DIGI INTERNATIONAL INC
Form 10-Q
August 08, 2006

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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: June 30, 2006

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: 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, including 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 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 o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

On July 31, 2006, there were 24,837,672 shares of the registrant s $.01 par value Common Stock outstanding.

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Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
Section 1350 Certification

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
	(in thousands, except per common share data)			
Net sales	$ 35,860	$ 30,208	$ 103,616	$ 88,989
Cost of sales	15,222	12,003	44,126	34,489
Gross profit	20,638	18,205	59,490	54,500
Operating expenses:				
Sales and marketing	7,277	6,446	20,830	19,300
Research and development	5,402	3,778	15,227	11,850
General and administrative	4,208	3,998	13,591	11,070
Acquired in-process research and development		300		300
Total operating expenses	16,887	14,522	49,648	42,520
Operating income	3,751	3,683	9,842	11,980
Interest income and other, net	575	306	1,461	809
Income before income taxes	4,326	3,989	11,303	12,789
Income tax provision (benefit)	978	1,505	3,205	(1,455)
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Net income per common share:				
Basic	$ 0.14	$ 0.11	$ 0.35	$ 0.64
Diluted	$ 0.14	$ 0.11	$ 0.34	$ 0.61
Weighted average common shares, basic	23,124	22,588	22,968	22,381
Weighted average common shares, diluted	23,904	23,296	23,695	23,420

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, 2006	September 30, 2005
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,422	$ 12,990
Marketable securities	51,442	37,184
Accounts receivable, net	19,232	16,897
Inventories	19,090	18,527
Other	5,419	5,115
Total current assets	109,605	90,713
Property, equipment and improvements, net	19,904	20,808
Identifiable intangible assets, net	21,152	26,342
Goodwill	38,612	38,675
Other	1,041	1,093
Total assets	$ 190,314	$ 177,631
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Capital lease obligations, current portion	$ 406	$ 414
Accounts payable	5,235	6,272
Income taxes payable	6,944	3,306
Accrued expenses:		
Compensation	4,223	5,308
Other	5,172	5,048
Deferred revenue	293	370
Total current liabilities	22,273	20,718
Capital lease obligations, net of current portion	817	1,181
Net deferred tax liabilities	255	2,195
Total liabilities	23,345	24,094
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; 25,873,164 and 25,456,755 shares issued	259	255

Additional paid-in capital	141,649	136,513
Retained earnings	43,994	35,896
Accumulated other comprehensive income	396	639
Treasury stock, at cost, 2,732,834 and 2,794,562 shares	(19,329)	(19,766)
Total stockholders equity	166,969	153,537
Total liabilities and stockholders equity	$ 190,314	$ 177,631

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, 2006	Nine months ended June 30, 2005
	(in thousands)	
Operating activities:		
Net income	$ 8,098	$ 14,244
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	1,949	1,710
Amortization of identifiable intangible assets and other assets	5,744	4,667
Acquired in-process research and development		300
Deferred income taxes	(1,987)	(3,602)
Tax benefit related to the exercise of stock options		2,045
Stock-based compensation	1,742	
Other	(436)	(479)
Changes in operating assets and liabilities:		
Accounts receivable	(696)	(1,949)
Inventories	(1,068)	169
Other assets	(293)	(709)
Accounts payable and accrued expenses	(2,838)	(1,879)
Income taxes payable	3,636	(3,276)
Net cash provided by operating activities	13,851	11,241
Investing activities:		
(Purchase) settlement of held-to-maturity marketable securities, net	(14,258)	19,836
Purchase of property, equipment, improvements and certain other identifiable intangible assets	(1,055)	(772)
Acquisitions, net of cash acquired		(53,665)
Net cash used in investing activities	(15,313)	(34,601)
Financing activities:		
Borrowing from short-term loans, net of payments		5,000
Payments on line of credit		(1,250)
Payments on capital lease obligations	(372)	(38)
Proceeds from exercise of stock options	2,931	5,415
Tax benefit related to the exercise of stock options	485	
Proceeds from employee stock purchase plan transactions	555	576
Net cash provided by financing activities	3,599	9,703

Effect of exchange rate changes on cash and cash equivalents	(705)	474
Net increase (decrease) in cash and cash equivalents	1,432	(13,183)
Cash and cash equivalents, beginning of period	12,990	19,528
Cash and cash equivalents, end of period	$ 14,422	$ 6,345

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

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

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

Basis of Presentation

The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the Company or Digi) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted, pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including the summary of significant accounting policies, presented in the Company s 2005 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 (except for the reversal of certain income tax reserves described in Note 8) necessary for a fair statement of the condensed consolidated financial position and the condensed consolidated results of operations and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year.

Recently Issued Accounting Pronouncements

In July, 2006 the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning October 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its consolidated financial statements.

2. COMPREHENSIVE INCOME

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

Comprehensive income was as follows (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Foreign currency translation gain (loss), net of income tax	85	(496)	(243)	384
Comprehensive income	$ 3,433	$ 1,988	$ 7,855	$ 14,628

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. NET INCOME PER COMMON SHARE

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

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

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
Numerator:				
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Denominator:				
Denominator for basic net income per common share weighted average shares outstanding	23,124	22,588	22,968	22,381
Effect of dilutive securities:				
Employee stock options and employee stock purchase plan	780	708	727	1,039
Denominator for diluted net income per common share adjusted weighted average shares	23,904	23,296	23,695	23,420
Net income per common share, basic	$ 0.14	$ 0.11	$ 0.35	$ 0.64
Net income per common share, diluted	$ 0.14	$ 0.11	$ 0.34	$ 0.61

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, and 990,800 and 615,650 common shares for the three and nine month periods ended June 30, 2005, respectively, were not included in the computation of diluted earnings per common share because the options exercise prices were greater than the average market price of common shares and, therefore, their effect would be anti-dilutive.

