DIGI INTERNATIONAL INC
Form 10-Q
February 09, 2011

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

FORM 10-Q

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

For the quarterly period ended: December 31, 2010

OR

o **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: 1-34033

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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

On January 31, 2011, there were 25,197,256 shares of the registrant s $.01 par value Common Stock outstanding.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended December 31, 2010	2009
	(in thousands, except per common share data)	
Net sales	$ 48,334	$ 42,968
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	22,820	20,163
Amortization of purchased and core technology	848	1,092
Gross profit	24,666	21,713
Operating expenses:		
Sales and marketing	9,798	9,240
Research and development	7,808	6,486
General and administrative	4,395	4,158
Total operating expenses	22,001	19,884
Operating income	2,665	1,829
Total other income, net	19	3
Income before income taxes	2,684	1,832
Income tax provision	368	633
Net income	$ 2,316	$ 1,199
Net income per common share:		
Basic	$ 0.09	$ 0.05
Diluted	$ 0.09	$ 0.05
Weighted average common shares, basic	25,110	24,701
Weighted average common shares, diluted	25,445	24,979

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 31, 2010	September 30, 2010
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 64,206	$ 50,943
Marketable securities	27,392	36,634
Accounts receivable, net	23,177	24,090
Inventories	27,124	26,550
Deferred tax assets	3,346	3,344
Other	2,568	2,141
Total current assets	147,813	143,702
Property, equipment and improvements, net	16,219	16,396
Identifiable intangible assets, net	18,187	19,851
Goodwill	85,752	86,210
Deferred tax assets	2,718	320
Other	478	486
Total assets	$ 271,167	$ 266,965
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 9,759	$ 7,449
Accrued compensation	4,866	5,850
Deferred payment on acquisition	2,940	2,914
Other	5,145	5,384
Total current liabilities	22,710	21,597
Income taxes payable	2,312	2,838
Deferred tax liabilities	1,196	1,457
Other noncurrent liabilities	437	517
Total liabilities	26,655	26,409
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; 28,729,698 and 28,666,311 shares issued	288	287
Additional paid-in capital	188,824	185,427

Retained earnings	93,965	91,649
Accumulated other comprehensive loss	(11,601)	(9,589)
Treasury stock, at cost, 3,550,677 and 3,584,215 shares	(26,964)	(27,218)
Total stockholders equity	244,512	240,556
Total liabilities and stockholders equity	$ 271,167	$ 266,965

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 31,	
	2010	2009
	(in thousands)	
Operating activities:		
Net income	$ 2,316	$ 1,199
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation of property, equipment and improvements	713	665
Amortization of identifiable intangible assets	1,697	1,944
Stock-based compensation	871	998
Excess tax benefits from stock-based compensation	(59)	
Deferred income tax benefit	(584)	(249)
Other	401	(197)
Changes in operating assets and liabilities	(607)	(445)
Net cash provided by operating activities	4,748	3,915
Investing activities:		
Purchase of marketable securities	(2,174)	(8,161)
Proceeds from maturities of marketable securities	11,409	519
Purchase of property, equipment, improvements and certain other intangible assets, net of proceeds from sale	(721)	(904)
Net cash provided by (used in) investing activities	8,514	(8,546)
Financing activities:		
Payments on capital lease obligations		(6)
Excess tax benefits from stock-based compensation	59	
Proceeds from stock option plan transactions	443	
Proceeds from employee stock purchase plan transactions	269	
Net cash provided by (used in) financing activities	771	(6)
Effect of exchange rate changes on cash and cash equivalents	(770)	(344)
Net increase (decrease) in cash and cash equivalents	13,263	(4,981)
Cash and cash equivalents, beginning of period	50,943	48,434
Cash and cash equivalents, end of period	$ 64,206	$ 43,453

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 Annual Report on Form 10-K for the year ended September 30, 2010 as filed with the SEC (2010 Financial Statements).

