186                     | 22,968   |
| Effect of dilutive securities:  |                             |          |                            |          |
| Employee stock options and employee stock purchase plan                               | 858                         | 780      | 846                        | 727      |
| Denominator for diluted net income per common share adjusted weighted average shares  | 26,152                      | 23,904   | 26,032                     | 23,695   |
| Net income per common share, basic  | \$ 0.27                     | \$ 0.14  | \$ 0.56                    | \$ 0.35  |
| Net income per common share, diluted  | \$ 0.26                     | \$ 0.14  | \$ 0.55                    | \$ 0.34  |

Potentially dilutive shares related to stock options to purchase 595,784 and 1,100,901 common shares for the three and nine month periods ended June 30, 2007, respectively, and potentially dilutive shares related to stock options to purchase 1,084,850 and 1,324,850 common shares for the three and nine month periods ended June 30, 2006, 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.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****3. COMPREHENSIVE INCOME**

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 |          | Nine months ended |          |
|--|--------------------|----------|-------------------|----------|
|  | June 30,           |          | June 30,          |          |
|  | 2007               | 2006     | 2007              | 2006     |
| Net income                               | \$ 6,798           | \$ 3,348 | \$ 14,197         | \$ 8,098 |
| Foreign currency translation (loss) gain | (154)              | 85       | 486               | (243)    |
| Comprehensive income                     | \$ 6,644           | \$ 3,433 | \$ 14,683         | \$ 7,855 |

**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 our 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 our 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 us, including consultants, advisers and directors. Options 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 our 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 our 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 our Compensation Committee but shall not be less than the fair market value of our common stock based on the closing price on the date of grant.

Additionally, we have outstanding stock options for shares of our stock under various plans assumed in connection with our prior acquisition of NetSilicon, Inc. (the Assumed Plans). Additional awards cannot be made by us under the Assumed Plans.

Also, we sponsor 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

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

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 our Common Stock that may be purchased under the plan.

Effective October 1, 2005 we 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.

Stock-based compensation expense (pre-tax) is included in the consolidated results of operations as follows (in thousands):

|                                | Three months ended June 30, |        | Nine months ended June 30, |          |
|--------------------------------|-----------------------------|--------|----------------------------|----------|
|                                | 2007                        | 2006   | 2007                       | 2006     |
| Cost of sales                  | \$ 33                       | \$ 22  | \$ 100                     | \$ 65    |
| Sales and marketing            | 254                         | 185    | 740                        | 504      |
| Research and development       | 183                         | 132    | 514                        | 401      |
| General and administrative     | 284                         | 240    | 904                        | 772      |
| Total stock-based compensation | \$ 754                      | \$ 579 | \$ 2,258                   | \$ 1,742 |

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

On July 27, 2006, we 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. We did not replace MaxStream's outstanding options with Digi options. The value of our 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 were deposited to an escrow fund established at Wells Fargo Bank, National Association. These amounts were held in escrow for a period not to exceed one year from the date of closing to satisfy possible claims that could arise pursuant to specific representation and warranty sections of the merger agreement. The escrowed amounts of cash and stock were included in the determination of the purchase consideration on the date of acquisition because our management believed the outcome of the representation and warranty matters was reasonably determinable. We paid the former shareholders the full amount of the escrowed cash and stock from escrow on August 1, 2007.

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

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation was adjusted by \$0.4 million in March 2007 resulting in an increase in working capital and a reduction in goodwill due to the filing of an amended final tax return for MaxStream. The adjusted purchase price allocation resulted in goodwill of \$26.0 million and a charge of \$2.0 million for acquired in-process research and development. We believe that the acquisition resulted in the recognition of goodwill primarily because MaxStream's wireless technologies and products significantly expand our wireless offering, covering both short and medium range distances using embedded modules and boxed/package solutions, enabling us 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 we 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 June 30,<br>2006 |             | Nine months ended June 30,<br>2006 |             |
|--------------------------------------|-------------------------------------|-------------|------------------------------------|-------------|
|                                      | Pro forma                           | As Reported | Pro forma                          | As Reported |
| Net sales                            | \$ 39,685                           | \$ 35,860   | \$ 113,765                         | \$ 103,616  |
| Net income                           | \$ 3,435                            | \$ 3,348    | \$ 8,106                           | \$ 8,098    |
| Net income per common share, basic   | \$ 0.14                             | \$ 0.14     | \$ 0.33                            | \$ 0.35     |
| Net income per common share, diluted | \$ 0.13                             | \$ 0.14     | \$ 0.32                            | \$ 0.34     |