4. STOCK-BASED COMPENSATION

Stock-based awards are granted under the terms of the Company s Stock Option Plan (the Stock Option Plan), Non-Officer Stock Option Plan (the Non-Officer Plan) and the 2000 Omnibus Stock Plan (the Omnibus Plan) (collectively, the Plans). The Plans provide for the issuance of stock-based incentives, including incentive stock options (ISOs) and nonstatutory stock options (NSOs), to employees and others who provide services to the Company, including consultants, advisers and directors. Options granted under the Plans generally vest over a four year service period and will expire if unexercised after ten years from the date of grant.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

The exercise price for ISOs and non-employee director options granted under the Stock Option Plan or the Omnibus Plan is set at the fair market value of the Company s common stock based on the closing price on the date of grant. The exercise price for nonstatutory options granted under the Plans is set by the Compensation Committee of the Board of Directors. While the Plans expressly permit grants at less than fair market value, the Company s practice is to only award grants at fair market value. The authority to grant options under the Plans and set other terms and conditions rests with the Compensation Committee. The Stock Option Plan and Non-Officer Plan terminate in 2006 and the Omnibus Plan terminates in 2010.

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

Also, the Company sponsors an Employee Stock Purchase Plan covering all domestic employees with at least 90 days of service. The Purchase Plan allows eligible participants the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period.

Prior to October 1, 2005, the Company accounted for its stock-based awards using the intrinsic-value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related interpretations, in accordance with Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (FAS No. 123). Accordingly, compensation costs for stock options granted were measured as the excess, if any, of the fair value of the Company s common stock at the date of grant over the exercise price to acquire the common stock. Such compensation expense, if any, was amortized on a straight-line basis over the option vesting period.

Effective October 1, 2005, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment (FAS No. 123R), as amended by FASB Staff Position No. FAS 123(R)-4 (FSP FAS 123(R)-4), using the modified prospective method of application. Under this method, compensation expense is recognized both for (i) awards granted, modified or settled subsequent to September 30, 2005 and (ii) the nonvested portion of awards granted prior to October 1, 2005. Compensation expense recorded during the three and nine month periods ended June 30, 2006 includes approximately $0.2 million and $0.5 million, respectively, related to awards issued subsequent to September 30, 2005. In addition, compensation expense recorded during the three and nine month periods ended June 30, 2006 includes approximately $0.3 million and $1.2 million, respectively, related to the current vesting portion of awards issued prior to September 30, 2005.

The impact of adopting FAS No. 123R for the Company s three and nine month period ended June 30, 2006 was an increase in compensation expense of $0.5 million ($0.3 million after tax) and $1.7 million ($1.1 million after tax), respectively, and a reduction of $0.02 and $0.05, respectively, for both basic and diluted earnings per share. The adoption of FAS No. 123R, effective October 1, 2005, is expected to incrementally increase pre-tax compensation expense by approximately $2.3 million during fiscal 2006.

FAS No. 123R also requires that the windfall tax benefit resulting from the tax deductibility of the increase in the value of share-based arrangements be presented as a component of cash flows from financing activities in the Condensed Consolidated Statement of Cash Flows. In periods prior to October 1, 2005, such amounts were presented as a component of cash flows from operating activities.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

A summary of option activity under the Plans as of June 30, 2006 and changes during the nine months then ended is presented below (in thousands, except per common share amounts):

	Available for Grant	Options Outstanding	Weighted Average Exercise Price per Common Share	Weighted Average Contractual Term (in years)	Aggregate Intrinsic Value
Balances, September 30, 2005	950	4,511	$ 9.98		
Granted	(468)	468	12.33		
Exercised		(417)	7.04		
Forfeited	92	(92)	10.15		
Expired	25	(25)	22.73		
Balances, June 30, 2006	599	4,445	$ 10.43	5.55	$ 13,899
Exercisable at June 30, 2006		3,420	$ 9.96	4.56	$ 12,771

The intrinsic value of an option is the amount by which the fair value of the underlying stock exceeds its exercise price. The total intrinsic value of all options exercised during the nine month period was $1.9 million. The weighted average fair value of options granted during the nine months ended June 30, 2006 was $5.79. The weighted average fair value was determined based upon the fair value of each option on the grant date, utilizing the Black-Scholes option-pricing model and the following assumptions:

Risk free interest rate	4.28% - 4.97 %
Expected option holding period	3 - 5 years
Expected volatility	50% - 60%
Weighted average volatility	55%
Expected dividend yield	0

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

A summary of the Company s nonvested options as of June 30, 2006 and changes during the nine months then ended is presented below (in thousands, except per common share amounts):

	Weighted Average Grant Date

	Number of Options	Fair Value per Common Share
Nonvested at September 30, 2005	967	$ 4.81
Granted	468	5.79
Vested	(318)	4.08
Forfeited	(92)	5.55
Nonvested at June 30, 2006	1,025	$ 5.42

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

The Company used historical data to estimate pre-vesting forfeiture rates. As of June 30, 2006 the total unrecognized compensation cost related to nonvested stock-based compensation arrangements net of expected forfeitures was $5.3 million and the related weighted average period over which it is expected to be recognized is approximately 2.8 years.

The Company s pro forma net income and pro forma earnings per share for the three months and nine months ended June 30, 2005, which include pro forma net income and earning per share amounts as if the fair-value-based method of accounting had been used, are as follows (in thousands, except per common share amounts):

	Three months ended June 30, 2005	Nine months ended June 30, 2005
Net income as reported	$ 2,484	$ 14,244
Add: Total stock-based compensation expense included in reported net income, net of related tax effects		37
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(311)	(1,044)
Pro forma net income	$ 2,173	$ 13,237
Net income per common share:		
Basic as reported	$ 0.11	$ 0.64
Basic pro forma	$ 0.10	$ 0.59
Diluted as reported	$ 0.11	$ 0.61
Diluted pro forma	$ 0.09	$ 0.57

5. ACQUISITIONS

Rabbit Semiconductor Inc.

On May 26, 2005, the Company acquired Rabbit Semiconductor Inc. (Rabbit), formerly Z-World, Inc., a privately held corporation for a purchase price of $49.3 million in cash (excluding cash acquired of $0.4 million and assumption of $1.3 million of debt) in exchange for all outstanding shares of Rabbit s common stock and outstanding stock options. The Company did not replace Rabbit s outstanding options with Digi options.