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 balance sheet data were derived from our 2010 Financial Statements, but do not include all disclosures required by accounting principles generally accepted in the United States of America.

Recently Issued Accounting Pronouncements

There have been no accounting pronouncements recently issued that will affect our Condensed Consolidated Financial Statements.

2. COMPREHENSIVE INCOME

Comprehensive income is comprised of net income, foreign currency translation adjustments and unrealized (loss) gain on available-for-sale marketable securities, net of tax. Comprehensive income was as follows (in thousands):

	Three months ended December 31,	
	2010	2009
Net income	$ 2,316	$ 1,199
Other comprehensive income:		
Change in foreign currency translation adjustment	(2,008)	(710)
Change in unrealized (loss) gain on investments, net of income tax benefit (provision) of $3 and ($23), respectively	(4)	36
Comprehensive income	$ 304	$ 525

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 our stock result from dilutive common stock options and shares purchased through the employee stock purchase plan.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. NET INCOME PER COMMON SHARE (CONTINUED)

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 31, 2010	2009
Numerator:		
Net income	$ 2,316	$ 1,199
Denominator:		
Denominator for basic net income per common share weighted average shares outstanding	25,110	24,701
Effect of dilutive securities:		
Employee stock options and employee stock purchase plan	335	278
Denominator for diluted net income per common share adjusted weighted average shares	25,445	24,979
Net income per common share, basic	$ 0.09	$ 0.05
Net income per common share, diluted	$ 0.09	$ 0.05

Potentially dilutive common shares related to outstanding stock options to purchase 2,654,929 and 3,438,953 common shares for the three month periods ended December 31, 2010 and 2009, 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. SELECTED BALANCE SHEET DATA

(in thousands)	December 31, 2010	September 30, 2010
Accounts receivable, net:		
Accounts receivable	$ 23,682	$ 24,639
Less allowance for doubtful accounts	(505)	(549)
	$ 23,177	$ 24,090
Inventories:		
Raw materials	$ 21,829	$ 21,678
Work in process	288	418
Finished goods	5,007	4,454
	$ 27,124	$ 26,550
Other accrued expenses:		
Accrued professional fees	$ 742	$ 838

Accrued warranty		840		877
Income taxes payable		465		564
Deferred gain on building sale short-term		277		289
Other accrued expenses		2,821		2,816
	$	5,145	$	5,384

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

5. MARKETABLE SECURITIES

Our marketable securities consist of certificates of deposit, corporate bonds and government municipal bonds.

We analyze our available-for-sale investments for impairment on an ongoing basis. We consider factors in determining whether an unrealized loss is a temporary loss or an other-than-temporary loss such as: (a) whether we have the intent to sell the security or (b) whether it is more likely than not that we will be required to sell the security before its anticipated recovery. We also consider factors such as the length of time and extent to which the securities have been in an unrealized loss position and the trend of any unrealized losses.

We obtain quoted market prices and trading activity for each security, where available, and review the financial solvency of each security issuer and obtain other relevant information from our investment advisors to estimate the fair value for each security in our investment portfolio. As of December 31, 2010, 24 of our securities were trading below our amortized cost basis. We determined each decline in value to be temporary based upon the factors described above. We expect to realize the fair value of these securities, plus accrued interest, either at the time of maturity or when the security is sold.

All of our current holdings are classified as available-for-sale marketable securities and are recorded at fair value on our balance sheet with the unrealized gains and losses recorded in accumulated other comprehensive income (loss).

Our marketable securities at December 31, 2010 were comprised of the following (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses (2)	Fair Value (1)
Current marketable securities:				
Corporate bonds	$ 16,967	$ 7	$ (6)	$ 16,968
Certificates of deposit	5,003			5,003
Government municipal bonds	5,423		(2)	5,421
Current marketable securities	$ 27,393	$ 7	$ (8)	$ 27,392

(1) Included in amortized cost and fair value is purchased and accrued interest of $363.

(2) The aggregate related fair value of securities with unrealized losses as of December 31, 2010 was $19,136.