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)**

|                                      | June 30, 2007 | September 30, 2006 |
|--------------------------------------|---------------|--------------------|
| Accounts receivable, net:            |               |                    |
| Accounts receivable                  | \$ 22,373     | \$ 20,800          |
| Less allowance for doubtful accounts | 481           | 495                |
|                                      | \$ 21,892     | \$ 20,305          |
| Inventories:                         |               |                    |
| Raw materials                        | \$ 18,852     | \$ 16,491          |
| Work in process                      | 1,665         | 606                |
| Finished goods                       | 4,788         | 4,814              |
|                                      | \$ 25,305     | \$ 21,911          |
| Other accrued expenses:              |               |                    |
| Product warranty accrual             | \$ 959        | \$ 1,104           |
| Accrued professional fees            | 624           | 879                |
| Other accrued expenses               | 1,985         | 3,609              |
|                                      | \$ 3,568      | \$ 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):

|                                | June 30, 2007         |               |           | September 30, 2006    |               |           |
|--------------------------------|-----------------------|---------------|-----------|-----------------------|---------------|-----------|
|                                | Gross carrying amount | Accum. amort. | Net       | Gross carrying amount | Accum. amort. | Net       |
| Purchased and core technology  | \$ 48,064             | \$ (34,926)   | \$ 13,138 | \$ 48,022             | \$ (31,492)   | \$ 16,530 |
| License agreements             | 2,440                 | (2,190)       | 250       | 2,440                 | (1,890)       | 550       |
| Patents and trademarks         | 7,882                 | (3,628)       | 4,254     | 7,608                 | (2,837)       | 4,771     |
| Customer maintenance contracts | 700                   | (376)         | 324       | 700                   | (324)         | 376       |
| Customer relationships         | 11,544                | (3,539)       | 8,005     | 11,470                | (2,356)       | 9,114     |
| Total                          | \$ 70,630             | \$ (44,659)   | \$ 25,971 | \$ 70,240             | \$ (38,899)   | \$ 31,341 |

Amortization expense was \$1.9 million for both the three months ended June 30, 2007 and 2006 and \$5.7 million and \$5.5 million for the nine months ended June 30, 2007 and 2006, 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 (three months) | \$ 1,884 |
| 2008                | 5,375    |
| 2009                | 4,036    |
| 2010                | 3,640    |
| 2011                | 3,070    |
| 2012                | 2,514    |

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

|   | Nine months ended June 30, |           |
|---|----------------------------|-----------|
|   | 2007                       | 2006      |
| Beginning balance, October 1            | \$ 65,841                  | \$ 38,675 |
| Purchase price adjustment MaxStream     | (374)                      |           |
| Purchase price adjustment FS Forth      |                            | (147)     |
| Foreign currency translation adjustment | 175                        | 84        |
| Ending balance, June 30                 | \$ 65,642                  | \$ 38,612 |

During the nine months ended June 30, 2007, goodwill related to the purchase of MaxStream, acquired during fiscal 2006, was reduced by \$0.4 million to reflect additional working capital associated with the filing of an amended final tax return. During the nine months ended June 30, 2006, 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.

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

Income taxes have been provided for at an effective rate of (14.2%) and 14.0% for the three and nine month periods ended June 30, 2007, respectively, compared to an effective rate of 22.6% and 28.4% for the three and nine month periods ended June 30, 2006, respectively. In the third quarter of fiscal 2007, we recorded discrete tax benefits of \$2.9 million, of which \$2.3 million primarily resulted from the reversal of previously established income tax reserves that are no longer required as a result of the closing of a domestic tax return. In addition, we completed a foreign tax audit in the third quarter of 2007 and reversed \$0.6 million in income tax reserves that had been previously established and are no longer required. During the first quarter of 2007, 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, we recorded a discrete income tax 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.

In the third quarter of fiscal 2006, we received tax refunds of \$0.3 million related to final determination of prior year uncertainties and recorded other tax benefits primarily related to prior years' research and development credit totaling \$0.3 million. These items aggregating \$0.6 million were accounted for as a discrete event in the third quarter of fiscal 2006.

The discrete events previously described benefited our effective tax rates as shown in the table below:

|   | Three months ended June 30, |        | Nine months ended June 30, |       |
|---|-----------------------------|--------|----------------------------|-------|
|   | 2007                        | 2006   | 2007                       | 2006  |
| Effective tax rate before impact of discrete events | 35.0%                       | 34.8%  | 36.1%                      | 33.9% |
| Impact of discrete events                           | -49.2%                      | -12.2% | -22.1%                     | -5.5% |
| Effective tax rate                                  | -14.2%                      | 22.6%  | 14.0%                      | 28.4% |

The effective tax rate before the impact of the discrete events for the nine months ended June 30, 2007 is approximately equal to the U.S. statutory rate of 35%. The effective tax rate before the impact of the discrete events for the nine months ended June 30, 2006 is slightly less than the U. S. statutory rate of 35%, primarily due to utilization of income tax credits and the combined extraterritorial income exclusion and the U.S. domestic production activities deduction.