The transaction was accounted for using the purchase method of accounting. Accordingly, the purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in goodwill of $30.6 million. The Company believes that the acquisition resulted in the recognition of goodwill primarily because the complementary nature of Rabbit microprocessor and microprocessor-based modules and Z-World single board computer product lines are anticipated to extend Digi s position in the commercial grade device networking module business.

The following unaudited pro forma condensed consolidated results of operations have been prepared as if the acquisition of Rabbit had occurred as of October 1, 2004. Pro forma adjustments primarily include amortization of identifiable intangible assets and the $0.3 million charge related to acquired in-process research and development associated with the Rabbit acquisition. Had the Company acquired Rabbit as of

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

5. ACQUISITIONS (CONTINUED)

October 1, 2004, 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, 2005		Nine months ended June 30, 2005	
	Pro forma	As Reported	Pro forma	As Reported
Net sales	$ 34,227	$ 30,208	$ 107,160	$ 88,989
Net income	$ 1,015	$ 2,484	$ 11,803	$ 14,244
Net income per common share, basic	$ 0.04	$ 0.11	$ 0.53	$ 0.64
Net income per common share, diluted	$ 0.04	$ 0.11	$ 0.50	$ 0.61

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 2005, nor are they necessarily indicative of the results that will be obtained in the future.

FS Forth-Systeme GmbH/Sistemas Embebidos S.A.

Effective April 1, 2005, the Company acquired FS Forth-Systeme GmbH/Sistemas Embebidos S.A. (collectively referred to as FS Forth) from Embedded Solutions AG of Germany. FS Forth is a provider of embedded modules, software and development services. The purchase price included a payment of $4.8 million in cash, with contingent consideration of up to $2.0 million payable in installments of $0.8 million on October 1, 2006 and $1.2 million on October 1, 2007 if FS Forth achieves certain future milestones.

The transaction was accounted for using the purchase method of accounting. Accordingly, the purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in goodwill of $2.4 million. The Company believes that the FS Forth acquisition resulted in the recognition of goodwill primarily because of the anticipated extension of its commercial grade device networking module business. At the time of the acquisition, FS Forth had modules that immediately added value to the Company s broader module product line. During the first quarter of fiscal 2006, goodwill attributable to the FS Forth acquisition was reduced by a purchase price adjustment of $0.1 million as the result of a change in certain tax liabilities, as defined in the purchase agreement.

The Company has determined that the FS Forth acquisition was not material to the consolidated results of operations or financial condition of the Company; therefore, pro forma financial information is not presented.

6. INVENTORIES

Inventories are stated at the lower of cost or market value, with cost determined using the first-in, first-out method. Inventories consisted of the following (in thousands):

	June 30, 2006	September 30, 2005
Raw materials	$ 14,406	$ 15,074
Work in process	1,051	569
Finished goods	3,633	2,884
	$ 19,090	$ 18,527

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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, 2006			September 30, 2005		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	$41,114	$(30,159)	$10,955	$41,086	$(26,517)	$14,569
License agreements	2,440	(1,790)	650	2,440	(1,490)	950
Patents and trademarks	5,911	(2,597)	3,314	5,691	(1,956)	3,735
Customer maintenance contracts	700	(306)	394	700	(254)	446
Customer relationships	7,854	(2,015)	5,839	7,803	(1,161)	6,642
Total	$58,019	$(36,867)	$21,152	$57,720	$(31,378)	$26,342

Amortization expense was $1.9 million and $1.4 million for the three months ended June 30, 2006 and 2005, respectively, and $5.5 million and $4.2 million for the nine months ended June 30, 2006 and 2005, respectively.

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2006 and the five succeeding fiscal years is as follows (in thousands):

2006 (three months)	$1,780
2007	5,870
2008	4,021
2009	2,741
2010	2,605
2011	2,268

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

	Nine months ended June 30,	
	2006	2005
Beginning balance, October 1	$ 38,675	$ 5,816
Acquisition of Rabbit		32,517
Acquisition of FS Forth		2,365
Purchase price adjustment FS Forth	(147)	
Foreign currency translation adjustment	84	(156)
Ending balance, June 30	$ 38,612	$ 40,542

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. Contingent consideration of up to $2.0 million may be payable to FS Forth based upon the achievement of certain future milestones (see Note 5).

8. INCOME TAXES

In the third quarter of fiscal 2006, the Company received tax refunds of $0.3 million related to final determination of prior year uncertainties and recorded other tax benefits primarily relating to a prior period research and development

credit totaling $0.3 million. These items aggregating $0.6 million are accounted for as a discrete event in the third quarter of fiscal 2006.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. INCOME TAXES (CONTINUED)

In the first quarter of fiscal 2005, the Internal Revenue Service (IRS) completed an audit of certain of the Company s prior fiscal years income tax returns, subject to final approval by the Congressional Joint Committee on Taxation. As a result of a settlement agreement associated with this audit, the Company paid $3.2 million to the IRS in the first quarter of fiscal 2005 resulting in a reduction to its income taxes payable liability. In February 2005, the Congressional Joint Committee on Taxation approved the settlement with the IRS. The Company had tax reserves recorded in excess of the ultimate settlement amount, which resulted in the reversal of $5.7 million of excess income tax reserves during the second quarter of fiscal 2005. This reversal was accounted for as a discrete event in the second quarter of fiscal 2005.

9. FINANCIAL GUARANTEES

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

	Three months ended June 30,			
	Balance at March 31	Warranties issued	Settlements made	Balance at June 30
2006	$1,050	$160	$(128)	$1,082
2005	$ 900	$274	$(126)	$1,048

	Nine months ended June 30,			
	Balance at October 1	Warranties issued	Settlements made	Balance at June 30
2006	$1,187	$268(1)	$(373)	$1,082
2005	$ 855	$610	$(417)	$1,048

(1) Warranties issued includes a decrease in estimate adjustment of $117,000 in the first quarter of fiscal 2006.