Our marketable securities at September 30, 2010 were comprised of the following (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses (2)	Fair Value (1)
Current marketable securities:				
Corporate bonds	$ 26,163	$ 7	$ (9)	$ 26,161
Certificates of deposit	5,001	6		5,007
Government municipal bonds	5,463	5	(2)	5,466
Current marketable securities	$ 36,627	$ 18	$ (11)	$ 36,634

(1) Included in amortized cost and fair value is purchased and accrued interest of $451.

(2) The aggregate related fair value of securities with unrealized losses as of September 30, 2010 was $18,909.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

6. FAIR VALUE MEASUREMENTS

Fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. This standard also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability based upon the best information available in the circumstances. The categorization of financial assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The hierarchy is broken down into three levels defined as follows:

Level 1 Inputs are quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly.

Level 3 Inputs are unobservable for the asset or liability and their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 may also include certain investment securities for which there is limited market activity or a decrease in the observability of market pricing for the investments, such that the determination of fair value requires significant judgment or estimation.

Fair value is applied to financial assets, such as certificates of deposit, corporate bonds and government municipal bonds, which are classified and accounted for as available-for-sale. These items are stated at fair value at each reporting period using the above guidance.

The following tables provide information by level for financial assets that are measured at fair value on a recurring basis (in thousands):

		Fair Value Measurements at December 31, 2010 using:		
	Total carrying value at December 31, 2010	Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$ 37,203	$ 37,203	$	$
Available-for-sale marketable securities:				
Corporate bonds	16,968		16,968	
Certificates of deposit	5,003		5,003	
Government municipal bonds	5,421		5,421	
Total cash equivalents and marketable securities measured at fair value	$ 64,595	$ 37,203	$ 27,392	$

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

6. FAIR VALUE MEASUREMENTS (CONTINUED)

	Total carrying value at September 30, 2010	Fair Value Measurements at September 30, 2010 using: Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$ 29,416	$ 29,416	$	$
Available-for-sale marketable securities:				
Corporate bonds	26,161		26,161	
Certificates of deposit	5,007		5,007	
Government municipal bonds	5,466		5,466	
Total cash equivalents and marketable securities measured at fair value	$ 66,050	$ 29,416	$ 36,634	$

Cash equivalents are measured at fair value using quoted market prices in active markets for identical assets. We value our Level 2 assets using inputs that are based on market indices of similar assets within an active market. There were no transfers in or out of our Level 2 financial assets during the three months ended December 31, 2010.

We had no financial assets valued with Level 3 inputs as of December 31, 2010 nor did we purchase or sell any Level 3 financial assets during the three months ended December 31, 2010.

The use of different assumptions, applying different judgment to inherently subjective matters and changes in future market conditions could result in significantly different estimates of fair value of our securities, currently and in the future. If market conditions deteriorate, we may incur impairment charges for securities in our investment portfolio.

7. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS

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

	December 31, 2010			September 30, 2010		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	$ 46,301	$ (39,631)	$ 6,670	$ 46,484	$ (38,917)	$ 7,567
License agreements	2,840	(2,555)	285	2,840	(2,537)	303
Patents and trademarks	9,892	(6,799)	3,093	9,753	(6,522)	3,231
Customer maintenance contracts	700	(621)	79	700	(604)	96
Customer relationships	17,338	(9,460)	7,878	17,481	(9,096)	8,385
Non-compete agreements	1,033	(851)	182	1,039	(770)	269
Total	$ 78,104	$ (59,917)	$ 18,187	$ 78,297	$ (58,446)	$ 19,851

Amortization expense was $1.7 million and $1.9 million for the three month periods ended December 31, 2010 and 2009, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

7. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS (CONTINUED)

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2011 and the five succeeding fiscal years is as follows (in thousands):

2011 (nine months)	$	4,448
2012		4,214
2013		3,203
2014		2,883
2015		1,855
2016		657

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

	Three months ended December 31,			
		2010		2009
Beginning balance, October 1	$	86,210	$	86,558
Foreign currency translation adjustment		(458)		(58)
Ending balance, December 31	$	85,752	$	86,500

8. INCOME TAXES

Income taxes have been provided at an effective rate of 13.7% and 34.6% for the three month periods ended December 31, 2010 and 2009, respectively.