**Table of Contents****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****9. FINANCIAL GUARANTEES**

In general, we warrant our 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. We have the option to repair or replace products we deem 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<br>April 1 | Three months ended June 30,<br>Warranties issued      Settlements made |          | Balance at<br>June 30 |
|------|-----------------------|--|----------|-----------------------|
| 2007 | \$ 1,006              | \$ 176   | \$ (223) | \$ 959                |
| 2006 | \$ 1,050              | \$ 160   | \$ (128) | \$ 1,082              |

|      | Balance at<br>October 1 | Nine months ended June 30,<br>Warranties issued (1)      Settlements made |          | Balance at<br>June 30 |
|------|-------------------------|---|----------|-----------------------|
| 2007 | \$ 1,104                | \$ 485  | \$ (630) | \$ 959                |
| 2006 | \$ 1,187                | \$ 268  | \$ (373) | \$ 1,082              |

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

We are not responsible and do not warrant that custom software versions created by original equipment manufacturer (OEM) customers based upon our software source code will function in a particular way, will conform to any specifications or are fit for any particular purpose and do 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, we 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 will be recorded as an accrued liability and an addition to goodwill as of September 30, 2007 if FS Forth achieves certain future milestones. Any contingent consideration will be paid on October 1, 2007.

*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 names us as defendants along with 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. We believe that the claims against the NetSilicon defendants are without merit and have 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, we elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. Had it been approved by the Court, this proposed settlement would have resulted in a dismissal, with prejudice, of all claims in the litigation against us and against any of the other issuer defendants who elected to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as

individual defendants. This proposed settlement was conditioned on, among other things, a ruling by the District Court that the claims against NetSilicon and against the other issuers who had agreed to the settlement would be certified for class action treatment for purposes of the proposed settlement, such that all investors included in the proposed classes in these cases would be bound by the terms of the settlement unless an investor opted to be excluded from the settlement in a timely and appropriate fashion.

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

**10. CONTINGENCIES (CONTINUED)**

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 us could 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 this ruling. On April 6, 2007 the Court of Appeals denied the plaintiffs' petition for rehearing of the Court's December 5, 2006 ruling. The Court of Appeals, however, noted that the plaintiffs remained free to ask the District Court to certify classes different from the ones originally proposed which might meet the standards for class certification that the Court of Appeals articulated in its December 5, 2006 decision.

In light of the Court of Appeals' December 5, 2006 decision regarding certification of the plaintiffs' claims, the District Court entered an order on June 25, 2007 terminating the proposed settlement between the plaintiffs and the issuers, including NetSilicon. Because any possible future settlement with the plaintiffs, if a settlement were ever to be negotiated and ultimately agreed to, would involve the certification of a class action for settlement purposes, the impact of the Court of Appeals' rulings on the possible future settlement of the claims against NetSilicon cannot now be predicted.

Given that the proposed settlement has been terminated, we intend to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. We maintain liability insurance for such matters and expect 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 June 30, 2007, we have accrued a liability for the deductible amount of \$250,000 which we believe reflects the amount of loss that is probable. In the event we have losses that exceed the limits of the liability insurance, such losses could have a material effect on our business and our consolidated results of operations or financial condition.

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

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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 our management as of the time of such statements and relate to, among other things, expectations of the business environment in which we operate, projection of our future performance, perceived opportunities in the market and statements regarding our mission and vision. Forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance or achievements to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Our future operating results and performance trends may be affected by a number of factors, including, without limitation, those described under Item 1A, Risk Factors in our 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 our filings with the Securities and Exchange Commission, including without limitation, our quarterly reports on Form 10-Q and our registration statements, could cause our actual future results to differ from those projected in the forward-looking statements as a result of the factors set forth in our 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 our critical accounting policies was provided in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended September 30, 2006.

**OVERVIEW**

We operate 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. We place a high priority on development of innovative reliable products that provide differentiated features and functions and allow for ease of integration with customers' applications. We compete 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.

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

We plan to extend our 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. A connected or networked device is more productive because it can be remotely monitored and controlled, and data from it can be stored, analyzed and used in real time. We believe that wireless connectivity will be a key driver of the next wave of Internet growth. Our Cellular, WiFi, Zigbee, and proprietary RF networking products and technologies put us in a position to provide end-to-end wireless networking solutions.