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

10. SHORT-TERM LOAN

On May 20, 2005, the Company entered into a short-term loan agreement with Wells Fargo in the amount of $21.0 million. This short-term loan was used to finance the Rabbit acquisition. Interest was based on the daily LIBOR rate plus 0.35%. The Company repaid $16.0 million as of June 30, 2005. The remaining $5.0 million was paid in full on July 15, 2005.

At the time the Company acquired Rabbit (see Note 5), Rabbit maintained a $5.0 million revolving line of credit with an outstanding balance of $1.3 million. In June 2005, the Company repaid all but $25,000 of this line of credit which was classified as a current short-term loan.

11. SEGMENT INFORMATION

Prior to the first quarter of fiscal 2006 the Company operated in two reportable segments. Effective October 1, 2005, the Company changed its organizational structure to functional reporting to eliminate redundancies in management and infrastructure. In addition, certain intellectual property that was previously utilized primarily in products that comprised the Device Networking Solutions segment has now been integrated throughout the Company s products in order to provide more functionality and allow for ease of migration to next generation technologies for the Company s customers. As a result of these changes in organizational structure and use of the Company s product technology, the Chief Executive Officer, as the chief operating decision maker, now reviews and assesses financial information, operating results, and performance of the Company s business in the aggregate. Accordingly, the Company has a single operating and reporting segment effective October 1, 2005 and has restated the previous periods ended June 30, 2005 to conform to the single reportable segment.

12. 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 as defendants the Company, NetSilicon, certain of its officers and certain underwriters involved in NetSilicon s IPO, among numerous others, and asserts, among other things, that NetSilicon s IPO prospectus and registration statement violated federal securities laws because they contained material misrepresentations and/or omissions regarding the conduct of NetSilicon s IPO underwriters in allocating shares in NetSilicon s IPO to the underwriters customers. The Company believes that the claims against the NetSilicon defendants are without merit and has defended the litigation vigorously. Pursuant to a stipulation between the parties, the two named officers were dismissed from the lawsuit, without prejudice, on October 9, 2002. In June 2003, the Company elected to participate in a proposed settlement agreement with the plaintiffs in this litigation. If ultimately approved by the Court, this proposed settlement would result in a dismissal, with prejudice, of all claims in the litigation against the Company and against any of the other issuer defendants who elect to participate in the proposed settlement, together with the current or former officers and directors of participating issuers who were named as individual defendants.

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

12. LEGAL PROCEEDINGS (CONTINUED)

If the proposed settlement is not consummated, the Company intends to continue to defend the litigation vigorously. The litigation process is inherently uncertain and unpredictable, however, and there can be no guarantee as to the ultimate outcome of this pending lawsuit. The Company maintains liability insurance for such matters and expects that the liability insurance will be adequate to cover any potential unfavorable outcome, less the applicable deductible amount of $250,000 per claim.

As of June 30, 2006, the Company has accrued a liability for the deductible amount of $250,000 which the Company believes reflects the amount of loss that is probable. In the event the Company has losses that exceed the limits of the liability insurance, such losses could have a material effect on the business, or consolidated results of operations or financial condition of the Company.

On April 13, 2004, the Company filed a lawsuit against Lantronix Inc. (Lantronix) alleging that certain of Lantronix s products infringe the Company s U.S. Patent No. 6,446,192. The Company filed the lawsuit in the U.S. District Court in Minnesota. The lawsuit sought both monetary and non-monetary relief. On May 3, 2004, Lantronix filed a lawsuit against the Company alleging that certain of the Company s products infringe Lantronix s U.S. Patent No. 6,571,305, in the U.S. District Court for the Central District of California. The lawsuit sought both monetary and non-monetary relief. On February 7, 2005 Lantronix and Acticon Technologies LLC filed a lawsuit against the Company alleging that certain of the Company s products infringe U.S. Patent No. 4,972,470. The lawsuit was filed in the U.S. District Court for the Eastern District of Texas. The lawsuit sought both monetary and non-monetary relief. On May 12, 2005 Lantronix filed a lawsuit against the Company alleging that certain of the Company s products infringe Lantronix s U.S. Patent No. 6,881,096. The lawsuit was filed in the U.S. District Court for the Eastern District of Texas. The lawsuit sought both monetary and non-monetary relief. On May 2, 2006, Lantronix and the Company settled all pending infringement litigations between the companies. Under and subject to the terms of the agreement, the companies have cross-licensed each others patents, and each company will have the benefit and protection afforded by all of each others current and future patents for a period of six years.

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

13. SUBSEQUENT EVENTS

On July 27, 2006, the Company acquired MaxStream, Inc., a privately held corporation for a purchase price of approximately $38.5 million in cash and stock, with $19.25 million paid in cash and 1,650,919 shares paid in the Company s stock. The transaction is being accounted for using the purchase method of accounting. Accordingly, the purchase price will be allocated to the estimated fair value of the assets acquired and the liabilities assumed. On July 26, 2006, the Company entered into a short-term loan agreement with Wells Fargo in the amount of $5.0 million to finance this acquisition. Interest is based on the daily LIBOR rate plus 0.35% (5.70% at July 31, 2006). Per the terms of the agreement, payment of the outstanding balance is due October 31, 2006; however, the Company has the option to prepay without penalty. The Company intends to repay the loan before the end of the fourth quarter of fiscal 2006.

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

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

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

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

The future operating results and performance trends of the Company may be affected by a number of factors, including, without limitation, those described under Risk Factors in the Company s Annual Report on Form 10-K for the year ended September 30, 2005. Those risk factors, and other risks, uncertainties and assumptions identified from time to time in the Company s filings with the Securities and Exchange Commission, including without limitation, its Annual Report on Form 10-K, its quarterly reports on Form 10-Q and its registration statements, could cause the Company s actual future results to differ from those projected in the forward-looking statements as a result of the factors set forth in the Company s various filings with the Securities and Exchange Commission and of changes in general economic conditions, changes in interest rates and/or exchange rates and changes in the assumptions used in making such forward-looking statements.