In the three month period ended December 31, 2010, we recorded a discrete tax benefit of $0.6 million primarily resulting from the reversal of tax reserves for various jurisdictions tax matters related to the expiration of the statutes of limitations and from the enactment of legislation extending the research and development tax credit that allowed us to record tax credits earned during the last three quarters of fiscal 2010 in the first quarter of fiscal 2011. The benefit resulting from such discrete tax events reduced our effective tax rate by 21.5 percentage points for the three month period ended December 31, 2010.

A reconciliation of the beginning and ending amount of uncertain tax positions is as follows (in thousands):

Unrecognized tax benefits as of September 30, 2010	$	2,265
Increases related to:		
Prior year income tax positions		30
Decreases related to:		
Expiration of the statute of limitations		(466)
Unrecognized tax benefits as of December 31, 2010	$	1,829

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is $1.7 million. We recognize interest and penalties related to income tax matters in income tax expense. We recorded a reduction of $0.1 million of interest and penalties, net of tax during the three months ended December 31, 2010. As of December 31, 2010 and September 30, 2010, we had accrued interest and penalties related to unrecognized tax benefits of $0.5 million and $0.6 million, respectively, included in long-term income taxes payable on our consolidated balance sheet.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. INCOME TAXES (CONTINUED)

There are no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease over the next 12 months.

We operate in multiple tax jurisdictions both in the U.S. and outside of the U.S. Accordingly, we must determine the appropriate allocation of income to each of these jurisdictions. This determination requires us to make several estimates and assumptions. Tax audits associated with the allocation of this income, and other complex issues, may require an extended period of time to resolve and may result in adjustments to our income tax balances in those years that are material to our consolidated financial position and results of operations. We are no longer subject to income tax examination for tax years prior to fiscal 2009 and 2006 in the case of U.S. federal and foreign income tax authorities, respectively, and for tax years generally before fiscal 2006, in the case of state taxing authorities, consisting primarily of Minnesota and California.

9. FINANCIAL GUARANTEES

In general, we warrant our products to be free from defects in material and workmanship under normal use and service. The warranty periods range from one 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 incidents and are evaluated on an ongoing basis to ensure the adequacy of the warranty accrual. The following table summarizes the activity associated with the product warranty accrual (in thousands):

	Three months ended December 31,			
	Balance at October 1	Warranties expensed	Settlements made	Balance at December 31
2010	$ 877	$ 118	$ (155)	$ 840
2009	$ 970	$ 196	$ (214)	$ 952

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 we 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

10. CONTINGENCIES

Contingent obligations

Initial Public Offering Securities Litigation

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 our subsidiary NetSilicon, Inc. and approximately 300 other public companies. We acquired Net Silicon, Inc. on February 13, 2002. The complaint names us as a defendant 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.

As previously disclosed, the parties advised the District Court on February 25, 2009 that they had reached an agreement-in-principle to settle the litigation in its entirety. A stipulation of settlement was filed with the District Court on April 2, 2009. On June 9, 2009, the District Court preliminarily approved the proposed global settlement. Notice was provided to the class, and a settlement fairness hearing, at which members of the class had an opportunity to object to the proposed settlement, was held on September 10, 2009. On October 6, 2009, the District Court issued an order granting final approval to the settlement. Ten appeals were initially filed objection to the definition of the settlement class and fairness of the settlement, and since our Annual Report on Form 10-K for the year ended September 30, 2010, five of those appeals remain pending. Two appeal briefs have been filed by the remaining five objector groups, and those appeals remain pending.