We anticipate that growth in the future will result from both products that are developed internally as well as from acquired products, 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. Following are the business highlights for the three and nine months ended June 30, 2007 and 2006:

Net sales of \$43.5 million for the three months ended June 30, 2007 represented an increase of \$7.6 million, or 21.4%, compared to net sales of \$35.9 million for the three months ended June 30, 2006. Net sales of \$128.2 million for the nine months ended June 30, 2007, represented an increase of \$24.6 million, or 23.7%, compared to net sales of \$103.6 million for the nine months ended June 30, 2006.

Gross profit margin decreased to 52.8% compared to 54.3% for the three months ended June 30, 2007 and 2006, respectively. Gross profit margin decreased to 52.7% compared to 54.0% for the nine months ended June 30, 2007 and 2006, respectively.

Operating expenses as a percent of net sales decreased by 2.7 and 2.8 percentage points for the three and nine months ended June 30, 2007, compared to the same periods in 2006, as we continue to focus on controlling expenses while increasing revenue. Total operating expenses for the three months ended June 30, 2007 were \$17.9 million, or 41.1% of net sales, compared to \$15.7 million, or 43.8% of net sales, for the three months ended June 30, 2006, an increase of \$2.2 million. Total operating expenses for the nine months ended June 30, 2007 were \$53.4 million, or 41.7% of net sales, compared to \$46.1 million, or 44.5% of net sales, for the nine months ended June 30, 2006, an increase of \$7.3 million.

Net income increased \$3.5 million to \$6.8 million, or \$0.26 per diluted share, for the three months ended June 30, 2007, compared to \$3.3 million, or \$0.14 per diluted share, for the three months ended June 30, 2006. Net income increased \$6.1 million to \$14.2 million, or \$0.55 per diluted share, for the nine months ended June 30, 2007, compared to \$8.1 million, or \$0.34 per diluted share, for the nine months ended June 30, 2006. During the third quarter of fiscal 2007, we reversed previously established income tax reserves which provided us an income tax benefit of \$2.9 million, or \$0.11 per diluted share, pertaining to the closing of a domestic tax return and a settlement of a foreign tax audit. In addition, 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.

Our net working capital position (total current assets less total current liabilities) increased \$23.9 million to \$107.2 million during the nine months ended June 30, 2007 and our current ratio was 5.7 to 1 as of that date. Cash and cash equivalents and marketable securities increased \$19.1 million to \$78.0 million during the nine month period. At June 30, 2007, we 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 our 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 June 30, |        | 2006      |        | %          | Nine months ended June 30, |        | 2006       |        | %          |
|--|-----------------------------|--------|-----------|--------|------------|----------------------------|--------|------------|--------|------------|
|  | 2007                        |        |           |        | (decrease) | 2007                       |        |            |        | (decrease) |
| Net sales  | \$ 43,527                   | 100.0% | \$ 35,860 | 100.0% | 21.4%      | \$ 128,193                 | 100.0% | \$ 103,616 | 100.0% | 23.7%      |
| Cost of sales<br>(exclusive of<br>amortization of<br>purchased and core<br>technology shown<br>separately below) | 19,392                      | 44.6   | 15,222    | 42.4   | 27.4       | 57,257                     | 44.7   | 44,126     | 42.6   | 29.8       |
| Amortization of<br>purchased and core<br>technology  | 1,132                       | 2.6    | 1,171     | 3.3    | (3.3)      | 3,409                      | 2.6    | 3,507      | 3.4    | (2.8)      |
| Gross profit   | 23,003                      | 52.8   | 19,467    | 54.3   | 18.2       | 67,527                     | 52.7   | 55,983     | 54.0   | 20.6       |
| Operating<br>expenses:   |                             |        |           |        |            |                            |        |            |        |            |
| Sales and<br>marketing   | 8,517                       | 19.6   | 7,277     | 20.3   | 17.0       | 25,102                     | 19.6   | 20,830     | 20.1   | 20.5       |
| Research and<br>development  | 6,039                       | 13.8   | 5,402     | 15.1   | 11.8       | 18,079                     | 14.1   | 15,227     | 14.7   | 18.7       |
| General and<br>administrative  | 3,349                       | 7.7    | 3,037     | 8.4    | 10.3       | 10,229                     | 8.0    | 10,084     | 9.7    | 1.4        |
| Total operating<br>expenses  | 17,905                      | 41.1   | 15,716    | 43.8   | 13.9       | 53,410                     | 41.7   | 46,141     | 44.5   | 15.8       |
| Operating income   | 5,098                       | 11.7   | 3,751     | 10.5   | 35.9       | 14,117                     | 11.0   | 9,842      | 9.5    | 43.4       |
| Total other<br>income, net   | 855                         | 2.0    | 575       | 1.6    | 48.7       | 2,385                      | 1.9    | 1,461      | 1.4    | 63.2       |
| Income before<br>income taxes  | 5,953                       | 13.7   | 4,326     | 12.1   | 37.6       | 16,502                     | 12.9   | 11,303     | 10.9   | 46.0       |
| Income tax<br>(benefit) provision  | (845)                       | (1.9)  | 978       | 2.8    | (186.4)    | 2,305                      | 1.8    | 3,205      | 3.1    | (28.1)     |
| Net income   | \$ 6,798                    | 15.6%  | \$ 3,348  | 9.3%   | 103.0%     | \$ 14,197                  | 11.1%  | \$ 8,098   | 7.8%   | 75.3%      |