CRITICAL ACCOUNTING POLICIES

A description of the Company s critical accounting policies was provided in the Management s Discussion and Analysis of Financial Condition and Results of Operations section of the Company s Annual Report on Form 10-K for the year ended September 30, 2005. Effective October 1, 2005 the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment (FAS No. 123R), as amended by FSP FAS 123(R)-4, using the modified prospective method of application (see Note 4 to Condensed Consolidated Financial Statements).

OVERVIEW

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

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

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

During the third quarter of fiscal 2006, the Company made good progress with new product releases and telecommunications carrier certifications, and is continuing its growth from cellular products, ConnectPort Display, and acquired product lines. The Company has maturing products, including its network interface cards and multi-port serial adapters, which are expected to decline in future periods. Net sales of network interface cards decreased from 9.8% of total net sales for the three months ended June 30, 2005, to 1.8% of total net sales for the three months ended June 30, 2006. Net sales from network interface cards are expected to decline to approximately 1% or less of total quarterly net sales beginning with the fourth quarter of fiscal 2006. Multi-port serial adapters net sales are anticipated to continue a general trend of flattening to slow decline over future quarters.

For the three and nine months ended June 30, 2006:

Net sales of $35.9 million, for the three months ended June 30, 2006, represented an increase of $5.7 million, or 18.7%, compared to net sales of $30.2 million for the three months ended June 30, 2005. Net sales of $103.6 million, for the nine months ended June 30, 2006, represented an increase of $14.6 million, or 16.4%, compared to net sales of $89.0 million for the nine months ended June 30, 2005.

Gross profit margin decreased to 57.6% compared to 60.3% for the three months ended June 30, 2006 and 2005, respectively. Gross profit margin decreased to 57.4% compared to 61.2% for the nine months ended June 30, 2006 and 2005, respectively.

Total operating expenses for the three months ended June 30, 2006 were $16.9 million compared to $14.5 million for the three months ended June 30, 2005, an increase of $2.4 million. Total operating expenses for the nine months ended June 30, 2006 were $49.7 million compared to $42.5 million for the nine months ended June 30, 2005, an increase of $7.2 million. As a result of adopting FAS No. 123R, stock-based compensation of $0.6 million and $1.7 million was recorded in operating expenses for the three and nine months ended June 30, 2006. Because FAS No. 123R was adopted prospectively, there were no charges for stock-based compensation for the three and nine months ended June 30, 2005.

Net income increased $0.8 million to $3.3 million, or $0.14 per diluted share, for the three months ended June 30, 2006, compared to $2.5 million, or $0.11 per diluted share, for the three months ended June 30, 2005. Net income decreased $6.1 million to $8.1 million, or $0.34 per diluted share, for the nine months ended June 30, 2006, compared to $14.2 million, or $0.61 per diluted share, for the nine months ended June 30, 2005. Stock-based compensation expense reduced earnings per diluted share by $0.02 and $0.05 for the three and nine months ended June 30, 2006, respectively. As a result of a settlement with the IRS in February of 2005, the Company recorded a reversal of $5.7 million of excess income tax reserves during the second quarter of fiscal 2005. This reversal was accounted for as a discrete event and resulted

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

OVERVIEW (CONTINUED)

in an income tax benefit of $5.7 million and an increase in diluted earnings per share of $0.24 for the nine months ended June 30, 2005.

The Company s net working capital position (total current assets less total current liabilities) increased $17.3 million to $87.3 million during the nine months ended June 30, 2006 and its current ratio was 4.9 to 1 as of that date. Cash and cash equivalents and marketable securities increased $15.7 million to $65.9 million during the period. At June 30, 2006, the Company had no debt other than capital lease obligations.

FS Forth and Rabbit were acquired on April 1, 2005 and May 26, 2005, respectively for a combined purchase price of $53.7 million (before cash acquired of $0.4 million). For further information on these acquisitions, see Note 5, Acquisitions in the accompanying notes to the consolidated financial statements.

CONSOLIDATED RESULTS OF OPERATIONS

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

	Three months ended June 30,				Nine months ended June 30,			
	2006 (1)		2005		2006 (1)		2005	
Net sales	$ 35,860	100.0%	$ 30,208	100.0%	$ 103,616	100.0%	$ 88,989	100.0%
Cost of sales	15,222	42.4	12,003	39.7	44,126	42.6	34,489	38.8
Gross profit	20,638	57.6	18,205	60.3	59,490	57.4	54,500	61.2
Operating expenses:								
Sales and marketing	7,277	20.3	6,446	21.3	20,830	20.1	19,300	21.6
Research and development	5,402	15.1	3,778	12.5	15,227	14.7	11,850	13.3
General and administrative	4,208	11.7	3,998	13.3	13,591	13.1	11,070	12.5
Acquired in-process research and development		0.0	300	1.0		0.0	300	0.3
Total operating expenses	16,887	47.1	14,522	48.1	49,648	47.9	42,520	47.7
Operating income	3,751	10.5	3,683	12.2	9,842	9.5	11,980	13.5
Interest income and other, net	575	1.6	306	1.0	1,461	1.4	809	0.9
Income before income taxes	4,326	12.1	3,989	13.2	11,303	10.9	12,789	14.4
Income tax provision (benefit)	978	2.8	1,505	5.0	3,205	3.1	(1,455)	(1.6)
Net income	$ 3,348	9.3%	$ 2,484	8.2%	$ 8,098	7.8%	$ 14,244	16.0%

(1)

As a result of adopting FAS No. 123R as of October 1, 2005 on a modified prospective basis, stock-based compensation expense (pre-tax) is included in the consolidated results of operations for the three and nine months ended June 30, 2006 as follows (in thousands):

	Three months ended June 30, 2006	Nine months ended June 30, 2006
Cost of sales	$ 22	$ 65
Sales and marketing	185	504
Research and development	132	401
General and administrative	240	772
Totals	$ 579	$ 1,742

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

NET SALES

Net sales for the three and nine months ended June 30, 2006 were $35.9 million and $103.6 million compared to net sales of $30.2 million and $89.0 million for the three and nine months ended June 30, 2005, or an increase of 18.7% and 16.4%, respectively.