Under the settlement, our insurers are to pay the full amount of settlement share allocated to us, and we would bear no financial liability beyond our deductible of $250,000. While there can be no guarantee as to the ultimate outcome of this pending lawsuit, we expect that our 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, 2010, we have an accrued liability for the anticipated settlement of $300,000 which we believe is adequate and reflects the amount of loss that is probable and a receivable related to the insurance proceeds of $50,000, which represents the anticipated settlement of $300,000 less our $250,000 deductible. In the event we should have losses that exceed the limits of the liability insurance, such losses could have a material adverse effect on our business and our consolidated results of operations or financial condition.

Patent Infringement Lawsuit

On May 11, 2010, SIPCO, LLC filed a patent infringement lawsuit against us in federal court in the Eastern District of Texas. The lawsuit included allegations against Digi and five other companies pertaining to the infringement of SIPCO s patents by wireless mesh networking products. The lawsuit seeks monetary and non-monetary relief. We cannot predict the outcome of this matter or estimate a range of loss at this time or whether it will have a materially adverse impact on our business prospects and our consolidated financial condition, results of operations or cash flow.

In addition to the matters discussed above, 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.

11. RESTRUCTURING

On April 23, 2009, we announced a business restructuring to increase our focus on wireless products and solutions that include hardware, software and services.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

11. RESTRUCTURING (CONTINUED)

A summary of the restructuring charges and other activity within the restructuring accrual during the first quarter of fiscal 2011 is listed below (in thousands):

	Employee Termination Costs	Other	Total
Balance September 30, 2010	$ 13	$ 60	$ 73
Payments	(3)		(3)
Reversals		(50)	(50)
Balance December 31, 2010	$ 10	$ 10	$ 20

During the first quarter of fiscal 2011, we reversed $50,000 related to legal fees in conjunction with compensation-related items that are no longer probable of assertion. We expect the remaining liability to be completed by the end of the second quarter of fiscal 2011.

12. SUBSEQUENT EVENT

On January 18, 2011 Advanced Processor Technologies LLC filed a patent infringement lawsuit against Digi and eight other defendants in federal court in the Eastern District of Texas. The lawsuit alleges that certain products of Digi and the other defendants infringe two plaintiff patents covering data processors with memory management units. The lawsuit seeks monetary and non-monetary relief. We cannot predict the outcome of this matter or estimate a range of loss at this time or whether it will have a materially adverse impact on our business prospects and our consolidated financial condition, results of operations or cash flow.

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

The terms we, our or us mean Digi International Inc. and all of the subsidiaries included in the consolidated financial statements unless the context indicates otherwise. Our management s discussion and analysis should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended September 30, 2010, as well as our reports on Forms 10-Q and 8-K and other publicly available information.

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 us as of the time of such statements and relate to, among other things, expectations of the business environment in which we operate, projections 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 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, 2010. 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 materially 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, 2010.

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

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 compete for customers on the basis of existing and planned product features, service capabilities, company reputation, brand recognition, technical support, relationships with partners, quality and reliability, product development capabilities, price and availability. We help customers connect, monitor, and control local or remote electronic devices over a network, via the Internet or via satellite.

Net sales increased from $43.0 million in the first quarter of fiscal 2010 to $48.3 million in the first quarter of fiscal 2011, an increase of $5.3 million, or 12.5%. Net sales in the first quarter of fiscal 2011 also increased by $1.0 million, or 2.3%, compared to the fourth quarter of fiscal 2010. Net income and net income per diluted share increased from $1.2 million, or $0.05 per diluted share, in the first quarter of fiscal 2010 to $2.3 million, or $0.09 per diluted share, in the first quarter of fiscal 2011, an increase of $1.1 million, or $0.04 per diluted share. The increase in net income includes a discrete tax benefit of $0.6 million or $0.02 per diluted share as further describe in Note 8 to our Condensed Consolidation Financial Statements.

During fiscal 2011 we fully reinstated our incentive compensation program, which was only partially reinstated in the prior year, resulting in an additional $0.7 million of operating expenses in the first quarter of fiscal 2011.