**NET SALES**

Net sales for the three and nine months ended June 30, 2007 were \$43.5 million and \$128.2 million compared to net sales of \$35.9 million and \$103.6 million for the three and nine months ended June 30, 2006, or an increase of 21.4% and 23.7%, respectively. Net sales of products acquired as a result of the MaxStream acquisition, which occurred on



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July 27, 2006, were \$5.4 million and \$15.0 million for the first three and nine months of fiscal 2007. The following summarizes our net sales for the periods indicated:

| (\$ in thousands) | Three months ended June 30, |        | % increase |            |       | Nine months ended June 30, |        | % increase |        |       |
|-------------------|-----------------------------|--------|------------|------------|-------|----------------------------|--------|------------|--------|-------|
|                   | 2007                        | 2006   |            | (decrease) |       | 2007                       | 2006   | (decrease) |        |       |
| Non-embedded      | \$ 24,750                   | 56.9%  | \$ 22,176  | 61.8%      | 11.6% | \$ 74,361                  | 58.0%  | \$ 62,804  | 60.6%  | 18.4% |
| Embedded          | 18,777                      | 43.1   | 13,684     | 38.2       | 37.2  | 53,832                     | 42.0   | 40,812     | 39.4   | 31.9  |
| Total net sales   | \$ 43,527                   | 100.0% | \$ 35,860  | 100.0%     | 21.4% | \$ 128,193                 | 100.0% | \$ 103,616 | 100.0% | 23.7% |

*Non-Embedded*

Net sales of network connected products, USB, cellular gateways and MaxStream non-embedded products increased net sales by \$4.2 million and \$15.3 million for the three and nine months ended June 30, 2007 as compared to the three and nine months ended June 30, 2006, respectively. Multi-port serial adapter products net sales declined by \$1.6 million and \$3.7 million for the three and nine months ended June 30, 2007 compared to the same periods in the prior year as this mature product line slowly declines.

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

Net sales of embedded modules and microprocessors increased by \$5.5 million and \$15.1 million for the three and nine months ended June 30, 2007 compared to the three and nine months ended June 30, 2006, respectively, due to continued market acceptance of embedded products and MaxStream modules. This was offset by a decline of \$0.4 million and \$2.1 million of NIC net sales for the three and nine months ended June 30, 2007 as compared to the three and nine months ended June 30, 2006, respectively, as our NIC products are near the end of their product life cycle.

Fluctuation in foreign currency rates compared to the same periods one year ago had a favorable impact on net sales of \$0.5 million and \$1.7 million in the three and nine month periods ended June 30, 2007.

**GROSS PROFIT**

Gross profit margin for the three and nine months ended June 30, 2007 was 52.8% and 52.7% compared to 54.3% and 54.0% for the three and nine months ended June 30, 2006. The decrease in gross profit margin was primarily due to lower sales of high gross profit margin mature products and other product mix changes and customer mix changes within both the embedded and non-embedded product categories. We anticipate that our gross profit margins for the remainder of the fiscal year will be consistent with current levels.

**OPERATING EXPENSES**

| (\$ in thousands)          | Three months ended June 30, |       | increase   |       | Nine months ended June 30, |           | increase   |           |       |          |
|----------------------------|-----------------------------|-------|------------|-------|----------------------------|-----------|------------|-----------|-------|----------|
|                            | 2007                        | 2006  | (decrease) |       | 2007                       | 2006      | (decrease) |           |       |          |
| Operating expenses:        |                             |       |            |       |                            |           |            |           |       |          |
| Sales and marketing        | \$ 8,517                    | 19.6% | \$ 7,277   | 20.3% | \$ 1,240                   | \$ 25,102 | 19.6%      | \$ 20,830 | 20.1% | \$ 4,272 |
| Research and development   | 6,039                       | 13.8  | 5,402      | 15.1  | 637                        | 18,079    | 14.1       | 15,227    | 14.7  | 2,852    |
| General and administrative | 3,349                       | 7.7   | 3,037      | 8.4   | 312                        | 10,229    | 8.0        | 10,084    | 9.7   | 145      |
| Total operating expenses   | \$ 17,905                   | 41.1% | \$ 15,716  | 43.8% | \$ 2,189                   | \$ 53,410 | 41.7%      | \$ 46,141 | 44.5% | \$ 7,269 |