Net sales of the Company s device server, core modules and single board computers, terminal server, USB, chips and software, and cellular product lines increased $8.8 million and $27.5 million, or 45.1% and 52.4%, in the three and nine months ended June 30, 2006 compared to the three and nine months ended June 30, 2005. Net sales attributable to the asynchronous, synchronous, remote access server (RAS), and integrated services digital network (ISDN) products decreased $3.1 million and $12.9 million, or 28.6% and 35.2% for the three and nine months ended June 30, 2006, compared to the same periods one year ago. Network interface cards made up 1.8% and 3.1% of total net sales for the three and nine months ended June 30, 2006 compared to 9.8% and 13.0% for the three and nine months ended June 30, 2005. Net sales from network interface cards are expected to decline to approximately 1% or less of total quarterly net sales beginning with the fourth quarter of fiscal 2006. Multi-port serial adapters net sales are anticipated to continue a general trend of flattening to slow decline over future quarters.

Fluctuation in foreign currency rates, included in the product line net sales above, compared to the same periods one year ago had a favorable impact on net sales of $0.1 million in the three month period ended June 30, 2006 and an unfavorable impact on net sales of $0.9 million in the nine month period ended June 30, 2006.

GROSS PROFIT

Gross profit margin for the three and nine months ended June 30, 2006 was 57.6% and 57.4% compared to 60.3% and 61.2% for the three and nine months ended June 30, 2005. The decrease in gross profit margin was due primarily to fluctuations in customer and product mix of 1.1% and 1.7%, the impact of Rabbit product sales which carry a lower gross profit margin of 1.1% and 1.7%, and higher manufacturing expenses of 0.5% and 0.4%.

We expect that our gross profit margin will be approximately 55% to 60% over the next several years. Since we have certain mature products with higher gross margins that are declining in sales volume, and new products, such as our embedded modules that currently carry lower gross profit margins and are increasing in sales volume, we anticipate that our gross profit margin will be slightly less than our historical gross profit margin as a result of the product mix change and the position within their respective product life cycles.

OPERATING EXPENSES

Sales and marketing expenses for the three months ended June 30, 2006 were $7.3 million, or 20.3% of net sales, compared to $6.4 million, or 21.3% of net sales, for the three months ended June 30, 2005. The net increase of sales and marketing expense for the three months ended June 30, 2006 compared to 2005 is primarily due to $0.5 million in increased ongoing expenses as a result of the Rabbit acquisition in the third quarter of 2005 and $0.2 million in stock-based compensation expense. Sales and marketing expenses for the nine months ended June 30, 2006 were $20.9 million, or 20.1% of net sales, compared to $19.3 million, or 21.6% of net sales, for the nine months ended June 30, 2005. The net increase in sales and marketing expenses for the nine months ended June 30, 2006 compared to 2005 is primarily due to an increase of

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

OPERATING EXPENSES (CONTINUED)

$2.4 million in ongoing expenses as a result of the acquisitions of Rabbit and FS Forth in the third quarter of fiscal 2005 and stock-based compensation expense of $0.5 million in fiscal 2006, partially offset by a decrease of $1.2 million in sales and marketing compensation related expenses.

Research and development expenses for the three months ended June 30, 2006 were $5.4 million, or 15.1% of net sales, compared to $3.8 million, or 12.5% of net sales, for the three months ended June 30, 2005. The net increase in research and development expenses for the three months ended June 30, 2006 over 2005 is primarily due to $0.8 million of increased ongoing expenses related to the Rabbit acquisition, $0.1 million in stock-based compensation in the third quarter of 2006, and a net increase of $0.5 million in variable compensation related expenses. Research and development expenses for the nine months ended June 30, 2006 were $15.2 million, or 14.7% of net sales, compared to $11.9 million, or 13.3% of net sales, for the nine months ended June 30, 2005. The net increase in research and development expenses is primarily due to $3.7 million of increased ongoing expenses as a result of the acquisitions made by the Company in the third quarter of fiscal 2005 and $0.4 million of stock-based compensation expense in fiscal 2006. The Company realized savings of $1.0 million in research and development expenses compared to the same quarter of the prior year primarily related to the network interface card products and certain chip development projects.

General and administrative expenses were $4.2 million, or 11.7% of net sales, for the three months ended June 30, 2006 compared to $4.0 million, or 13.3% of net sales, for the three months ended June 30, 2005. The net increase in general and administrative expense for the three months ended June 30, 2006 compared to 2005 is primarily due to $0.4 million related to the additional ongoing expenses of the Rabbit acquisition in 2005, $0.2 million in stock-based compensation expense in 2006 offset by a $0.3 million reduction in professional fees. General and administrative expenses were $13.6 million, or 13.1% of net sales, for the nine months ended June 30, 2006 compared to $11.1 million, or 12.5% of net sales, for the nine months ended June 30, 2005. The net increase in general and administrative expenses was due primarily to $0.8 million in increased ongoing expenses as a result of the Rabbit and FS Forth acquisitions in 2005, $0.8 million of stock-based compensation in fiscal 2006 and a $0.7 million increase in professional fees. Intangibles amortization associated with acquisitions resulted in a net increase of $1.1 million. This was offset by decreases of $0.4 million of compensation related expenses and $0.5 million of various other general and administrative expenses.

INTEREST INCOME AND OTHER, NET

Interest income and other, net was $0.6 million for the three months ended June 30, 2006 compared to $0.3 million for the three months ended June 30, 2005. The Company realized interest income on marketable securities and cash equivalents of $0.7 million and $0.5 million for the three months ended June 30, 2006, and 2005, respectively. This increase in interest income is primarily due to the increase in the average interest rates of 4.6% for the three months ended June 30, 2006 from 2.7% for the three months ended June 30, 2005. The average invested balance for the three months ended June 30, 2006 and 2005 was $61.3 million and $60.8 million, respectively.