We continue to show growth in our wireless products net sales. Our target markets are primarily in the Smart Grid, fleet management and medical markets. We anticipate that growth in the future will result from products and services that are developed internally as well as from products and services that are acquired. We are continuing to invest in wireless products and services while closely monitoring and controlling discretionary spending.

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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 (dollars in thousands):

	Three months ended December 31,				% increase
	2010		2009		(decrease)
Net sales	$ 48,334	100.0%	$ 42,968	100.0%	12.5%
Cost of sales (exclusive of amortization of purchased and core technology shown separately below)	22,820	47.2	20,163	46.9	13.2
Amortization of purchased and core technology	848	1.8	1,092	2.6	(22.3)
Gross profit	24,666	51.0	21,713	50.5	13.6
Operating expenses:					
Sales and marketing	9,798	20.3	9,240	21.5	6.0
Research and development	7,808	16.1	6,486	15.1	20.4
General and administrative	4,395	9.1	4,158	9.6	5.7
Total operating expenses	22,001	45.5	19,884	46.2	10.6
Operating income	2,665	5.5	1,829	4.3	45.7
Other income, net	19	0.1	3	0.0	N/M
Income before income taxes	2,684	5.6	1,832	4.3	46.5
Income tax provision	368	0.8	633	1.5	(41.9)
Net income	$ 2,316	4.8%	$ 1,199	2.8%	93.2%

N/M means not meaningful

NET SALES

Net sales increased $5.3 million for the three months ended December 31, 2010 compared to the three months ended December 31, 2009 which was primarily driven by increased volume and demand rather than pricing changes. We did not experience a material change in revenue due to pricing. Our wireless product net sales grew from $15.1 million, or 35.2% of net sales, in the first quarter of fiscal 2010 to $20.2 million, or 41.8% of net sales, in the first quarter of fiscal 2011, an increase of 33.5%.

The following summarizes our net sales by product categories for the periods indicated:

	Three months ended December 31,					
($ in thousands)	2010		2009		$ increase	% increase
Non-embedded	$ 27,224	56.3%	$ 24,897	57.9%	$ 2,327	9.3%
Embedded	21,110	43.7	18,071	42.1	3,039	16.8
Total net sales	$ 48,334	100.0%	$ 42,968	100.0%	$ 5,366	12.5%

Non-embedded

Our non-embedded revenue increased by $2.3 million or 9.3% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The increase resulted primarily from increases in net sales of cellular routers and wireless communication adaptors, which were partially offset by a decrease in net sales of serial servers, USB products and serial cards.

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

NET SALES (CONTINUED)

Embedded

Our embedded revenue increased by $3.0 million or 16.8% for the three months ended December 31, 2010 compared to the three months ended December 31, 2009. The increase resulted primarily from increases in net sales of modules, chips and engineering design services.

The following summarizes our net sales by geographic region:

	Three months ended December 31,			
($ in thousands)	2010	2009	$ increase	% increase
North America	$ 27,751	$ 25,525	$ 2,226	8.7%
EMEA	12,673	11,021	1,652	15.0
Asia countries	6,142	5,335	807	15.1
Latin America	1,768	1,087	681	62.6
Total net sales	$ 48,334	$ 42,968	$ 5,366	12.5%

The fluctuation of foreign currency rates for the three month period ended December 31, 2010 had an unfavorable impact on net sales of $0.4 million primarily due to the strengthening of the U.S. Dollar against the Euro compared to the same period in the prior fiscal year.

GROSS MARGIN

Gross margin for the three months ended December 31, 2010 was 51.0% compared to 50.5% for the three months ended December 31, 2009. The increase in the gross margin for the first quarter of fiscal 2011 as compared to the same period a year ago was primarily due to a reduction of purchased and core technology amortization as certain purchased and core technologies are now fully amortized, product cost reductions and manufacturing efficiencies, partially offset by unfavorable changes in product mix.