Total operating expenses increased \$2.2 million for the comparable three month periods ended June 30, 2007 and 2006 which is primarily attributable to the inclusion of operating expenses of \$1.6 million pertaining to MaxStream and \$0.8 million of variable compensation expenses related to the increases in both revenue and profitability, partially offset by a \$0.2 million reduction due to the timing of various chip development projects. For the nine month periods ended June 30, 2007 and 2006, total operating expenses increased by \$7.3 million due to primarily to the inclusion of operating expenses of \$4.5 million pertaining to MaxStream, \$3.2 million of variable compensation expenses related to the increases in both revenue and profitability, \$0.3 related to the timing of various chip development projects, offset by a decrease of \$1.3 million in professional fees.

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

Sales and marketing expenses for the three months ended June 30, 2007 were \$8.5 million, or 19.6% of net sales, compared to \$7.3 million, or 20.3% of net sales, for the three months ended June 30, 2006. The increase of \$1.2 million in sales and marketing expenses for the three months ended June 30, 2007 compared to 2006 is primarily due to \$0.7 million in expenses as a result of the acquisition of MaxStream and an increase of \$0.5 million of salaries and incentive compensation related expenses associated with the increases in both revenue and profitability. Sales and marketing expenses for the nine months ended June 30, 2007 were \$25.1 million, or 19.6% of net sales, compared to \$20.9 million, or 20.1% of net sales, for the nine months ended June 30, 2006. The net increase in sales and marketing expenses of \$4.2 million is primarily due to expenses of \$2.1 million as the result of the acquisition of MaxStream and an increase of \$1.9 million for salaries and incentive compensation related expenses associated with the increases in both revenue and profitability.

Research and development expenses for the three months ended June 30, 2007 were \$6.1 million, or 13.8% of net sales, compared to \$5.4 million, or 15.1% of net sales, for the three months ended June 30, 2006. The increase in research and development expenses for the three months ended June 30, 2007 compared to 2006 is primarily due to expenses of \$0.6 million as a result of the MaxStream acquisition, an increase of \$0.3 million for salaries and incentive compensation related expenses associated with the increases in both revenue and profitability, offset by a decrease of \$0.2 million due to the timing of various chip development projects. Research and development expenses for the nine months ended June 30, 2007 were \$18.1 million, or 14.1% of net sales, compared to \$15.2 million, or 14.7% of net sales, for the nine months ended June 30, 2006. The increase in research and development expenses of \$2.9 million is due primarily to expenses of \$1.4 million as a result of the acquisition of MaxStream, an increase of \$1.1 million in salaries and incentive compensation related expenses associated with the increases in both revenue and profitability and an increase of \$0.3 million pertaining to the timing of various chip development projects.

General and administrative expenses were \$3.3 million, or 7.7% of net sales, for the three months ended June 30, 2007 compared to \$3.0 million, or 8.4% of net sales, for the three months ended June 30, 2006. For the three months ended June 30, 2007 compared to the same period in 2006, general and administrative expenses increased by \$0.3 million as a result of expenses resulting from the MaxStream acquisition. General and administrative expenses were \$10.2 million, or 8.0% of net sales, for the nine months ended June 30, 2007 compared to \$10.1 million, or 9.7% of net sales, for the nine months ended June 30, 2006. The net increase in general and administrative expenses of \$0.1 million was due primarily to expenses of \$1.0 million as a result of the MaxStream acquisition, an increase of \$0.2 million in incentive compensation related expenses associated with the increases in revenue and profitability, offset by a decrease in professional fees of \$1.3 million.

**OTHER INCOME, NET**

Other income, net was \$0.9 million and \$2.4 million for the three and nine months ended June 30, 2007 compared to \$0.6 million and \$1.5 million for the three and nine months ended June 30, 2006, respectively. We realized interest income on marketable securities and cash and cash equivalents of \$2.4 million and \$1.5 million for the nine month periods ended June 30, 2007 and 2006, respectively, due to higher average interest rates and an increase in the average invested balance. We earned an average interest rate of 5.1% for the nine months ended June 30, 2007 compared to 4.1% for the nine months ended June 30, 2006. The average invested balance for the three months ended June 30, 2007 and 2006 was \$70.4 million and \$61.3

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

million, respectively. The average invested balance for the nine months ended June 30, 2007 and 2006 was \$62.6 million and \$53.3 million, respectively.