Interest income and other, net was $1.5 million for the nine months ended June 30, 2006 compared to $0.8 million for the nine months ended June 30, 2005. The Company realized interest income at higher average interest rates of 4.1% for the nine months ended June 30, 2006 from 2.3% for the nine months ended June 30, 2005. In the fiscal 2006 period, the average cash and marketable securities balances decreased to

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

INTEREST INCOME AND OTHER, NET (CONTINUED)

$53.3 million compared to the fiscal 2005 period which was $72.7 million. Other expense remained relatively flat between periods.

INCOME TAXES

Income taxes have been provided for at an effective rate of 22.6% and 28.4% for the three and nine month periods ended June 30, 2006, respectively, compared to an effective rate of 37.7% and (11.4%) for the three and nine month periods ended June 30, 2005, respectively. In the third quarter of fiscal 2006, the Company received tax refunds of $0.3 million related to final determination of prior year uncertainties and recorded other tax benefits primarily relating to a prior period research and development credit totaling $0.3 million. These items aggregating $0.6 million are accounted for as a discrete event in the third quarter of fiscal 2006.

In February 2005, the Congressional Joint Committee on Taxation approved a settlement with the Internal Revenue Service on an audit of certain of the Company s prior fiscal years income tax returns. The Company had established tax reserves in excess of the ultimate settled amounts. As a result, the Company reversed $5.7 million of excess income tax reserves during the second quarter of fiscal 2005. This reversal was accounted for as a discrete event and resulted in an income tax benefit during the second fiscal quarter of 2005 of $5.7 million.

The effective tax rate of 33.1%, excluding the $5.7 million discrete event, is not a measure of financial performance under generally accepted accounting principles (GAAP). Management believes that excluding this one-time non-recurring item provides useful information to investors regarding the Company s effective tax rate in comparison to the U.S. statutory rate. The reconciliation of this measure to the most directly comparable GAAP financial measure follows (in thousands except per common share amounts):

		Nine months ended June 30, 2005
Income tax benefit as reported	$	(1,455)
Impact of favorable tax settlement	$	5,689
Income tax provision excluding favorable tax settlement	$	4,234
Net income as reported	$	14,244
Net income excluding favorable tax settlement	$	8,555
Effective income tax rate on pretax income as reported		-11.4%
Effective income tax rate on pretax income excluding favorable tax settlement		33.1%
Net income per common share, basic, as reported	$	0.64
Net income per common share, diluted, as reported	$	0.61
Net income per common share, basic, excluding favorable tax settlement	$	0.38
Net income per common share, diluted, excluding favorable tax settlement	$	0.37

The effective tax rates for both the first nine months of fiscal 2006 and 2005, adjusted for the $5.7 million discrete event, are lower than the U.S. statutory rate of 35.0% primarily due to the utilization of income tax credits and exclusion of extraterritorial income. The effective tax rate for the first nine months of fiscal 2006 is lower than the effective tax rate for the first nine months of fiscal 2005, adjusted for the discrete event, due to tax refunds related to final determination of prior year uncertainties and other tax benefits totaling $0.6 million which were accounted for as a discrete event in the third quarter of fiscal 2006.

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

LIQUIDITY AND CAPITAL RESOURCES

The Company has financed its operations principally with funds generated from operations. At June 30, 2006, the Company had cash, cash equivalents and marketable securities totaling $65.9 million compared to $50.2 million at September 30, 2005. The Company s working capital increased $17.3 million to $87.3 million at June 30, 2006 compared to $70.0 million at September 30, 2005.

Net cash provided by operating activities was $13.8 million for the nine months ended June 30, 2006 compared to $11.2 million for the nine months ended June 30, 2005. The increase in net cash provided by operating activities of $2.6 million between comparable nine month periods ended June 30, 2006 and 2005 is primarily the result of a payment of $3.2 million to the IRS in November of 2004 as part of the settlement agreement related to the review of prior fiscal years.

Net cash used in investing activities was $15.3 million during the nine months ended June 30, 2006 compared to net cash used by investing activities of $34.6 million during the same period in the prior fiscal year. Net purchases of marketable securities were $14.3 million during the nine months ended June 30, 2006 compared to net settlements of marketable securities of $19.8 million during the same period one year ago. Purchases of property, equipment, improvements and certain other intangible assets were $1.0 million and $0.8 million for the nine months ended June 30, 2006 and 2005, respectively. During the nine months ended June 30, 2005, the Company paid $48.9 million for the acquisition of Rabbit and $4.8 million for the acquisition of FS Forth.

The Company anticipates total fiscal 2006 capital expenditures to approximate $1.9 million.

The Company generated $3.6 million from financing activities during the nine months ended June 30, 2006 compared to $9.7 million during the same period a year ago. The source of cash is primarily the result of proceeds from stock option and employee stock purchase plan transactions in both periods, and the reflection of cash provided by the adjustment for tax benefits related to the exercise of stock options as a financing activity in fiscal 2006. In addition, there were capital lease payments during 2006 of $0.4 million and an insignificant amount of payments in 2005. During the third quarter of fiscal 2005, the Company entered into a $21.0 million short-term loan of which $16.0 million was repaid during the same quarter resulting in net borrowings of $5.0 million in the nine months ended June 20, 2005 (see Note 10 to the Company s Condensed Consolidated Financial Statements). The Company determined that it was more economical to borrow funds to finance the Rabbit acquisition than to liquidate marketable securities prior to their scheduled maturities. The Company acquired $1.3 million of revolving line of credit debt as part of the Rabbit acquisition of which $25,000 was outstanding at June 30, 2005 (see Note 10 to the Company s Condensed Consolidated Financial Statements).

On July 26, 2006, the Company entered into a short-term loan agreement in the amount of $5.0 million to finance the July 27, 2006 acquisition of MaxStream, Inc. For further information see Note 13, Subsequent Events in the accompanying notes to the consolidated financial statements.