We expect that gross margin will be approximately 50.0% to 51.0% for the full fiscal year 2011.

OPERATING EXPENSES

The following summarizes our operating expenses:

	Three months ended December 31,					
($ in thousands)	2010		2009		$ increase	% increase
Operating expenses:						
Sales and marketing	$ 9,798	20.3%	$ 9,240	21.5%	$ 558	6.0%
Research and development	7,808	16.1	6,486	15.1	1,322	20.4
General and administrative	4,395	9.1	4,158	9.6	237	5.7
Total operating expenses	$ 22,001	45.5%	$ 19,884	46.2%	$ 2,117	10.6%

The increase in sales and marketing expenses of $0.6 million is primarily due to an increase of $0.4 million for compensation-related expenses to fully restore the incentive compensation program and increased commissions related to the increase in net sales.

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

OPERATING EXPENSES (CONTINUED)

The increase in research and development expenses of $1.3 million is due primarily to an increase of $0.7 million for compensation-related expenses mostly as a result of a fully restored incentive compensation program, an increase in headcount, and $0.6 million in product certification, custom development projects and development expenses focused in the iDigi® Platform.

The increase in general and administrative expenses of $0.2 million was due primarily to an increase in professional fees and outside services.

We expect that total operating expenses will be approximately 41.5% to 45.5% of net sales for the full fiscal year 2011.

OTHER INCOME, NET

Other income, net remained relatively flat for the three months ended December 31, 2010 as compared to the same period a year ago as there was a slight reduction in both interest income and foreign currency transaction losses.

INCOME TAXES

For the three months ended December 31, 2010, income taxes have been provided at an effective rate of 13.7% compared to 34.6% for the three months ended December 31, 2009. In the three month period ended December 31, 2010, we recorded a discrete tax benefit of $0.6 million primarily resulting from the reversal of tax reserves for various jurisdictions tax matters related to the expiration of the statutes of limitations and from the enactment of legislation extending the research and development tax credit that allowed us to record tax credits earned during the last three quarters of fiscal 2010 in the first quarter of fiscal 2011. The benefit resulting from such discrete tax events reduced our effective tax rate by 21.5 percentage points for the three month period ended December 31, 2010.

We expect our annualized 2011 income tax rate, including the impact of the above discrete tax items, to be approximately 30% to 33%.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations principally with funds generated from operations. At December 31, 2010, we had cash, cash equivalents and short-term marketable securities of $91.6 million compared to $87.6 million at September 30, 2010. Our working capital (current assets less total current liabilities) increased $3.0 million to $125.1 million at December 31, 2010 compared to $122.1 million at September 30, 2010. We anticipate total fiscal 2011 capital expenditures will be approximately $3.2 million.

Net cash provided by operating activities was $4.7 million for the three months ended December 31, 2010 as compared to $3.9 million for the three months ended December 31, 2009, or a net increase of $0.8 million. This increase is primarily due to an increase in net income for the three months ended December 31, 2010 compared to the same period a year ago. This was partially offset by a net decrease of $0.2 million related to changes in operating assets and liabilities.

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

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

Net cash provided by investing activities was $8.5 million during the three months ended December 31, 2010 as compared to net cash used by investing activities of $8.5 million during the three months ended December 31, 2009. Net proceeds of marketable securities occurred during the three months ended December 31, 2010 compared to the same period one year ago in which there were net purchases of marketable securities.

Net cash provided by financing activities was $0.8 million for the three months ended December 31, 2010, primarily related to proceeds from stock option plan and employee stock purchase plan transactions. There were no proceeds from these plans during the three months ended December 31, 2009 as we did not close on our first quarter of fiscal 2010 sales of stock under our Employee Stock Purchase Plan until after December 31, 2009 and there were no exercises of stock options.

We expect positive cash flows from operations and believe that our current cash, cash equivalents and marketable securities balances, cash generated from operations and our ability to secure debt and/or equity financing will be sufficient to fund our business operations for the next twelve months and beyond.