**INCOME TAXES**

Income taxes have been provided for at an effective rate of (14.2%) and 14.0% for the three and nine month periods ended June 30, 2007, respectively, compared to an effective rate of 22.6% and 28.4% for the three and nine month periods ended June 30, 2006, respectively. In the third quarter of fiscal 2007, we recorded discrete tax benefits of \$2.9 million, of which \$2.3 million primarily resulted from the reversal of previously established income tax reserves that are no longer required as a result of the closing of a domestic tax return. In addition, we completed a foreign tax audit in the third quarter of 2007 and reversed \$0.6 million in income tax reserves that had been previously established and are no longer required. During the first quarter of 2007, 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, we recorded a discrete income tax 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.

In the third quarter of fiscal 2006, we received tax refunds of \$0.3 million related to final determination of prior year uncertainties and recorded other tax benefits primarily related to prior years' research and development credit totaling \$0.3 million. These items aggregating \$0.6 million were accounted for as a discrete event in the third quarter of fiscal 2006.

The discrete events previously described benefited our effective tax rates as shown in the table below:

|   | Three months ended June 30, |        | Nine months ended June 30, |       |
|---|-----------------------------|--------|----------------------------|-------|
|   | 2007                        | 2006   | 2007                       | 2006  |
| Effective tax rate before impact of discrete events | 35.0%                       | 34.8%  | 36.1%                      | 33.9% |
| Impact of discrete events                           | -49.2%                      | -12.2% | -22.1%                     | -5.5% |
| Effective tax rate                                  | -14.2%                      | 22.6%  | 14.0%                      | 28.4% |

The effective tax rate before the impact of the discrete events for the nine months ended June 30, 2007 is approximately equal to the U.S. statutory rate of 35%. The effective tax rate before the impact of the discrete events for the nine months ended June 30, 2006 is slightly less than the U. S. statutory rate of 35%, primarily due to utilization of income tax credits and the combined extraterritorial income exclusion and the U.S. domestic production activities deduction.

We expect our annualized 2007 effective income tax rate to be in a range of 15% to 25%, including the impact of the \$3.4 million in discrete events recorded for the nine month period ended June 30, 2007.

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

We have financed our operations principally with funds generated from operations. At June 30, 2007, we had cash, cash equivalents and marketable securities of \$78.0 million compared to \$58.9 million at September 30, 2006. Our working capital (total current assets less total current liabilities) increased \$23.9 million to \$107.2 million at June 30, 2007 compared to \$83.3 million at September 30, 2006.

**Consolidated Statement of Cash Flow Highlights (in thousands)**

|  | Nine months ended June 30, |           |           |
|--|----------------------------|-----------|-----------|
|  | 2007                       | 2006      | Change    |
| Operating activities   | \$ 18,675                  | \$ 13,851 | \$ 4,824  |
| Investing activities   | (3,784)                    | (15,313)  | 11,529    |
| Financing activities   | 3,415                      | 3,599     | (184)     |
| Effect of exchange rate changes on cash and cash equivalents | 88                         | (705)     | 793       |
| Net increase in cash and cash equivalents                    | \$ 18,394                  | \$ 1,432  | \$ 16,962 |

**Reconciliation of Net Income to Cash Inflows (Outflows) from Operating Activities (in thousands)**

|   | Nine months ended June 30, |           |          |
|---|----------------------------|-----------|----------|
|   | 2007                       | 2006      | Change   |
| Net income  | \$ 14,197                  | \$ 8,098  | \$ 6,099 |
| Deferred income taxes                             | (1,612)                    | (1,987)   | 375      |
| Depreciation and amortization                     | 7,647                      | 7,693     | (46)     |
| Stock-based compensation                          | 2,258                      | 1,742     | 516      |
| Excess tax benefits from stock-based compensation | (315)                      | (485)     | 170      |
| Other reconciling items                           | 18                         | (436)     | 454      |
| Net income adjusted for non-cash expenses         | 22,193                     | 14,625    | 7,568    |
| Changes in working capital                        | (3,518)                    | (774)     | (2,744)  |
| Cash flows provided by operating activities       | \$ 18,675                  | \$ 13,851 | \$ 4,824 |

Net cash provided by operating activities was \$18.7 million and \$13.8 million for the nine months ended June 30, 2007 and 2006, respectively, resulting in a net increase of \$4.9 million. This net increase is primarily due to an increase of \$6.1 million of net income and \$1.5 million for non-cash expenses, primarily related to stock-based compensation, deferred income taxes and provisions for bad debts. Changes in working capital reduced cash flows by \$2.7 million resulting from \$2.5 million of additional material purchases and production builds in order to fulfill order demand, additional cash usage of \$2.8 million in income taxes payable, offset by \$2.6 million of additional cash generated by various other working capital items.