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

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

LIQUIDITY AND CAPITAL RESOURCES (CONTINUED)

As of June 30, 2006, the Company had contingent purchase price obligations outstanding of $2.0 million related to the acquisition of FS Forth (see Note 5 to the Company s Condensed Consolidated Financial Statements).

The following summarizes the Company s contractual obligations at June 30, 2006 (in thousands):

	Payments due by fiscal period				
	Total	Less than 1 year	1-3 years	3-5 years	Thereafter
Operating leases	$6,505	$2,151	$2,178	$1,085	$1,091
Capital leases	1,494	526	808	160	
Total contractual cash obligations	$7,999	$2,677	$2,986	$1,245	$1,091

The lease obligations summarized above relate to various operating lease agreements for office space and equipment. The capital leases summarized above are for manufacturing equipment at Rabbit. The table above excludes up to $2.0 million of additional contingent purchase price payments related to the FS Forth acquisition (see Note 5 to the Company s Condensed Consolidated Financial Statements).

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In July, 2006 the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning October 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its financial statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK (CONTINUED)

FOREIGN CURRENCY RISK

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

For the nine months ended June 30, 2006 and 2005, the Company had approximately $41.0 million and $38.9 million, respectively, of net sales to foreign customers including export sales, of which $16.6 million and $13.3 million, respectively, were denominated in foreign currency, predominantly Euros. In future periods, a significant portion of sales will continue to be made in Euros.

During the nine months ended June 30, 2006, the average monthly exchange rate for the Euro to the U.S. Dollar decreased approximately 0.7% from 1.2896 to 1.2809 and the average monthly exchange rate for the Japanese Yen to the U.S. Dollar decreased approximately 1.8% from .0094 to .0092 for the comparable nine month period ended June 30, 2005. A 10.0% change from the first nine months of fiscal 2006 average exchange rate for the Euro and Yen to the U.S. Dollar would have resulted in a 1.6% increase or decrease in net sales and a 1.1% increase or decrease in stockholders equity. The above analysis does not take into consideration any pricing adjustments the Company may need to consider in response to changes in the exchange rate.

CREDIT RISK

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

ITEM 4. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

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

CHANGES IN INTERNAL CONTROLS

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

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The disclosure set forth in Note 12 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Form 10-Q is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Multiple risk factors exist which could have a material effect on the Company s operations, results of operations, profitability, financial position, liquidity and capital resources. These risk factors are more fully presented in the Company s 2005 Annual Report on Form 10-K as filed with the SEC.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

None

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit No.	Description
2(a)	Purchase and Assignment Contract dated March 30, 2005 between Embedded Solutions AG, Klaus Flesch, Angelika Flesch and Digi International GmbH (1)
2(b)	Agreement and Plan of Merger among Digi International Inc., Karat Sub Inc. and Z-World, Inc. dated as of May 26, 2005 (excluding schedules and exhibits, which the Company agrees to furnish supplementally to the Securities and Exchange Commission upon request) (2)
2(c)	Agreement and Plan of Merger among Digi International Inc., Ocean Acquisition Sub Inc. and MaxStream, Inc. dated as of July 27, 2006 (excluding schedules and exhibits, which the Company agrees to furnish supplementally to the Securities and Exchange Commission upon request) (3)
3(a)	Restated Certificate of Incorporation of the Company, as amended (4)
3(b)	Amended and Restated By-Laws of the Company, as amended (5)

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

Exhibit No.	Description
4(a)	Form of Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (6)
4(b)	Amendment dated January 26, 1999, to Share Rights Agreement, dated as of June 10, 1998 between Digi International Inc. and Wells Fargo Bank Minnesota, National Association (formerly known as Norwest Bank Minnesota, National Association), as Rights Agent (7)
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32	Section 1350 Certification

(1) Incorporated by reference to Exhibit 2(a) to the Company s Form 10-Q for the quarter ended March 31, 2005 (File No. 0-17972)

(2) Incorporated by reference to Exhibit 2 to the Company s Form 8-K dated May 26, 2006 (File No. 0-17972)

(3) Incorporated by reference to Exhibit 2 to the Company s Form 8-K dated July 27, 2006 (File No. 0-17972)

(4)

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)

(5) Incorporated by reference to Exhibit 3(b) to the Company s Form 10-K for the year ended September 30, 2001 (File No. 0-17972)

(6) Incorporated by reference to Exhibit 1 to the Company s Registration Statement on Form 8-A dated June 24, 1998 (File No. 0-17972)

(7) 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, 2006

By: /s/ Subramanian Krishnan

Subramanian Krishnan
Chief Financial Officer
(duly authorized officer and
Principal Financial Officer)

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EXHIBIT INDEX

Exhibit Number	Document Description	Form of Filing
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2(b)	Agreement and Plan of Merger among Digi International Inc., Karat Sub Inc. and Z-World, Inc. dated as of May 26, 2005 (excluding schedules and exhibits, which the Company agrees to furnish supplementally to the Securities and Exchange Commission upon request) (incorporated by reference to Exhibit 2 to the Company s Form 8-K dated May 26, 2005 (File No. 0-17972))	Incorporated by Reference
2(c)	Agreement and Plan of Merger among Digi International Inc., Ocean Acquisition Sub Inc. and MaxStream, Inc. dated as of July 27, 2006 (excluding schedules and exhibits, which the Company agrees to furnish supplementally to the Securities and Exchange Commission upon request) (incorporated by reference to Exhibit 2 to the Company s Form 8-K dated July 27, 2006 (File No. 0-17972))	Incorporated by Reference
3(a)	Restated Certificate of Incorporation of the Company, as Amended (incorporated by reference to the corresponding exhibit number to the Company s Form 10-K for the year ended September 30, 1993 (File No. 0-17972))	Incorporated by Reference
3(b)	Amended and Restated By-Laws of the Company (incorporated by reference to the corresponding exhibit number to the Company s Form 10-K for the year ended September 30, 2001 (File No. 0-17972))	Incorporated by Reference

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EXHIBIT INDEX (CONTINUED)

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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