The contractual obligations disclosed in our Annual Report on Form 10-K for the year ended September 30, 2010 had no material changes through December 31, 2010.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

There have been no accounting pronouncements recently issued that will affect our Condensed Consolidated Financial Statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

Our exposure to interest rate risk relates primarily to our investment portfolio. Our marketable securities are classified as available-for-sale and are carried at fair value. Marketable securities consist of certificates of deposit, corporate bonds and government bonds. Our investment policy specifies the types of eligible investments and minimum credit quality of our investments, as well as diversification and concentration limits which mitigate our risk. Our portfolio contains no auction rate securities. We do not use derivative financial instruments to hedge against interest rate risk because the majority of our investments mature in less than a year.

FOREIGN CURRENCY RISK

We have transactions that are executed in the U.S. Dollar, British Pound, Euro, Japanese Yen and Indian Rupee. As a result, we are exposed to foreign currency transaction risk associated with certain sales transactions being denominated in Euros, British Pounds, Japanese Yen or Indian Rupees, 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 formal hedging strategy to reduce foreign currency risk.

For the three months ended December 31, 2010 and 2009, we had approximately $20.6 million and $17.4 million, respectively, of net sales to foreign customers including export sales, of which $7.4 million and $5.8 million, respectively, were denominated in foreign currency, predominantly Euros and British Pounds. In future periods, we expect a significant portion of sales will continue to be made in both Euros and British Pounds.

The table below compares the average monthly exchange rates of the Euro, British Pound, Yen and Rupee to the U.S. Dollar:

	Three months ended December 31,		increase	% increase
	2010	2009	(decrease)	(decrease)
Euro	1.3600	1.4780	(0.1180)	(8.0)%
British Pound	1.5815	1.6337	(0.0522)	(3.2)
Yen	0.0121	0.0112	0.0010	8.6
Rupee	0.0222	0.0214	0.0008	3.7

A 10% change from the first three months of fiscal year 2011 average exchange rate for the Euro, British Pound, Yen and Rupee to the U.S. Dollar would have resulted in a 1.5% increase or decrease in net sales and a 2.0% increase or decrease in stockholders equity. The above analysis does not take into consideration any pricing adjustments we might consider in response to changes in such exchange rates.

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.

Investments are made in accordance with our investment policy and consist of certificates of deposit, government bonds and corporate bonds. We may have some exposure related to the fair value of our securities, which could change significantly based on changes in market conditions. If market conditions deteriorate, we may incur impairment charges for securities in our investment portfolio.

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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.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

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

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The disclosures set forth in Note 10 and Note 12 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 to the risk factors provided in Part I, Item 1A, of our 2010 Annual Report on Form 10-K as filed with the SEC on November 29, 2010.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. RESERVED

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)	Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent (3)
4(b)	Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares (4)
10	Offer Letter Agreement, dated as of October 28, 2010, between the Company and Steven E. Snyder*
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 required to be filed as an exhibit to this Form 10-Q.

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ITEM 6. EXHIBITS (CONTINUED)

(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 to the Company s Current Report on Form 8-K filed January 21, 2011 (File No. 1-34033)

(3) Incorporated by reference to Exhibit 4(a) to the Company s Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

(4) Incorporated by reference to Exhibit 4(b) to the Company s Registration Statement on Form 8-A filed on April 25, 2008 (File No. 1-34033)

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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 9, 2011	By: /s/ Steven E. Snyder Steven E. Snyder 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)	Share Rights Agreement, dated as of April 22, 2008, between the Company and Wells Fargo Bank, N.A., as Rights Agent	Incorporated by Reference
4(b)	Form of Amended and Restated Certificate of Powers, Designations, Preferences and Rights of Series A Junior Participating Preferred Shares	Incorporated by Reference
10	Offer Letter Agreement, dated as of October 28, 2010, between the Company and Steven E. Snyder	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