Net cash used in investing activities was \$3.8 million during the nine months ended June 30, 2007 compared to net cash used by investing activities of \$15.3 million during the same period in the prior fiscal year, resulting in \$11.5 million of additional cash generated. This additional cash generated is due to a \$13.6 million increase in settlements of marketable securities, net of purchases, offset by additional cash usage of \$1.3 million related to purchases of property, equipment, improvements and certain other



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

intangible assets, and \$0.8 million for contingent purchase price payments related to the FS Forth acquisition (see Note 10 to Condensed Consolidated Financial Statements). We anticipate total fiscal 2007 capital expenditures to approximate \$2.8 million.

We generated \$3.4 million from financing activities during the nine months ended June 30, 2007 compared to \$3.6 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.

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

The following summarizes our contractual obligations at June 30, 2007 (in thousands):

|                                    | Total    | Payments due by fiscal period |           |           |            |
|------------------------------------|----------|-------------------------------|-----------|-----------|------------|
|                                    |          | Less than<br>1 year           | 1-3 years | 3-5 years | Thereafter |
| Operating leases                   | \$ 6,193 | \$ 1,974                      | \$ 2,231  | \$ 1,279  | \$ 709     |
| Capital leases                     | 952      | 447                           | 505       |           |            |
| Total contractual cash obligations | \$ 7,145 | \$ 2,421                      | \$ 2,736  | \$ 1,279  | \$ 709     |

The lease obligations summarized above relate to various operating lease agreements for office space and equipment. 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 February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS 159)*. This Statement provides companies with an option to measure, at specified election dates, many financial instruments and certain other items at fair value that are not currently measured at fair value. A company that adopts SFAS 159 will report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. This Statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. This Statement is effective for fiscal years beginning after November 15, 2007, which for us is the first quarter of fiscal 2009. We are currently evaluating the impact that SFAS 159 could have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements (FAS 157)*. FAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of FAS 157 are effective for our fiscal year beginning October 1, 2008. We are currently evaluating the impact of the provisions of FAS 157 on our consolidated financial statements and do not believe the impact of the adoption will be material.

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

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS (CONTINUED)**

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). 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 us beginning October 1, 2007. We are in the process of determining the effect, if any, that the adoption of FIN 48 will have on our consolidated financial statements. However, we expect to reclassify a portion of our 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 our operations, results of operations, profitability, financial position, liquidity and capital resources. These risk factors are more fully presented in our 2006 Annual Report on Form 10-K as filed with the SEC.

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

**INTEREST RATE RISK**

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

**FOREIGN CURRENCY RISK**

Our transactions are executed in the U.S. Dollar, Euro or Japanese Yen. As a result, we are 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 our foreign subsidiaries are translated into U.S. Dollars for consolidation. We have not implemented a hedging strategy to reduce foreign currency risk.

For the nine months ended June 30, 2007 and 2006, we had approximately \$44.6 million and \$41.0 million, respectively, of net sales to foreign customers including export sales, of which \$22.3 million and \$16.6 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 2.7% from 1.2809 to 1.3160 and the average monthly exchange rate for the Japanese Yen to the U.S. Dollar decreased from .0092 to .0084 for the first nine months of fiscal year 2007 as compared to the same period one year ago. A 10.0% change from the first nine months of fiscal 2007 average exchange rate for the Euro and Yen to the U.S. Dollar would have resulted in a 1.7% increase or decrease in net sales and a 1.3% increase or



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

**FOREIGN CURRENCY RISK (CONTINUED)**

decrease in stockholders' equity. The above analysis does not take into consideration any pricing adjustments we may need to consider in response to changes in the exchange rate.

**CREDIT RISK**

We have some exposure to credit risk related to our 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, we conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of our 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 our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit 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.

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

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**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 are incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

There have been no material changes in the risk factors provided in Part I, Item 1A of our 2006 Annual Report on Form 10-K as filed with the SEC on December 6, 2006.

**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 (2)   |
| 4(a)        | Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank, 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, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (4) |
| 10(a)       | Severance Agreement between the Company and Lawrence A. Kraft dated July 30, 2007*  |
| 10(b)       | Severance Agreement between the Company and Joel K. Young dated July 30, 2007*  |

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**PART II. OTHER INFORMATION (CONTINUED)**

**ITEM 6. EXHIBITS (CONTINUED)**

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

\*Management contract or compensatory plan or arrangement.

- (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-Q for the quarter ended March 31, 2007 (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: August 8, 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 |
| 4(a)           | Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank, 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, 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)          | Severance Agreement between the Company and Lawrence A. Kraft dated July 30, 2007   | Filed Electronically      |
| 10(b)          | Severance Agreement between the Company and Joel K. Young dated July 30, 2007   | Filed Electronically      |
| 31(a)          | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer   | Filed Electronically      |
| 31(b)          | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer   | Filed Electronically      |
| 32             | Section 1350 Certification  | Filed Electronically      |